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STAFF PAPER

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IASB® Meeting

Project	**Goodwill and Impairment research project**		
Paper topic	Simplifying the impairment testing model in IAS 36 *Impairment of Assets*		

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Purpose

1. As explained in paragraph 10 of Agenda Paper 18A, in the past, the Board only had a high-level discussion on possible approaches to simplify the impairment testing model. No decisions were made by the Board.

2. Consequently, the purpose of this paper is to assist the Board members in developing their views about possible approaches to simplify the impairment testing model in IAS 36.

3. The Board is not being asked to make decisions at this meeting for the reasons explained in paragraphs 12–13 of Agenda Paper 18A.

Structure of the paper

4. The paper is structured as follows:

(a)	objective of simplifying the impairment testing model;	paragraph 5
(b)	possible approaches to simplifying the impairment testing model;	paragraphs 6–39

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(i) a single method to determine the recoverable amount;	paragraphs 9–28
(ii) relief from annual testing;	paragraphs 29–39
(c) minutes from the GPF meeting; and	Appendix A
(d) extracts from Topic 350-20 of FASB Codification relating to qualitative factors for goodwill impairment.	Appendix B

Objective of simplifying the impairment testing model

5. The objective of considering possible simplifications to the impairment testing model is to investigate whether it is possible to reduce the cost of impairment testing without making the impairment test less robust

Possible approaches to simplifying the impairment testing model

6. The Board could consider one or more of the following possible approaches to simplify the impairment testing model:

   (a) using a single basis to determine recoverable amount of a cash generating unit (CGU) instead of the current requirement to determine the higher of two amounts—value in use (VIU) and fair value less costs of disposal (FVLCD).

   (b) providing relief from the requirement to perform an annual impairment test of a CGU to which goodwill is allocated, and instead allowing an indicator-based impairment test.[1]

7. In addition to the above, the Board could also consider less significant changes to IAS 36, such as:

[1] References to a CGU to which goodwill is allocated should be read as references also to a group of CGUs to which goodwill is allocated.

(a) easing the VIU calculation by (i) removing the restrictions imposed by IAS 36 on cash flow estimates; and/or (ii) being less specific about whether pre-tax or post-tax inputs should be used.

(b) providing additional guidance to assist entities in applying IAS 36.

We will analyse these other possible changes for a future meeting.

8. In March 2017, the staff sought feedback from the Global Preparers Forum (GPF) on the possible simplifications described in paragraphs 6–7 of this paper. See *Appendix A* of this paper for the minutes from the GPF meeting. The feedback from GPF members has been considered in the staff analysis of the simplifications.

A single method to determine the recoverable amount

9. The objective of IAS 36 is to prescribe procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. IAS 36 defines recoverable amount as the higher of an asset's (or CGU's) FVLCD and its value in use. Value in use is the present value of the future cash flows to be derived from continuing use and disposal of the asset. The cash flow projections used in calculating value in use should be based on reasonable and supportable assumptions that represent *management's best estimate* of the range of economic conditions that will exist over the remaining useful life of the asset. However, in FVLCD calculations, an entity is required to use assumptions that *market participants* would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

10. It is not always necessary to determine both FVLCD and value in use of a CGU. However, if an entity determines that one of these amounts is less than the CGU's carrying amount, the entity has to determine the other amount before it concludes on the recoverable amount of the CGU. Consequently, when an entity has to determine both amounts and if the entity determines FVLCD using a discounted cash flow calculation, there is complexity and possible confusion because of the need to consider whether there is in fact a difference between the inputs for calculating value in use (management's best estimates) and those used for calculating FVLCD (market participant assumptions).

11. There was some feedback from PIR of IFRS 3 that requiring the use of a single method, rather than the higher of two methods, might reduce complexity without causing a loss of information for users of financial statements.

Staff analysis

12. The Board could either:

    (a) retain only one of the two methods (value in use or FVLCD) as the sole basis for measuring recoverable amount; or

    (b) retain both methods and require an entity to select a method that reflects the manner in which the entity expects to recover the asset—FVLCD if the entity expects to recover the asset through sale, and value in use if the entity expects to recover the asset primarily through use.

13. The staff received some feedback from a few stakeholders that the complexity described in paragraph 10 of this paper is not a persuasive argument for changing the basis for determining recoverable amount. This is because an entity does not need to calculate both value in use and FVLCD of a CGU in all situations. It needs to do this only when calculating one of these amounts has shown that there may be an impairment.

14. However, moving to a single model will probably help in improving the effectiveness of the impairment testing model. A more straightforward impairment test using one model could:

    (a) be easier to apply and understand; and

    (b) reduce concerns that the current model makes it too easy to delay and (or) conceal impairment losses.

15. The following considerations would help in deciding the method to retain:

    (a) are the considerations of the International Accounting Standards Committee (IASC), the predecessor of the Board, when developing the principle for measuring recoverable amount still relevant today?

    (b) what are the similarities and differences between value in use and FVLCD?

Considerations of the IASC

16. In developing a principle for measuring recoverable amount, the IASC considered what a rational entity will do on discovering that an asset is impaired. The IASC reasoned that the entity will either (a) sell the asset if the net proceeds from the sale exceed the benefits from continuing to use the asset; or (b) continue to use the asset even if its service potential is lower than originally expected.

17. The IASC (a) concluded that the resulting decision from the entity is, in substance, an investment decision based on estimated net future cash flows expected from the asset; and (b) decided that measuring the recoverable amount at the higher of value in use and net selling price would best reflect that conclusion.

18. The term net selling price was replaced with FVLCD in 2004 when the Board issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

19. The IASC considered and rejected measuring recoverable amount based only on fair value for the following reasons:

    (a) no preference should be given to the market's expectation. An entity may have superior information about future cash flows and may plan to use an asset in a manner different from the market's view of the best use.

    (b) market values are a way to estimate fair value but only if they reflect the fact that both parties, the acquirer and the seller, are willing to enter a transaction.

    (c) if an entity can generate greater cash flows by using an asset than selling it, it would be misleading to base recoverable amount on the market price because a rational entity would not be willing to sell.

    (d) recoverable amount of an asset is the amount that an entity expects to recover from an asset, including the effect of synergies with other assets.

20. The IASC considered and rejected measuring recoverable amount based only on value in use for the following reasons:

    (a) if an asset's FVLCD is higher than its value in use, a rational entity will dispose of the asset. In this situation, it is logical to base recoverable

amount on the asset's FVLCD to avoid recognising an impairment loss that is unrelated to economic reality.

(b) if an asset's FVLCD is greater than its value in use, but management decides to keep the asset, the extra loss (the difference between FVLCD and value in use) properly falls in later periods because it results from management's decision in these later periods to keep the asset.

21. An important fact to be noted in assessing whether the IASC's considerations are still relevant today is that there was no comprehensive Standard on fair value measurement when IAS 36 or IFRS 5 were issued. IFRS 13 *Fair Value Measurement* provides a deeper analysis of the characteristics of a fair value measurement than was available to the IASC when it developed IAS 36. For example, IFRS 13 discusses what assumptions a rational market participant buying an asset would make about how to use the asset (such as in a productive process, or simply as scrap). For a future Board meeting, the staff will analyse whether that deeper analysis in IFRS 13 provides any reason to rethink the arguments considered by the IASC.

Similarities and differences between value in use and FVLCD

22. On the basis of feedback from GPF and other stakeholders, the staff believe that entities generally use Level 3 inputs in measuring FVLCD of a CGU because of the absence of observable inputs. The staff also believe that discounted cash flow techniques are commonly used in measuring fair value. Fair values derived using discounted cash flow techniques are corroborated using multiples-based valuation. Value in use, by definition, is a discounted cash flow amount. This background helps in analysing and understanding the differences between value in use and FVLCD.

23. At a high level, the main difference is that VIU is based on management's best estimate of cash flow projections whereas FVLCD is based on assumptions that market participants would use. Nevertheless, paragraph BCZ20 of the Basis for Conclusions on IAS 36 explains that IASC believed that IAS 36 included sufficient requirements to prevent an entity from using assumptions different from the marketplace without justification. For example, an entity is required to determine value in use using:

(a) cash flow projections based on reasonable and supportable assumptions and giving greater weight to external evidence; and

(b) a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

24. If the requirements in IAS 36 are correctly applied, the cash flow projections used in calculating value in use should not be very different from those used in calculating fair value. On the other hand, on the basis of informal discussions with a few individuals from large accounting firms, the staff understand that management is generally motivated to make optimistic cash flow forecasts and that the level of optimism might be somewhat lower if management were estimating what cash flows other market participants would derive from the asset(s).

25. Another difference is that in calculating value in use, estimates of cash flows are required to exclude estimated cash flows that are expected to arise from (a) a future restructuring to which an entity is not yet committed; or (b) improving or enhancing the asset's performance. There is no such restriction in fair value measurement.

26. Paragraph 53A of IAS 36 highlights a few factors that are not reflected in fair value but reflected in value in use.

> 53A Fair value differs from value in use. Fair value reflects the assumptions market participants would use when pricing the asset. In contrast, value in use reflects the effects of factors that may be specific to the entity and not applicable to entities in general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to market participants:
>
> (a) additional value derived from the grouping of assets (such as the creation of a portfolio of investment properties in different locations);
>
> (b) synergies between the asset being measured and other assets;

(c) legal rights or legal restrictions that are specific only to the current owner of the asset; and

(d) tax benefits or tax burdens that are specific to the current owner of the asset.

27. The staff will further analyse the similarities and differences between value in use and fair value and present the analysis to the Board at a future meeting.

28. Paragraph 12(b) mentions another possible approach—retaining both methods and requiring an entity to use the method that reflects how the entity expects to recover the asset. The staff think that this method will result in the impairment testing model being based mostly on value in use.

Relief from annual testing

29. IAS 36 requires a CGU to which goodwill has been allocated to be tested for impairment annually. In addition, impairment test shall be performed whenever there is any indication that an asset may be impaired.

30. The annual impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. Different CGUs may be tested for impairment at different times. However, if some or all of the goodwill allocated to a CGU was acquired in a business combination during the current annual period, that CGU must be tested for impairment before the end of the current annual period.

31. There was some feedback from the PIR of IFRS 3 that requiring an impairment test only if impairment indicators are present for goodwill and other indefinite life intangible assets may reduce complexity (‘indicator-only approach’). This would also be consistent with the approach for finite life assets in the scope of IAS 36.

32. IAS 36 requires that an entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall perform an impairment test. IAS 36 provides a list of indicators that an asset may be impaired. These indicators are not exhaustive and they are required to be considered as a minimum.

Staff analysis

33. As explained in the Basis for Conclusions on IAS 36, the Board required an annual impairment test for indefinite life intangible assets because the Board observed that non-amortisation of an intangible asset increases the reliance that must be placed on impairment reviews of that asset to ensure that its carrying amount does not exceed its recoverable amount. In respect of goodwill, the existence of a rigorous and operational impairment test was seen as a precondition for removing the requirement to amortise in all cases. The IASC introduced the requirement to carry out an annual impairment test for goodwill and indefinite life intangible assets at the same time as it removed a previous requirement to amortise those assets.

34. There was feedback from investors that impairment losses are often recognised too late (even with an annual impairment test). The staff think that without a mandatory annual test, concerns may arise that 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. Nevertheless it might be possible to mitigate these concerns by having robust indicators.

35. A robust indicator could be whether the key performance targets for a business combination have been achieved during the first few years following the combination. See paragraphs 7–19 of Agenda Paper 18D.

36. If the key performance targets are not met then this indicator would trigger a requirement to measure the recoverable amount of the CGU. The staff envisage this indicator would only operate over the first few years following a combination, for example 3 years.

37. The indicator would operate as follows:

    (a) on acquisition an entity would disclose the key performance targets supporting the purchase price paid for the acquiree. These would need to be specific to the effects of the acquisition (and hence support the goodwill figure) and measurable. For example, a key performance target might be the level of expected sales of the acquiree (if the acquiree is not integrated) or the expected increase in sales or cost

reduction for a specific part of the business benefiting from the synergies of the acquisition (if the acquiree is integrated). The entity would also identify the periods over which it expects to achieve these targets (for example an increase in revenue at 5 per cent per year for 3 years).

(b) at the end of the first reporting period after the acquisition the entity would assess whether the targets were met. If those targets have not been met for CGUs to which goodwill was allocated, then this would trigger a requirement to measure the recoverable amount of those CGUs.

(c) the entity would also update the key targets at each reporting period to reflect any changes in management's forecasts. The revised key targets at the end of one reporting period would be used as the basis for the impairment indicator in the following reporting period (for example, management may determine it should revise the expected increase in revenue from 5 per cent to 4 per cent per year).

(d) at the end of the second reporting period, the entity would assess whether the revised key targets are met. If those key targets have not been met, then this indicator would trigger a requirement to measure the recoverable amount of the CGU. Again management would consider whether it needs to update its key targets going forward.

Optional qualitative test in US GAAP

38. The staff have suggested the indicator-only approach on the basis of a similar qualitative assessment introduced into US GAAP in 2011. 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 having a likelihood of more than 50 percent. See *Appendix B* for the extract of the qualitative factors from US GAAP.

39. The staff will (a) seek information from the FASB staff about how the optional qualitative assessment is being applied in practice; (b) analyse whether the

qualitative factors and the likelihood test could be incorporated in IAS 36; and (c) present the analysis to the Board at a future meeting.

Questions for the Board

1. Do you have any questions or comments on the possible approaches explained in this paper?
2. Do you think staff should consider other approaches to simplify the impairment testing model?

Appendix A
Extracts of the Minutes from GPF meeting, March 2017

Impairment of goodwill (Agenda Paper 3)

A1. The staff sought feedback from GPF members on the following ideas the staff are exploring for possible simplifications to the goodwill impairment testing requirements in IAS 36 *Impairment of Assets*:

(a) one-model approach to determining recoverable amount of an asset instead of the current two-model approach (higher of value in use and fair value less costs of disposal);

(b) relief from annual testing by not requiring an entity to test goodwill for impairment when there is no indication that goodwill may be impaired (indicator approach);

(c) improving value in use methodology by allowing the use of post-tax discount rate and relaxing some restrictions on the cash flows to be included; or

(d) providing additional guidance on allocating goodwill arising in a business combination to a pre-combination cash generating unit (CGU).

A2. Several GPF members favoured an indicator approach to provide relief from annual impairment testing and relaxing the restrictions on cash flows to be included in computing value in use. In relation to the indicator approach, one GPF member asked the staff to consider whether missing the budgeted targets should be an indicator that triggers impairment testing.

A3. In relation to the one-model approach, a few GPF members indicated a preference for a model that uses value in use because they think that:

(a) in practice, entities end up using value in use because there is usually no observable price for a CGU, and when an observable price is available, that price is not a better reflection of the value of the CGU, for example if the price is observed only for a small block of shares and does not reflect a control premium; and

(b) value in use better reflects the fact that an entity holds, for example, property, plant and equipment for use in the production or supply of goods or services.

A4. Individual GPF members had other suggestions for clarifications or changes that the Board could make to IAS 36, including:

(a) that the discount rate used should be consistent with the level of cash flow projections;

(b) allowing an entity to use its own weighted average cost of capital instead of that of a peer group;

(c) removing the requirement to disclose a sensitivity analysis because those disclosures make it easy to derive an entity's budgets.

A5. One GPF member said that the objective of the research project should not be to simplify the impairment testing, but to make the testing more robust.

Appendix B
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 of 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 of his meeting) amended paragraphs 350-20-35-3F and 350-20-35-3G. The text reproduced in this Appendix is the amended text.