IFRS

STAFF PAPER

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IASB® meeting

Project	Goodwill and Impairment		
Paper topic	Effectiveness of impairment test—Background and feasibility of designing a different impairment test		
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Purpose and structure of this paper

1. The purpose of this paper is to assist the International Accounting Standards Board (Board) make a decision about reintroducing amortisation of goodwill and whether that decision is conditional on the feasibility of improving the effectiveness of the impairment test of cash-generating units (CGUs) containing goodwill (impairment test) by designing a different impairment test.

2. This paper provides the Board with staff analysis on feedback about improving the effectiveness of the impairment test. The staff's analysis has been split into two agenda papers. This paper addresses feedback on whether there is a problem with the timeliness of recognition of impairment losses and with suggestions on designing a different impairment test to the one in IAS 36 *Impairment of Assets*. Agenda Paper 18C to this meeting addresses suggestions for improvements to the application of the existing impairment test.

3. Many respondents also commented on whether reintroducing amortisation of goodwill could resolve concerns on the effectiveness of the impairment test. Agenda Paper 18D to this meeting discusses this feedback. If the Board decides to reintroduce amortisation of goodwill, the staff will bring further analysis on whether the Board should continue with efforts to improve the effectiveness of the impairment test.

4. The paper is structured as follows:

   (a) Background (paragraphs 5–11); and

(b) Staff analysis of feedback on the effectiveness of the impairment test (paragraphs 12–49), including:

(i) the timeliness of impairment loss recognition (paragraphs 12–21); and

(ii) feasibility of designing a different impairment test (paragraphs 22–49).

Background

5. During the Post-implementation Review (PIR) of IFRS 3 *Business Combinations*, many stakeholders expressed concerns about the effectiveness of the impairment test. They said impairment losses on goodwill are often recognised too late, long after the events that caused those losses. Stakeholders urged the Board to make the test more effective at recognising impairment losses on goodwill on a timelier basis.

6. As discussed in the Discussion Paper *Business Combinations—Disclosures, Goodwill and Impairment* (Discussion Paper), the Board identified two broad reasons for concerns about the possible delays in recognising impairment losses on goodwill:

(a) management over-optimism—some stakeholders said management may sometimes be too optimistic in making assumptions for the cash flow forecasts needed to carry out the impairment test.

(b) shielding—goodwill does not generate cash flows independently and therefore cannot be measured directly. The impairment test therefore focuses on testing a CGU, or a group of CGUs, containing goodwill[1]. These typically contain headroom[2]. This headroom shields acquired goodwill against the recognition of impairment losses.

7. The Board considered the risk of over-optimism to be unavoidable, given the nature of the estimates required. IAS 36 contains requirements that reduce the risk that cash

[1] For ease of reference, the paper sometimes refers to the impairment test as applying to a CGU but the discussion applies equally to impairment test performed at the level of a group of CGUs.

[2] Headroom in a CGU comprises unrecognised assets and liabilities within a CGU, such as internally generated goodwill, and unrecognised differences between the carrying amount of recognised assets and liabilities and their recoverable amounts.

flow forecasts could be too optimistic. If estimates of cash flows are sometimes too optimistic, the Board considered that this is best addressed by auditors and regulators, not by changing IFRS Standards.

8. To address shielding, the Board considered whether it could design a different impairment test. In particular, the Board considered an impairment test of CGUs containing goodwill in which at least a portion of any reduction in the recoverable amount of a CGU would be attributed to the acquired goodwill (headroom approach).

9. Applying the headroom approach—discussed in Agenda Paper 18B to the Board's May 2021 meeting—an entity would compare:

   (a) the recoverable amount of the CGU; with

   (b) the sum of:

      (i) the carrying amount of the recognised assets and liabilities of the CGU; and

      (ii) the headroom of the CGU at the previous impairment testing date.

10. The Board concluded that the headroom approach:

   (a) would reduce shielding but not eliminate it;

   (b) could result in recognising impairments that are, in some circumstances, difficult to understand; and

   (c) would add cost.

11. Therefore, the Board's preliminary view was that it is not feasible to design a different impairment test that is significantly more effective than the existing impairment test at recognising impairment losses on goodwill on a timely basis at a reasonable cost.

Staff analysis of feedback on the effectiveness of the impairment test

Timeliness of impairment loss recognition

Summary of feedback

12. Overall, most respondents agreed with the reasons for concerns about the timeliness of impairment losses identified by the Board (see paragraph 6).

13. However, some respondents, many of whom were preparers, were unconvinced there was a significant problem. In their view:

    (a) optimism is natural and oversight from auditors ensures proper application of the impairment test;

    (b) IAS 36 has appropriate safeguards against optimism; and

    (c) shielding is inevitable and is inappropriate only when goodwill is not properly allocated to CGUs.

14. In addition, a few respondents highlighted possible reasons why, in their view, the test might be wrongly considered not robust enough:

    (a) one accounting firm said there might not be a shared understanding of the objective of the impairment test. The respondent said users of financial statements (users) tend to see the test as a source of information about the acquired business rather than a test that assesses whether the carrying amount of a CGU does not exceed its recoverable amount.

    (b) one national standard-setter said the test has limitations, but meets its objective of ensuring that the combined assets of the CGU, including goodwill, are carried at no more than their combined recoverable amounts.

    (c) one academic respondent said, in its view, there is no conclusive academic evidence suggesting that the impairment test is not effective because some evidence suggests the market reacts significantly to the recognition of impairment losses.

    (d) one consultant said a premise that impairment losses can be recognised without any delay, as circumstances unfold, is unrealistic—an impairment loss is usually the result of a combination of factors that cumulatively lead to a negative outlook for a business, resulting in the loss of value for particular assets.

(e) one user representative group said, in their view, the test itself is not the problem but the application and lack of transparency on the methods and assumptions used are. They said the disclosures the Board is proposing should help reduce the problem (see Agenda Paper 18C to the Board's April meeting).

Staff analysis

15. As indicated in paragraph 12, most respondents generally agreed with the reasons identified by the Board as to why there are concerns about the effectiveness of the impairment test. This implies that those respondents agreed that impairment losses on goodwill are sometimes recognised too late, long after the events that caused those losses.

16. Many respondents that disagreed with the Board's preliminary view to retain the impairment-only model said the impairment test was not working and that the Board had not been able to make the test more effective. This provides further evidence of impairment losses on goodwill being sometimes recognised too late.

17. The staff acknowledge the mixed academic evidence on the usefulness of information provided by the impairment test. As noted in Agenda Paper 18F to the Board's May 2021 meeting, academic evidence shows that entities experience negative share price returns up to 12 quarters before the impairment loss announcement which could imply that impairment losses may not be timely. However, announcements of impairment losses on goodwill are associated with negative stock market reaction, indicating that such announcements help resolve uncertainty and thus provides new and useful information to users[3].

18. Despite this mixed academic evidence, there is still a concern amongst stakeholders that the impairment test is ineffective. Therefore, the staff think the Board should consider whether and, if so, how to respond to this concern.

[3] Li, K. K. and Sloan, R. G. (2017), 'Has Goodwill Accounting Gone Bad?', *Review of Accounting Studies*, 22 (2), 964-1003.

19. Some of the ideas suggested by respondents might help respond to this concern. For example, the staff think the Board could consider clarifying the purpose of the impairment test—that is to ensure that the carrying value of the assets in a CGU as a whole is recoverable. This would help avoid misunderstandings and unrealistic expectations of what the impairment test can, and is designed to achieve.

20. The staff agree with the respondent in paragraph 14(e) that the Board's preliminary views to improve the disclosures about business combinations (for example, information about their subsequent performance) can help resolve some aspects of the concerns about the effectiveness of the impairment test by providing information about the performance of a business combination even when an impairment loss has not been recognised. The staff also agree with respondents who said the disclosures on subsequent performance of business combinations could be used as an indicator that goodwill may be impaired. These disclosures might therefore help mitigate against over-optimistic forecasts.

21. The Board could stop there in its response to the concerns about the effectiveness of the impairment test (that is by clarifying the purpose of the impairment test and introducing disclosures about the subsequent performance of a business combination). However. the next section discusses respondents' suggestions on designing a different impairment test. Agenda Paper 18C discusses respondents' suggestions for improvements to the application of the impairment test in IAS 36.

Designing a different impairment test

Summary of feedback

22. Most respondents agreed it is not feasible to design a different impairment test that is significantly more effective than the existing impairment test at a reasonable cost. Those respondents agreed that the headroom approach would increase cost for preparers while only reducing, rather than eliminating, shielding.

23. However, some respondents disagreed and said that there are ways to improve the impairment test, including:

    (a) a fundamental review of IAS 36 (paragraph 24);

(b) pursuing some form of headroom approach (paragraphs 25–27); and

(c) other methods to ensure CGUs are carried at no more that their recoverable amounts (paragraphs 28).

24. Although acknowledging it would be outside the scope of this project, a few respondents, mainly accounting firms and accounting bodies, said that a significantly more effective impairment test could be designed only if the Board undertook a fundamental review of IAS 36, including the concept of CGUs.

25. Some respondents said the Board should explore anything that might reduce the effect of shielding and suggested reconsidering the headroom approach (see paragraph 9) or a variant of that approach that the Board discussed during the development of the Discussion Paper—the pre-acquisition headroom approach.

26. Unlike the headroom approach, the pre-acquisition headroom approach would be easier and less costly to apply because it would require an entity to calculate the headroom only at the date of acquisition. Specifically, under the pre-acquisition headroom approach an entity would compare:

(a) the recoverable amount of the CGUs; with

(b) the sum of:

(i) the carrying amount of the recognised assets and liabilities of the CGUs; and

(ii) the headroom of the CGUs at the date of acquisition.

27. A few respondents suggested alternative methods to test CGUs containing goodwill for impairment that are similar to the pre-acquisition headroom approach. Paragraphs 32–37 analyse these approaches further.

28. A few respondents suggested alternative impairment tests and other approaches to ensure CGUs are carried at no more than their recoverable amounts, including reconsidering the accounting for internally generated goodwill and other intangible assets which a few respondents said would largely reduce shielding and result in a more effective impairment test. Paragraphs 38–49 analyse these approaches.

Staff analysis

29. This section includes staff analysis on whether the Board should reconsider designing a different impairment test based on respondents' suggestions:

(a) headroom approach (paragraphs 30–31);

(b) pre-acquisition headroom and similar approaches (paragraphs 32–37);

(c) implied goodwill approach (paragraphs 38–40);

(d) direct value approach (paragraphs 41–43); and

(e) other approaches (paragraphs 44–49).

Headroom approach

30. The Board decided not to pursue the headroom approach for the reasons set out in paragraph 10 of this paper and most respondents agreed with the Board's rationale. In the staff's view, respondents suggesting that the Board reconsider the headroom approach did not provide compelling new evidence to revisit the Board's preliminary view.

31. One respondent suggested isolating any headroom associated with the excess of the fair values of the recognised assets and liabilities (excluding acquired goodwill) over their carrying values from other headroom and said this could improve the allocation of any 'impairment' calculated by the headroom approach to acquired goodwill. However, the staff think the allocation of any impairment loss to acquired goodwill would still be subjective and imperfect because goodwill is not directly measurable.

Pre-acquisition headroom and similar approaches

32. The Board considered the pre-acquisition headroom approach when developing its preliminary views. The staff sees some merits in the arguments put forward by respondents who suggested exploring the pre-acquisition headroom approach, or similar approaches. In particular:

(a) the staff agree that such an approach would be less costly than the headroom approach because it would require the headroom to be calculated only at the acquisition date and not subsequently.

(b) an academic study[4] (see Agenda Paper 18F to the Board's May 2021 meeting), compared the association of share prices with goodwill accounted for applying amortisation and impairment approaches with different useful lives, an impairment-only model and a pre-acquisition headroom approach. The study found that the pre-acquisition headroom approach was most strongly associated with share prices and the researcher concluded that this approach was most aligned with an estimate of the economic decline of goodwill.

33. The Board decided to explore the headroom approach rather than a pre-acquisition headroom approach principally because unlike the headroom approach, the pre-acquisition headroom approach uses a static measure of the headroom and would ignore any increase in shielding generated post-acquisition. Hence, although less costly, the pre-acquisition headroom approach would be less effective at reducing the shielding effect. In addition, similar to the headroom approach, the pre-acquisition headroom approach would require determining how much of any impairment loss that results from the test should be allocated to the acquired goodwill and any such allocation would by nature be imperfect.

34. The International Valuation Standards Council (IVSC) step-up approach is similar to the pre-acquisition headroom approach but requires allocating any impairment loss first to the acquired goodwill. This would be subject to the same concerns discussed in paragraph 33. In addition, as discussed in the Discussion Paper, for those who view acquired and internally generated goodwill to be distinct, allocating all the impairment loss to acquired goodwill may sometimes produce a result that is inconsistent with the performance of the acquisition.

35. A notional goodwill approach similar to that in FRS 11 *Impairment of Fixed Assets and Goodwill* in UK generally accepted accounting principles (GAAP) was briefly considered by the Board during the course of the project but rejected in favour of the pre-acquisition headroom approach. This approach would require an entity to calculate a notional goodwill at the date of acquisition and include it in the carrying amount of the CGU for the purpose of the impairment test. The notional goodwill is

[4] Wheeler, E. M. (2020), *Subsequent Accounting for Goodwill* (The University of Wisconsin-Madison).

calculated by deducting the fair values of the net assets and purchased goodwill within the existing CGU from its estimated value in use (VIU) before combining the businesses.

36. The headroom in the pre-acquisition headroom approach comprises internally generated goodwill, unrecognised assets and the unrecognised differences between the carrying amount of recognised assets and liabilities and their recoverable amounts. In the notional goodwill approach only the first two of these three elements are included in the notional goodwill amount that is incorporated into the impairment test since the calculation is based on the fair values of the net assets of the existing business. Although a different calculation, the drawbacks discussed in paragraph 33 of this paper would apply to this approach as well.

37. The feedback on the headroom approach indicates that these approaches are unlikely to garner significant stakeholder support.

Implied goodwill approach

38. At a conceptual level, an implied goodwill approach tries to overcome the issue that goodwill cannot be measured directly by calculating an implied goodwill. This implied goodwill is calculated, for example, as the difference between the fair value of an entity's investment in a subsidiary with the fair value of that subsidiary's net assets. The implied goodwill is then compared with the carrying amount of goodwill to determine any potential impairment. One respondent suggested requiring entities to apply a simplified version of this approach used in German GAAP (GAS 23 *Accounting for Subsidiaries in Consolidated Financial Statements*). In this simplified approach impairment losses are calculated by comparing the fair value of the investment in the subsidiary with the sum of:

   (a) the total of the carrying amount of the net assets of the subsidiary; and

   (b) the carrying amount of goodwill.

39. Regardless of whether this comparison produces a positive or negative difference, entities are additionally encouraged to examine whether any material unrecognised reserves and liabilities that require a change in the amount of impairment have arisen since the date of initial consolidation. However, the staff are not aware of how this assessment operates in practice.

40. Such an approach would still be subject to drawbacks like the other approaches considered by the Board—for example, internally generated goodwill and unrecognised assets generated in the subsidiary since the acquisition could still shield the acquired goodwill from impairment. The approach would also add cost, for example the approach would require an entity to track the assets and liabilities of an acquired business on a standalone basis but often acquired businesses are integrated into an existing business after acquisition.. Finally, since the recoverable amount of CGUs containing goodwill is calculated using the fair value of the investment in the subsidiary, the implied goodwill approach would fundamentally change the unit of account in IAS 36.

Direct value approach

41. The IVSC's article *Opportunities for Enhancing the Goodwill Impairment Framework* suggested a direct value approach. Applying this approach, an entity would compare the recoverable amount of a CGU containing goodwill at the date of the impairment test with the recoverable amount of that CGU at the time of the acquisition. If the recoverable amount of the CGU has declined below its recoverable amount at the time of the acquisition, the entity would recognise the amount of the reduction in recoverable amount as an impairment loss of goodwill. The amount of any impairment loss would not be affected by the carrying amount of the CGU.

42. The article says this approach is less costly than the headroom approach because there is no need to determine the carrying amount of the CGUs containing goodwill at each testing date (for example, entities would not need to make judgements about allocating corporate assets to CGUs). Such an approach would prevent the pre-acquisition headroom from shielding acquired goodwill.

43. However, applying such an approach:

    (a) would not reduce the shielding effect of any headroom generated post-acquisition.

    (b) could give rise to counterintuitive results. For example, if the reduction in the recoverable amount of the CGU is due to the realisation (into cash) of the benefits of the assets in the CGU and this has already been reflected in a reduction of the carrying amounts of the CGU's assets, it would be counterintuitive for such a reduction to also trigger an impairment loss.

(c) would result in a fundamental change by delinking the impairment test from the carrying amounts of the CGU.

(d) it would not be possible to determine whether any reduction in the recoverable amount of a CGU is due to the acquired business and therefore to determine whether allocating the impairment loss to the acquired goodwill is appropriate.

Other approaches

44. Other approaches the Board could consider are:

(a) subsequent cash flow test (paragraphs 45–47);

(b) reconsider the accounting for internally generated goodwill and other intangible assets (paragraph 48); and

(c) fundamental review of IAS 36 (paragraph 49).

45. One accounting body suggested an approach similar to an approach in FRS 11 in UK GAAP in which an entity would perform a subsequent cash flow test to confirm the cash flow projections previously used to measure a CGU's value in use. If the actual cash flows are lower than projected and use of the actual cash flows in measuring the VIU would have resulted in recognising an impairment loss, the original impairment calculations would be reperformed using the actual cash flows.

46. Paragraphs BC195–BC198 of the Basis for Conclusions on IAS 36 explain that the Board decided not to include a subsequent cash flow test in the Exposure Draft of Proposed Amendments to IAS 36 in 2002 because:

(a) the test would ignore other elements in the measurement of VIU and as a result would not produce representationally faithful results in a present value measurement system;

(b) any amount recognised as an impairment loss would be hypothetical and would not provide decision-useful information; and

(c) the test would be burdensome to apply because it would require maintaining different sets of computations for each CGU to which goodwill has been allocated.

47. The staff think no evidence has been provided that would change these conclusions.

48. As discussed in Agenda Paper 18D to this meeting, the staff think reconsidering the accounting for internally generated goodwill and other intangible assets is beyond the scope of this project and, as mentioned in the Discussion Paper, stakeholders who want the Board to consider adding to its work plan a broader project on intangible assets can suggest doing so as part of the Board's Third Agenda Consultation.

49. Similarly, the staff think a fundamental review of IAS 36 is beyond the scope of this project. The staff agree with comments made by some Board members in previous meetings about the risk of expanding the project—which started as a response to the PIR of IFRS 3—beyond its scope. In the staff's view, any improvements to IFRS Standards considered in this project should address concerns about the effectiveness of the impairment test identified as part of the PIR.

Question for the Board
Does the Board have any comments or questions on the analysis presented in this paper? Are there areas on which the Board would like additional analysis to support its decision on the subsequent accounting for goodwill?