Staff paper

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IASB® meeting

Date	**May 2023**
Project	**Business Combinations—Disclosures, Goodwill and Impairment**
Topic	**Effectiveness of impairment test—feasibility of designing a different impairment test**
Contacts	Tim Craig (tcraig@ifrs.org)

Purpose and structure

1. The purpose of this paper is to ask the International Accounting Standards Board (IASB) to make a decision on the feasibility of designing a different impairment test that is significantly more effective than the impairment test of cash-generating units (CGUs) containing goodwill in IAS 36 *Impairment of Assets* (impairment test in IAS 36) at recognising impairment losses on goodwill on a timely basis at a reasonable cost.

2. The paper is structured as follows:

   (a) Background (paragraphs 3–7);

   (b) Summary of feedback (paragraphs 8–16);

   (c) Analysis (paragraphs 17–37); and

   (d) Staff recommendation (paragraph 38).

Background

3. As explained in Agenda Paper 18, the IASB identified two broad reasons for concerns about the possible delays in recognising impairment losses on goodwill:

   (a) management over-optimism; and

   (b) shielding.

4. To address shielding, the IASB considered whether it could design a different impairment test. In particular, the IASB considered an impairment test in which at least a portion of any reduction in the recoverable amount of a CGU would be attributed to the acquired goodwill, rather than allocating it first to the unrecognised headroom (headroom approach).

5. Applying the headroom approach—discussed in Agenda Paper 18B to the IASB's May 2021 meeting—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 previous impairment testing date.

6. Paragraphs 3.39–3.50 of the Discussion Paper contain the IASB's analysis of the headroom approach. The IASB 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.

7. Therefore, the IASB's preliminary view was that it is not feasible to design a different impairment test that is significantly more effective than the impairment test in IAS 36 at a reasonable cost.

Summary of feedback

8. Most respondents commenting on this topic agreed with the preliminary view. Those respondents agreed that the headroom approach would increase costs for preparers while only reducing, rather than eliminating, shielding.

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

   (a) pursuing some form of headroom approach (paragraphs 10–12);

   (b) other forms of impairment test (paragraph 13); and

   (c) other methods to ensure CGUs are carried at no more than their recoverable amounts (paragraphs 14–16).

Pursuing a form of headroom approach

10. A few respondents said the IASB should explore anything that might reduce the effect of shielding and suggested reconsidering the headroom approach (see paragraphs 5–6) or a variant of that approach that the IASB discussed when developing the Discussion Paper—the pre-acquisition headroom approach. Applying 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.

11. A few respondents suggested alternative methods to test CGUs containing goodwill for impairment that are similar to the pre-acquisition headroom approach. Paragraphs 20–24 analyse these approaches further.

12. Respondents said that unlike the headroom approach, the pre-acquisition headroom approach (or similar approaches to 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.

Other forms of impairment test

13. A few respondents suggested considering other forms of impairment tests such as an implied goodwill approach, a direct value approach and a subsequent cash flow test. Paragraphs 25–34 analyse these other forms of impairment tests.

Other methods

14. A few stakeholders suggested other approaches to ensure CGUs are carried at no more than their recoverable amounts, including reconsidering the accounting for goodwill (including internally generated goodwill) and identifying other intangible assets separately from goodwill as part of a future project on IAS 38 *Intangible Assets* which a few respondents said would largely reduce shielding and result in a more effective impairment test.

15. 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 by undertaking a fundamental review of IAS 36, including a review of the concept of CGUs.

16. Paragraphs 35–37 analyse these other methods.

Analysis

17. To assist the IASB in deciding whether to reconsider its preliminary view on designing a different impairment test, this section includes our analysis of the following respondent suggestions:

    (a) headroom approach (paragraphs 18–19);

    (b) pre-acquisition headroom and similar approaches (paragraphs 20–24);

    (c) implied goodwill approach (paragraphs 25–27);

    (d) direct value approach (paragraphs 28–30);

    (e) subsequent cash flow test (paragraphs 31–34); and

    (f) other methods (paragraphs 35–37).

Headroom approach

18. The IASB decided not to pursue the headroom approach for the reasons set out in paragraph 6 and most respondents agreed with that rationale. Respondents suggesting that the IASB reconsider the headroom approach did not, in our view, provide compelling new evidence to revisit the preliminary view.

19. 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, we 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

20. The IASB considered the pre-acquisition headroom approach (paragraph 10) when developing its preliminary views. There is some merit in the arguments put forward

by respondents who suggested exploring the pre-acquisition headroom approach, or similar approaches. In particular:

(a) we 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[1] (see paragraphs 87–92 of Agenda Paper 18F to the IASB'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 their estimate of the economic decline of goodwill.

21. The IASB 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 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 shielding. In addition, similar to the headroom approach, the pre-acquisition headroom approach would require determining how much of any resulting impairment loss should be allocated to acquired goodwill and any such allocation would be imperfect.

22. The International Valuation Standards Council's article *Opportunities for Enhancing the Goodwill Impairment Framework* describes a 'step-up approach'. This approach is similar to the pre-acquisition headroom approach but requires allocating any impairment loss first to the acquired goodwill. We think this would be subject to the same concerns discussed in paragraph 21. In addition, as discussed in the Discussion Paper, for those who view acquired and internally generated goodwill to be distinct,

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

allocating all the impairment loss to acquired goodwill may sometimes produce a result that is inconsistent with the performance of the acquisition.

23. The IASB considered, but rejected, a notional goodwill approach similar to that in FRS 11 *Impairment of Fixed Assets and Goodwill* in UK generally accepted accounting principles (GAAP). This approach would require an entity to calculate 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 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.

24. 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 elements are included in the notional goodwill amount that is incorporated into the impairment test. This is because the calculation is based on the fair values of the net assets of the legacy business. Although a different calculation, the drawbacks discussed in paragraph 21 also apply to this approach.

Implied goodwill approach

25. An implied goodwill approach tries to overcome the issue that goodwill cannot be measured directly by calculating an implied goodwill. Applying this approach, an 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. This 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 the implied goodwill 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.

26. 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, we are not aware of how this assessment operates in practice.

27. We think such an approach would still be subject to drawbacks. The approach would add cost, for example the approach would require an entity to track assets and liabilities of an acquired business on a standalone basis—however, acquired businesses are often integrated into an existing business after acquisition. Because the recoverable amount of CGUs containing goodwill is calculated using the fair value of the investment in the subsidiary, the implied goodwill approach would also fundamentally change the unit of account in IAS 36.

Direct value approach

28. The International Valuation Standards Council's article *Opportunities for Enhancing the Goodwill Impairment Framework* also 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.[2]

29. 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. The article says this approach would be more transparent and objective.

30. However, applying such an approach:

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

    (b) would result in a fundamental change by delinking the impairment test from the carrying amounts of the CGU; and

    (c) 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 acquired goodwill is appropriate.

Subsequent cash flow test

31. 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 cash flow projections previously used in measuring a CGU's VIU. If actual cash flows are lower than projected cash flows and the use of 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.

[2] Although, the article notes that certain events would require an adjustment to the recoverable amount at the time of the acquisition—for example, an impairment of long-lived assets.

32. Paragraphs BC195–BC198 of the Basis for Conclusions on IAS 36 explain the reasons the IASB decided not to include a subsequent cash flow test in the Exposure Draft of Proposed Amendments to IAS 36 and IAS 38 *Intangible Assets* in 2002, including that:

    (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.

33. We think no evidence has been provided that would change these conclusions.

34. One of the suggestions to improve the effectiveness of the impairment test in IAS 36 considered in Agenda Papers 18C and 18D is based on this approach, although the suggestion is for additional disclosure rather than something that would affect the measurement of the impairment loss.

Other methods

35. Other approaches suggested include:

    (a) reconsidering the accounting for goodwill and other unrecognised intangible assets (paragraph 36); and

    (b) performing a fundamental review of IAS 36 (paragraph 37).

36. We think reconsidering the accounting for goodwill (including internally generated goodwill) and other unrecognised intangible assets is beyond the scope of this project. The IASB said in the Discussion Paper, that those stakeholders who want the IASB to consider adding to its work plan a broader project on intangible assets can suggest

doing so as part of the IASB's Third Agenda Consultation. As part of its analysis of feedback on the Third Agenda Consultation, the IASB added a project on Intangible Assets to its research pipeline which aims to comprehensively review the accounting requirements for intangible assets. This is the appropriate project to consider whether the accounting for goodwill and other unrecognised intangible assets should be explored.

37. Similarly, we think a fundamental review of IAS 36 is beyond the scope of this project. We agree with comments made by some IASB 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 our view, any improvements to IFRS Accounting Standards considered in this project should address concerns about the effectiveness of the impairment test in IAS 36 identified as part of the PIR of IFRS 3 (see Agenda Paper 18C for discussion of possible changes to the impairment test that could be considered).

Staff recommendation

38. As a result of our analysis in paragraphs 17–37, we recommend the IASB maintain its preliminary view and conclude that it is not feasible to design a different impairment test that is significantly more effective than the impairment test in IAS 36 at a reasonable cost.

Question for the IASB
Does the IASB agree with our recommendation in paragraph 38?