STAFF PAPER

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IASB Meeting

Project	**Goodwill and impairment project**
Paper topic	Progress report: Improving the impairment requirements

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Objective of this paper

1. The purpose of this agenda paper is to provide Board members with an update on our progress in the impairment phase of the goodwill and impairment project. This update is intended to help Board members to assess our progress in context, together with the quantitative data presented by the Accounting Standards Board of Japan (ASBJ) and the European Financial Reporting Advisory Group (EFRAG) and feedback in the 2015 Agenda Consultation. This update also provides another opportunity for Board members to discuss and comment on the staff proposals for improving the impairment requirements before they are discussed with the US Financial Accounting Standards Board (FASB), expected next month.

2. During its October 2015 to April 2016 meetings the Board has discussed a number of approaches for improving the impairment requirements. This paper does not present any new analysis but rather combines all the different approaches together in one paper to present Board members with a complete picture of our progress so far and set out some possible next steps.

3. The staff is not asking the Board to make any decisions at this meeting, but rather to provide feedback on the ongoing research and the next steps in this phase of the project.

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Structure of this paper

4. This paper includes the following sections:

   (a) Feedback from the Post-implementation Review (PIR) of IFRS 3 *Business Combination*s on the impairment requirements

   (b) Objective of improving the impairment requirements

   (c) Summary of approaches being considered

   (d) Status of information requested by Board members

   (e) Staff recommendation for possible next steps

   (f) Questions for the Board

   (g) Appendix A: Ongoing research performed by the staff

   (h) Appendix B: Feedback from the Global Preparers Forum (GPF) in March 2016 on the disclosure approaches D1 and D2

Feedback from the IFRS 3 PIR on the impairment requirements

5. The Board's report and feedback statement on the IFRS 3 PIR provided the following next steps to address impairment:

Area of focus	**Assessed significance**	**Possible next steps**
Effectiveness and complexity of testing goodwill for impairment.	High	Research will be undertaken. We could review IAS 36 and we could consider improvements to the impairment model; particularly whether there is scope for simplification.

6. The PIR identified concerns that the current impairment 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.

7. 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 (VIU) calculation, including the prohibition on including expansion capital expenditures in cash flow projections 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, including allocating goodwill to cash-generating units (CGUs) for impairment testing purposes, and reallocating that goodwill if a restructuring occurs.

8. The following are the key messages we heard from users of financial statements about the current information provided about goodwill and impairment:

(a) Some say the current information is useful because it provides confirmatory value about the performance of the acquisition and about the stewardship of management.

(b) However some say the current information has limitations for the following main reasons:

(i) impairment losses are recognised too late.

(ii) impairment calculations are inherently very judgemental and the assumptions used in the calculations are subjective.

(iii) disclosures are not sufficient to assess whether the main inputs/assumptions are reasonable. However some users 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.

(iv) insufficient information to help them understand the subsequent performance of the acquired business and whether main targets/synergies of the acquisition are met, which are considered key to their analysis.

(c) Some users focus more on the timing of the impairment write-down and its overall magnitude rather than the specific amount of impairment recognised.

9. Based on our user outreach during and subsequent to the PIR, users appear to be particularly interested in understanding the following information about goodwill and impairment:

   (a) what management thought were the key drivers that justified the valuation of the acquisition (and hence the amount of goodwill);

   (b) assessing whether an acquisition has been successful; and

   (c) assessing the accountability of management.

Objective of improving the impairment requirements

10. Considering the feedback received in the PIR, the staff think there are two objectives:

    (a) Consider whether the impairment test could be simplified and its application improved without loss of information for investors, for example by addressing the challenges identified in paragraph 7.

    (b) Consider whether information can be improved for investors without imposing costs that would exceed the benefits provided by the improvements. This includes considering investors' concerns that the current requirements result in impairment losses being recognised too slowly and in too small amounts ('too little, too late').

11. In practice, many of the complexities regarding impairment testing relate to goodwill. However some concerns raised about the existing impairment test for goodwill during the PIR are also general concerns about the impairment model in IAS 36 and how it applies to other non-current, non-financial assets. Consequently, considering whether changes should be made to the existing impairment requirements for goodwill may best be done in parallel with considering changes to the overall impairment model.

Summary of approaches being considered

Possible approaches to simplify and improve application of impairment test (paragraph 10(a) of objective)

Discussed at October 2015 and February 2016 Board meetings[1]

Approach I1 One model approach

12. Moving from a two-model approach[2] to a single-model approach in determining impairment. One of the following methods could be considered for that single-model:

    (a) Method 1: Fair value less costs of disposal (FVLCD)

    (b) Method 2: Value in Use (VIU)

    (c) Method 3: Method depends on how the entity expects to recover the asset

Approach I2 Relief from annual test

13. Relief from the annual impairment test for goodwill by moving to an indicator-only approach to impairment testing as for other assets. We could also consider introducing one or both of the following additional indicators for goodwill to make the indicator-approach more robust:

    (a) a qualitative assessment of whether it is more likely than not that the fair value of a CGU (or group of CGUs) to which goodwill is allocated is less than its carrying amount; and/or

    (b) an assessment of whether actual performance of the acquisition was worse than its expected performance. This might operate only during the first few years following an acquisition, for example three years.

Approach I3 Improving VIU

14. Improving VIU calculation, in particular

    (a) removing the requirement to use a pre-tax discount rate because post-tax rates can be observed and are often used in practice;

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[1] The detailed staff analysis of these approaches is in February 2016 IASB Agenda Paper 18C and October 2015 IASB Agenda Paper 18B.

[2] IAS 36 defines recoverable amount as the higher of an asset's (or CGU's) fair value less costs of disposal (FVLCD) and its value in use (VIU).

(b) not requiring management to make adjustments to their forecasts to exclude estimated future cash inflows or outflows that are expected to arise from a future restructuring to which an entity is not yet committed or improving or enhancing the asset's performance; and/or

(c) consider whether education material could be developed to address other areas of difficulty such as better explaining the differences between the market perspective (used in FVLCD) and the entity perspective (used in VIU) and how to determine the terminal value/growth rate.

Approach I4 Guidance on allocating goodwill to CGUs

15. Developing guidance (or education material) on allocating and reallocating goodwill to CGUs, in particular to address concerns we have received from preparers that such allocation is difficult to apply in practice and concerns we have received from accounting firms that over aggregation (grouping) of CGUs is common. New guidance or requirements could help to ensure that goodwill is allocated at the appropriate level.

Possible approach to address concerns impairment is too little too late (paragraph 10(b) of the objective)

Discussed at March and April 2016 Board meetings[3]

Pre-acquisition headroom (PH) Approach

16. If goodwill is allocated to an existing CGU or group of CGUs (‘units’) of the acquirer and the unit’s recoverable amount exceeds its carrying amount, the excess (headroom) will provide an instant buffer against recognition of an impairment loss of the goodwill allocated to the unit. The PH Approach would eliminate any pre-acquisition buffering effect by incorporating into the impairment test calculation any such headroom, existing at the date of acquisition, of the existing units to which goodwill is allocated.

[3] The detailed staff analysis of the PH approach is in April 2016 IASB Agenda Paper 18A. This approach was previously referred to as the PAH approach.

Possible approaches to improve disclosures about goodwill and impairment (paragraph 10(b) of the objective)[4]

Discussed at February and March 2016 Board meeting[5]

Approach D1 Key performance targets

17. Disclosure of the key performance targets supporting the purchase price paid, and hence supporting the amount of goodwill recognised. The staff envisage this would include measureable targets and therefore would incorporate:

    (a) a quantitative, as well as qualitative, explanation for the purchase price paid. Such explanation would include the targets management has identified as benefits of the acquisition and in support of the acquisition price; and

    (b) identification of the periods over which targets are expected to be achieved where possible (for example an increase in revenue at 5 per cent per year for 3 years).

    The staff would expect the key performance targets to follow from management's own assessment which it performs when determining whether to undertake the acquisition and which are communicated to investors in support of the acquisition.

Approach D2 Comparison with actual performance

18. An annual comparison of actual performance against the key performance targets for a number of years following the acquisition. The staff think the number of years should be driven by the time horizon used by management when determining the key performance targets in Approach D1. The Board may want to also consider requiring a minimum period, for example three years.

Approach D3 Goodwill breakdown

19. Disaggregation of the amount of goodwill at the reporting date into the contributing past acquisitions.

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[4] Regardless of which approaches are considered to improve the disclosure requirements, a review of the existing disclosure requirements in IAS 36/IFRS 3 would be undertaken. The staff think the aim of this review would be to see if we can improve the existing requirements to assist better application and remove any requirements that are no longer necessary in light of any new disclosures we add.

[5] The detailed staff analysis of these disclosure approaches is in March 2016 IASB Agenda Paper 18B.

Approach D4 Goodwill recoverability

20. For each significant acquisition in the breakdown in Approach D3, an explanation to justify why the amount of goodwill is recoverable. For example management would be required to consider what evidence there is that synergies and going concern value remain from each major past acquisition.

Status of information requested by Board members*:*

21. Quantitative information about the amount and trends of reported goodwill, impairment and intangible assets (to be presented at this meeting).

    (a) Objective: to understand how goodwill and other intangible asset balances have changed over time and the levels of impairments being recognised against goodwill over the same period. The main reason the Board asked for this data was to help it consider how to respond to concerns raised by interested parties during the IFRS 3 PIR that goodwill and intangible assets are growing significantly and could be overstated, and that impairment losses on goodwill are being recognised too late.

    (b) Current status of research: This data will be presented at this meeting by the staff of the Accounting Standards Board of Japan (ASBJ) and the European Financial Reporting Advisory Group (EFRAG).

22. Information about the relative frequency of use of FVLCD compared with VIU in determining recoverable amount in the IAS 36 impairment test.

    (a) Objective: to understand the relative use of the two calculation methods with the aim of understanding the magnitude of change and what proportion of entities we would be assisting, if we were to focus on one model or the other in Approach I1. Also examine how FVLCD is measured by those entities that use this method, ie do entities use discounted cash flow models or other approaches to measure FVLCD.

    (b) Current status of research: In progress. Some information is provided in paragraphs A2-A3 in Appendix A.

23. Information about the timing of goodwill impairments relative to the related business combination.

(a) Objective: to understand how quickly goodwill impairments are recognised after a business combination. The main reason the Board asked the staff to collect this data was to assess whether the first few years following an acquisition are the most critical to test for impairment. This would help us to assess whether more robust indicators are necessary in the early years following an acquisition in Approach I2.

(b) Current status: In progress. Some information is provided in paragraphs A4-A5 in Appendix A.

24. Type of quantitative information currently being communicated to investors in support of an acquisition.

(a) Objective: to understand what kind of quantitative information entities are currently providing to investors in support of an acquisition to see the type of information that might be disclosed under Approach D1.

(b) Current status: In progress. Some information is provided in paragraphs A6-A7 in Appendix A.

Staff recommendation for possible next steps

25. The staff recommend that the following should be the next steps for the impairment phase of the goodwill and impairment project after this May 2016 meeting:

26. <u>Step 1</u>: Develop the PH Approach further by considering the following:

(a) The pros and cons, including the likely behavioural incentives/effects, of permitting or requiring the following methods to be used when allocating impairment losses under the PH Approach:

(i) in full to goodwill before the PH (allocation method used in the staff proposal in April 2016 IASB Agenda Paper 18A);

(ii) in full to the PH before goodwill (essentially the existing allocation method in IAS 36);

(iii) proportional allocation of the impairment loss between the PH and goodwill (not yet considered); or

(iv) another more sophisticated method (not yet considered because of concerns it adds too much complexity to the PH Approach).

(b) Examples of how the PH Approach would apply if:

(i) a pre-acquisition deficit exists that would not be fully recognised as an impairment loss on identification of this indicator of impairment in accordance with the requirements in IAS 36 (for example because the CGU is mainly comprised of financial assets); and

(ii) the impairment loss arises primarily because of the effect of an increase in the discount rate in the measurement of recoverable amount of the CGU / group of CGUs.

27. Step 2: Solicit feedback from the FASB and the Accounting Standards Advisory Forum (ASAF) on the approaches being considered for improving the impairment requirements.

28. Step 3: Perform field testing and additional outreach with preparers, users and auditors about the possible disclosure requirements in approaches D1 and D2. The objective would be to help us understand what information would be both meaningful and possible to prepare, identify any potential audit issues and decide what information would be appropriate in the financial statements (or at least incorporated by cross-reference), as opposed to solely considered as part of management commentary. The staff have already obtained some feedback from the Global Preparers Forum (GPF) on disclosure approaches D1 and D2 (see Appendix B).

29. The staff also welcome Board comments on the ongoing research in Appendix A.

Questions
(1) Are Board members supportive of the next steps in this project in paragraphs 26-28?
(2) Do Board members have any comments on the research in Appendix A and whether it is helpful?
(3) Do Board members have any other comments or questions?

Appendix A: Ongoing research performed by the staff

A1. This appendix provides an update on the staff's ongoing research in response to the information requested by Board members in paragraphs 22-24.

Information about the relative use of FVLCD compared with VIU (paragraph 22)

A2. Comprehensive information about the relative use of FVLCD compared with VIU would take time to collect because it would necessitate looking at individual financial statements of entities. Consequently as a first step the staff are looking for academic or other studies that have already completed such reviews.

A3. So far the staff have identified one report that provides information in this area. In January 2013 the European and Securities Market Authority (ESMA) issued a report titled *European enforcers review of impairment of goodwill and other intangible assets in the IFRS financial statements*. That report contains data about use of VIU and FVLCD. In this report ESMA evaluated the appropriateness of disclosures in the 2011 IFRS financial statements of a sample of 235 issuers with significant amounts of goodwill.[6] Some of its finding were:

(a) More than three quarters of the issuers stated that the recoverable amount is determined based on VIU, whereas 6% of the issuers use FVLCD. Another 14% of issuers declare that both VIU and FVLCD are used to determine the recoverable amount, depending on the CGU.

(b) Of the issuers that described the basis of the FVLCD calculation, very few stated that this was estimated based on a binding sales agreement, and 19% of the issuers stated that comparable transactions were used. The issuers referring to comparable transactions are engaged in various industries and come from various countries, i.e. there are no observable industry or country trends. The majority of the issuers stated that they determined the

[6] The review was performed on a sample of 235 European listed entities from 23 jurisdictions. The sample was selected through a two-step process to ensure representation of the largest European issuers with the most significant amount of goodwill, and a wide coverage of industries and balanced geographical representation across Europe.

FVLCD based on discounted cash flow computations. Another 8% of the issuers stated that they used other methodologies.

Information about the timing of goodwill impairments relative to the related acquisition (paragraph 23)

A4. Comprehensive information about the timing of goodwill impairments relative to the related acquisition would take time to collect because it would necessitate looking at individual financial statements of entities. Consequently as a first step the staff are looking for academic or other studies that have already completed such reviews.

A5. So far the staff have not found any studies that cover entities applying IFRS. However, the staff have identified one paper that looks at the timing of impairments under US GAAP. The study concludes based on a sample of 929 acquisitions between 1999 and 2007 where both the acquirer and acquiree are listed on US stock exchanges that[7]:

(a) the average time between the acquisition date and the recognition of an impairment loss ranges from 2 to 3 years.

(b) 9.41% of the impairments were recorded in the same year of the acquisition, 38.17% of the impairments occurred within one year of the acquisition and 61.83% within two years. Only 23.41% of the write offs took place four or more years following the acquisition.

Quantitative information communicated to investors in support of the acquisition (paragraph 24)

A6. The staff have been looking at the type of quantitative information that entities currently provide to investors in support of significant acquisitions. So far we have been able to obtain information communicated to investors in support of the acquisition for half of the 45 largest acquisitions between January 2012 and January 2014 worldwide (covering many countries and industries, but with most of the larger acquisitions being in the US).

[7] 2013 Research paper titled *Overpaid acquisitions and goodwill impairment losses — Evidence from the US* (http://www.isihome.ir/freearticle/ISIHome.ir-24015.pdf)

A7. Many of the reasons provided in the investor communications for making acquisitions are qualitative in nature and would be difficult to measure. However, the staff found that a significant number of the entities provided some quantitative data about revenue or costs synergies, usually with a stated time period for realising those synergies. Sometimes this information is also provided in the financial statements, but not in as much detail as in the less formal investor presentations about the acquisitions. In some cases entities also report progress in meeting those synergies in their annual report (generally outside the financial statements). A few entities also provided other types of qualitative information, for example the effect on earnings per share or expected return on investment, but such data was far less common than quantitative data about synergies.

Appendix B Feedback from the Global Preparers Forum (GPF) in March 2016 on the disclosure approaches D1 and D2

B1. The staff sought the views of GPF members on improving the disclosure requirements about goodwill and impairment to provide better, more timely information, to users of financial statements. In particular, the staff asked the GPF for feedback on a possible requirement to disclose:

(a) the key assumptions or targets supporting the purchase price paid for an acquisition, and hence supporting the amount of goodwill recognised; and

(b) a basic annual comparison of actual performance of the acquisition against those key assumptions and targets for a period of time following the acquisition.

B2. Nearly all GPF members expressed some concerns about preparing the disclosures. However one member agreed that something should be done in this area to improve management stewardship and the information provided to financial statement users. That member stated that significant amounts of shareholder money are being spent on acquisitions without proper monitoring of whether an acquisition is successful. Furthermore, some academic research concludes that the majority of acquisitions are destructive to shareholder value. That member encouraged the staff to continue to pursue their proposals, and in particular to keep asking companies how they track whether an acquisition has been successful.

B3. The following concerns were expressed by GPF members about disclosing key performance assumptions and targets supporting the purchase price paid:

(a) This would require disclosure of sensitive information that could give away the company’s competitive advantage. Examples of sensitive information provided by GPF members included profit-related information and internal metrics on what the company is willing to pay and accept in an acquisition.

(b) It would be difficult to make the key targets measurable and auditable. This is because the key targets are not necessarily figures such as sales, operating profit, etc. but rather factors that are difficult to measure such as acquisition of human competencies.

(c) Entities are already required to do a purchase price allocation and explain what goodwill is composed of. This information is sufficient.

B4. The following concerns were expressed by GPF members about disclosing a basic comparison of actual performance of the acquirer against the key performance targets:

(a) Often the acquiree is integrated quickly into the acquirer's business. This means it is difficult to determine, going forward, what relates to the acquisition and what relates to the existing business. Consequently such a comparison would not be practical. For example, it is difficult to identify which cost savings or revenue increases are as a result of the acquisition and which would have been made anyway

(b) Often the targets that are anticipated are not met but this does not mean that the acquisition is not successful. For example:

(i) often changes to expected plans and targets are made after the acquisition is made, to maximise the value of the business and also in response to other factors, for example changes in the economy; and

(ii) sometimes other unexpected positive outcomes arise from the acquisition.

(c) This kind of monitoring is generally not performed unless acquisitions are very significant or are isolated from the rest of the acquirer's business. However some GPF members stated that there should be a duty for companies to provide updates on acquisitions to shareholders.

(d) Acquisitions of smaller companies will be very difficult to track in a large corporation. Often the acquisition is part of a very big operation and information about the effect of that individual acquisition is not tracked.

(e) The link between this disclosure requirement and the impairment test is not clear; for example, it is not clear how the information provided would be used in considering impairment. Some members acknowledged that there is a stewardship aspect to the proposals discussed, but noted that merely because an entity does not meet the key performance targets, this does not mean that there is an impairment loss. This is because even if an acquisition performs worse than expected, that may not result in impairment under the current test because of the headroom provided by the acquirer’s existing CGUs to which the goodwill is allocated (ie the amount by which the recoverable amount of the CGU exceeded its carrying amount before the allocation). In addition, the acquisition might be part of a larger investment plan and the performance of individual acquisitions within that plan might not be tracked.