Australian Government

Australian Accounting Standards Board

AASB Research Report No. X:

Could accounting standard setters look to market analysts for improved impairment guidance?

Summary of outreach results

February 2019

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Executive Summary

It has been widely observed that application of the existing version of IAS 36 *Impairment of Assets* is problematic in practice, causing significant issues at all levels of the financial reporting cycle.

Preparers have observed that the standard is difficult to apply in practice, unduly complicated and includes requirements that do not contribute to better accounting outcomes. Regulators are grappling with the outcomes ultimately reported by entities – evidenced by media releases encouraging company directors to be more mindful of the technical aspects of the impairment process and auditors to more rigorously challenge the assertions made by management, implying that impairments may not be recognised at the appropriate time. Previous research has indicated that users of the financial statements including investors and analysts often do not obtain useful information from impairment balances or disclosures. This suggests that the information is often of confirmatory value rather than providing new insight into the business' operations.

In considering potential solutions, the Australian Accounting Standards Board observed that the analyst or investor perspective has not been widely documented in response to the various requests for feedback at the international level, however the Board believe that this is a critical area of research that would yield valuable insights on the methodology applied in assessing value.

In light of this, this research report was compiled with the aim of considering the processes used by analysts and whether they could offer a fresh perspective that would assist in developing improvements to the existing accounting requirements within the four broad topics of: the purpose of impairment testing; external assessments of value; cash-generating units; and disclosure.

Through this process the authors gained insights into both the methods used by analysts on a daily basis and those pieces of information in financial statements that are considered genuinely beneficial to users. Key themes coming out of the research were:

- There is an overall lack of clarity on the purpose of the impairment test.
  Responses to questions raised as part of both phases of this outreach showed that opinions are divided as to whether the impairment test is intended to determine recoverability of a specific asset or group of assets, provide information on the subsequent results of a previous business acquisition or give information on the overall reasonableness of the balance sheet. An incorrect or misguided interpretation of the purpose of the test and related disclosures results in diversity in application and lack of comparability.
- There is dissatisfaction with the application guidance contained in the standard, the various options and restrictions that the standard prescribes and the level at which the impairment test should be performed.

The guidance requires an approach to impairment testing which is based on cash generating units (CGUs). One criticism of the standard is that the CGU concept is an artificial construct and does not align with management's day-to-day assessment of business results, therefore adding unnecessary complexity without providing management with additional information that is useful to them in decision-making.

- There is diversity in the way information related to impairment testing is disclosed and the level of detail that is included.

  This is again resulting in reduced usefulness of information presented and a lack of comparability between entities.

Giving consideration to this feedback, the recommendations made are outlined below.

Summary of recommendations to the IASB

1. Update the impairment testing requirements to include greater clarity as to the purpose of the impairment test, including guidance on what the test is and is not expected to achieve.

2. Perform further research on a modified-single model approach, with specific amendments to:
   a. remove the existing restrictions on Value in Use (ViU) regarding future restructurings and asset enhancements and replace those restrictions with guidance on when it would be reasonable to include such cash flows in an impairment model;
   b. allow the use of a pre-tax discount rate;
   c. reserve the use of the Fair Value Less Costs of Disposal (FVLCD) model for assets expected to be disposed of within the following financial reporting period; and
   d. permit the use of market-based assumptions within the cash flow model such as a forward curve for commodity prices and foreign exchange rates.

3. Enhance the functionality of the standard in respect of allocation of goodwill to CGUs. Perform further research on how the current requirements align with how an entity's results are viewed and decisions made internally. In light of those results, redraft the existing guidance as to what constitutes a CGU or relevant group of CGUs to clarify and provide support to this objective.

4. Given the importance placed by users on disclosure of assumptions, implement the following enhancements to the existing disclosure requirements:
   a. further guidance on the definition of a key assumption; and
   b. qualitative disclosure of expected synergies supporting the premium paid on acquisition.

Introduction

What is the issue and why is this important?

5. As part of the post-implementation review of IFRS 3 *Business Combinations*, the International Accounting Standards Board (IASB) received a substantial amount of feedback regarding the shortcomings of impairment testing under IAS 36 *Impairment of Assets*.
6. Concerns raised included:
    a. the result of existing processes is to allow impairments of goodwill in underperforming businesses to be "shielded" by better performing businesses;
    b. the results of the existing requirements is that impairments are being recognised "too little, too late"; and
    c. the existing standard is unduly complicated and includes requirements that do not practically contribute to better accounting outcomes.
7. The impairment test is used to verify the recoverability of assets on an entity's balance sheet. If it is widely believed that this test does not consistently achieve an appropriate accounting outcome, then this undermines the balance sheet as a useful financial statement. Many users rely on the general purpose financial report to satisfy their information needs, and accordingly those balance sheets should accurately reflect the likely recoverability of the assets recorded. Specific concerns include the fact that current requirements do not identify impairments soon enough, leaving the balance sheet and net profit overstated during that period; diversity in practice reduces comparability; and the process relies on management assumptions that are not consistent with the everyday operations of the business, rendering the result irrelevant outside of the impairment process.
8. In response to the abovementioned feedback, the IASB has explored various proposals for change through their 'Goodwill and Impairment' project. Since its launch the IASB has discussed:
    a. whether changes should be made to the existing impairment test for goodwill and other non-current non-financial assets;
    b. the subsequent accounting for goodwill, including the relative merits of an impairment-only approach and an amortisation and impairment approach;
    c. whether additional disclosures assessing outcomes of a previous business combination would result in more useful information in the market; and
    d. the extent to which other intangible assets should be recognised separately.
9. The Financial Accounting Standards Board (FASB) is also actively discussing accounting for identifiable intangible assets in a business combination, goodwill and goodwill impairment in the United States. The IASB and the FASB have been following each other's progress and hold regular joint meetings to discuss project summaries and progress reports.

10. A more comprehensive summary of the IASB's current work plan can be found in paragraphs 15-17 of this paper.

11. In preparing this research paper, the authors have had significant regard to the views of the investment community. Equity markets are continually aiming to arrive at a share price that reflects the present value of a company's future earnings. Investment analysts have been able to provide interesting insight into how they use the information in financial reports, and how they form an overall picture of an entity's value to contribute to an investment decision or recommendation. The authors believe that this perspective brings additional colour to the debate that considers how the accounting requirements could be improved to better serve the needs of users.

Background

Key requirements of IAS 36

12. IAS 36 seeks to ensure that an entity's assets are not carried at more than their recoverable amount, i.e. the higher of fair value less costs of disposal and value in use. For goodwill and certain intangible assets an annual impairment test is required, and in other cases entities are required to conduct impairment tests where there is an indication of impairment. Where an asset does not generate cash inflows that are largely independent of those from other assets, which is inherently the case for goodwill balances, the test may be conducted at a cash-generating unit (CGU) level.

What are the key elements of the current impairment test?

13. Generally, assets and CGUs are tested for impairment when any indicators of impairment are noted, giving consideration to both internal and external factors. Impairment is considered at an individual asset level, unless the asset does not generate independent cash flows, in which case impairment testing is completed for the CGU to which the asset belongs. Intangible assets with an indefinite useful life, those that are not yet available for use, and CGUs that contain goodwill must be tested for impairment annually regardless of the absence of indicators. The impairment test involves comparing the higher of (1) FVLCD or (2) ViU with the carrying amount of the asset, CGU or group of CGUs to which goodwill is allocated. Where there is a deficit in carrying amount, the carrying amount is reduced to the recoverable amount.

What are the key elements of the current impairment test that cause issues?

14. The specific aspects of the standard identified as a cause of concern in the IASB's post-issuance review are included below, along with a description of the broader implications.

Feedback received	Implication
a. Impairments of goodwill are being 'shielded' by unrecognised headroom and/or additional goodwill generated internally through management's efforts and investments.	Impairments of specific businesses are not recorded in financial statements in the period that they occur, leading to an overstatement of profit and net assets.
b. The process of allocating goodwill to cash generating units requires judgement and the standards provide limited guidance. Subsequent acquisitions and restructurings may render the actual composition of goodwill difficult to reconcile.	Limited guidance leads to diversity in practice, which reduces comparability.
c. Mandatory determination of recoverable amount is time-consuming and costly with no real practical benefit.	Entities spend time and money on a compliance process that has no alternative value to the business.
d. There is confusion among users around the differences between ViU and FVLCD, and the circumstances in which each model is most appropriately applied.	Users of the financial statements do not understand the implications of the differences between the two methods, and accordingly disclosure of the method applied does not provide meaningful information.
e. The requirements underlying the ViU model are reactive and driven by anti-avoidance concerns, which has resulted in a ViU concept that is far removed from its conceptual foundations.	The exclusion of future restructurings from ViU – as per the requirement of IAS 36 – does not reflect how acquirers price prospective transactions, nor necessarily the manner in which the entity itself views the business. Furthermore, the requirement to use a pre-tax discount rate is not reflective of how practitioners derive appropriate discount rates. As a result, the outcome of the impairment testing process does not reflect either a true business valuation or management's internal view of value
f. The separation and valuation of intangibles in an acquisition is a costly process and does not provide valuable information.	There is an argument that separate recognition is of limited (if any) utility unless there is a market for the assets. Users place little credence on the value of intangible assets such as brands or customer lists.

Current status of the IASB project

15. In April 2018, the IASB tabled 'April 2018 ASAF Agenda Paper 5 – Goodwill and Impairment' which set out a number of recommendations in respect of impairment testing[1]. In June 2017 the European Financial Reporting Advisory Group (EFRAG) published a discussion paper titled 'Goodwill Impairment Test: Can it be improved?' which debated the merits of a number of proposals put to that group. The proposals from these two bodies set out the basis of discussions with stakeholders in phase 1 and subsequently informed detailed outreach in phase 2.

16. In a meeting on 23 May 2018, the IASB Staff decided to pursue including in the ViU calculation expected cash flows from future restructuring and future performance enhancements that management is more likely than not to undertake. While it appears the original intention of the IASB's project was to amend IAS 36 minimally, the need to reconsider impairment as a whole has become increasingly evident.

17. Since that meeting, the IASB has finalised its discussion on the objectives for the next stage of this research project and has directed the staff to perform additional work to explore possible improvements to disclosures about acquisitions and possible simplifications to the accounting for goodwill and targeted improvements to the impairment test. As part of the October 2018 meeting the IASB reviewed a draft outline of a Discussion Paper and provided feedback for the staff to consider. The final discussion paper is due to be released in the second half of 2019.

The research process

Research scope and focus

Phase 1

18. During 2018, the Australian Accounting Standards Board (AASB) oversaw the preparation of a paper by the authors summarising feedback from targeted outreach conducted with preparers and analysts in Australia regarding the following:
    a. the current impairment testing requirements in IAS 36 for goodwill and other non-financial assets; and
    b. the proposed approaches for goodwill impairment testing recently considered by the IASB and the EFRAG.

19. Through the process further explained below, the authors presented respondents with a list of the proposed amendments to IAS 36, and requested feedback on the current impairment test, pain

[1] 'ASAF' refers to the Accounting Standards Advisory Forum, the members of which provide advice to the IASB on standard-setting issues.

points, and whether, in the respondent's opinion, each proposed amendment would result in more useful information in the market. An extract of the background information provided to respondents to facilitate these discussions is included as Appendix A to this document.

20. Ultimately the paper, entitled 'Feedback from preparers and analysts on Goodwill and Impairment', concluded by making the following recommendations.
    a. IAS 36 be amended to permit the following in respect of the ViU calculation:
        i. inclusion of cash flows from future restructurings and enhancements; and
        ii. use of a post-tax discount rate.
    b. Further research be conducted into:
        i. the allocation of goodwill amongst CGUs for impairment testing purposes; and
        ii. developing an approach for impairment testing that would result in entities recognising impairments on a more timely basis based on the methodology analysts use to assess impairment.
    c. Further research be conducted on disclosures related to impairment testing of goodwill and other non-financial assets.

The Board's response to the paper[2]

21. The Board decided on the following possible narrow-scope amendments to IAS 36 that could be raised with the IASB, pending further research:
    a. a single, discounted cash flow methodology for both ViU and FVLCD, including cash flows from future restructuring and enhancements, but with management assumptions for ViU and market-participant assumptions for FVLCD; and
    b. disclosure of the post-tax discount rate rather than the pre-tax discount rate.

22. Although it was not initially an area of focus during Phase 1, discussions with analysts and preparers frequently touched on the market's perceived ability to anticipate impairments before recognition in the entity's financial statements. In response to this finding, the Board requested further research into methods to recognising goodwill impairment on a more timely basis, considering feedback from analysts and investors in relation to the methods they adopt and the level at which goodwill is allocated for impairment testing purposes.

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[2] The minutes for the June 2018 AASB Board meeting can be obtained from:
< https://www.aasb.gov.au/admin/file/content102/c3/M165_AASBMinutes14June2018-unsigned.pdf>

23. In addition, the Board requested the next phase of work address potential additional disclosure requirements such as a sensitivity analysis for all impairment tests and greater clarity on key assumptions. This scope of work became the foundation of phase 2 of the project.

Phase 2

24. The aim of phase 2 was to bring the views of the analyst community together to further assist the AASB in forming their recommendations to the IASB. A key focus of the outreach was a follow up to the discussions outlined above in paragraph 22 – to understand the different valuation methods used by analysts and whether the financial reporting model could incorporate such methodologies. It was expected this could not only result in more timely recognition of impairments but also aid in streamlining a user's evaluation of a business' value.

25. Public workshops were held in mid-January 2019 in Melbourne and Sydney. At those workshops, attendees discussed their views on:
    a. The purpose of impairment testing
    b. External assessments of value
    c. Cash-generating units
    d. Disclosure
26. Subsequent to the workshops, telephone interviews were conducted with a small number of analysts who had expressed an interest in participating but were unable to attend the sessions.

Research Methodology

The conclusions of this Report are based on interviews with relevant stakeholders who are known to apply, analyse, audit, or otherwise use the impairment testing model outlined in IAS 36.

Phase 1

27. The authors made direct contact with a range of stakeholders, including individuals identified by the AASB Staff. The authors sought feedback from a diverse range of respondents including preparers, analysts, investors, regulators and auditors. Initial contact was made with the individuals nominated and the background information document included in Appendix A was provided. For those who indicated a willingness to participate, a time was arranged in which they and the authors joined a teleconference to discuss the research topics in Appendix A.

28. The phone calls were held between 23 May and 1 June 2018 and were attended by one or both of the principal authors. The conversation was guided by the background information document, however the discussions were wide ranging and in many cases not limited to the questions as

asked. Furthermore a number of respondents did not express views on all of the items included in Appendix A. Rather, respondents were encouraged to speak freely about their experiences with impairment testing and any ideas for improvement. The authors considered it important to document any suggestions made by the respondents outside the proposals already put forward by the various international bodies, so as to identify any trends or possible alternative inclusions in the final paper.

29. One respondent was not available for a phone call, however provided feedback on the topic via email.

Phase 2

30. Relevant stakeholders were identified through a consolidation of three key processes.
    a. The AASB and staff's existing networks, including those individuals who contributed to the phase 1 research.
    b. The authors compiled a LinkedIn article highlighting the aim of the research and inviting attendance at workshops, and shared it within their networks, requesting re-shares with the aim of reaching a wider audience.
    c. The AASB staff published a variation of the above mentioned LinkedIn article in the AASB Weekly News email on two occasions.

31. The authors made a conscious effort to engage with a diverse range of respondents; however the aim was to obtain feedback primarily from members of the analyst and investor community. Refer to paragraph 36 below for details of attendees by representative group.

32. Prior to the meeting, attendees were provided with a document which outlined the questions to be asked on the day – included as Appendix C – and were encouraged to consider their responses in advance. As part of the two workshops, the questions were asked in consecutive order and follow-up questions asked for clarification where necessary. With permission from all attendees, the sessions were recorded for report-collation purposes only.

33. The AASB was represented by Board and staff members at each of the workshops.

34. One respondent was not available for a phone call, however provided feedback on the topic via email.

Population analysed

Phase 1

35. In gathering feedback during phase 1, the authors interviewed the following:

Representative group	Total participation
Analysts or shareholders	9
Government	1
Valuation specialists	4
Preparers	5
Regulator	1
TOTAL	20

Phase 2

36. Invitees and attendances at the face-to-face workshops and one-on-one calls were as follows:

Note: The numbers below exclude the principal authors.

Representative group	Total participation[3]
Accounting firms	5
Analysts	9[4]
Government	1
Preparers	4
Tertiary education	1
TOTAL	20

Research limitations

[3] Does not include two AASB Board members participating in the capacity of board members, and one AASB Board and one AASB staff member participating in the capacity of workshop facilitators.
[4] Includes one AASB Board Member participating in their capacity as an analyst.

37. Limitations of this report relate to challenges in engaging with a sufficient number of relevant stakeholders and complications relating to the nature of the issues discussed throughout our review.

38. The response to invitations sent was relatively low, specifically from the analyst community. This has been attributed to, among other factors:
    a. the search strategy employed to identify participants in both phases was limited, being primarily based on the AASB's existing networks and relationships;
    b. the timing of the outreach sessions for phase 2 – invitations distributed in mid-December for workshops to be held in mid-January – meant that many respondents were on summer holidays when the invitations went out, when the workshops were held, or both; and
    c. limitations on time and resources meant that workshops were planned for face-to-face sessions in both Sydney and Melbourne. Despite offering teleconference facilities for both sessions, no responses were received from participants outside of these geographies.

39. Another fundamental challenge the authors faced is the inherent limitation on participants' responses to issues surrounding impairment testing because of the difficulty of controlling the many other factors that can affect a business' share price at any given time, the ability of analysts to make accurate predictions of business performance and the quality of disclosures available to users of the financial statements in making their assessments.

Next Steps

40. The AASB will communicate the research outcomes and their recommendations to the IASB and looks forward to working with them on seeking to improve the impairment testing requirements.

Recommendations to the IASB

Purpose of impairment testing

41. Update the impairment testing requirements to include greater clarity as to the purpose of the impairment test, including guidance on what the test is and is not expected to achieve.

The approach to impairment testing

42. Perform further research on a modified single model approach, with specific amendments to:

a. remove the existing restrictions on ViU regarding future restructurings and asset enhancements and replace those restrictions with guidance on when it would be reasonable to include such cash flows in an impairment model,
b. allow the use of a pre-tax discount rate;
c. reserve use of the FVLCD model for assets expected to be disposed of within the following financial reporting period; and
d. permit the use of market-based assumptions within the cash flow model such as a forward curve for commodity prices and foreign exchange rates.

Allocation of Goodwill to CGUs

43. Enhance the functionality of the standard in respect of allocation of goodwill to CGUs. Perform further research on how the current requirements align with how an entity's results are viewed and decisions made internally. In light of those results, redraft the existing guidance as to what constitutes a CGU or relevant group of CGUs to clarify and provide support to this objective.

Disclosure

44. Given the importance placed by users on disclosure of assumptions, implement the following enhanced disclosure proposals:
    a. further guidance on the definition of a key assumption; and
    b. qualitative disclosure of expected synergies supporting the premium paid on acquisition.

Summary of feedback received

Note to the Board: Currently the feedback is summarised for two phases separately. In the final research report we aim to combine the findings of phase 1 and 2 and relegating specific findings to the appendices

Phase 1

Are impairments too little too late?

45. Generally, respondents in all categories acknowledged that impairments appear to be recorded after the market recognises the issues and adjusts share price accordingly. Only one analyst offered an alternate view: that the continuous disclosure requirements in Australia adequately protect investors in ASX listed companies from the risk that impairments are disclosed to the market 'too late'.

46. However, five respondents from both the preparer and analyst categories separately indicated that impairments – when they are recorded – are not 'too little' but are taken heavily, on the basis that partial impairments are rarely seen, meaning that if and when an impairment is required the full amount of goodwill will be written off, regardless of the outcome of the model. Two factors were offered as explanation for this:
    a. impairments often have no effect on management performance indicators; and/or
    b. management knows the outcome of an impairment test before it is performed and is not afraid to report an impairment, because in recent years the market has not been seen to react negatively to such announcements, indicating that, as mentioned above, the impact may have already been taken into account by the market.

47. Several analysts also highlighted that in years of leadership change, organisations can be seen to 'take a bath' and record impairments more heavily than necessary. They suggest the prevalence of this phenomena reflects a combination of incumbent management historically safeguarding against accusations of poor decision-making, and new management being motivated to 'start with a clean slate'. Impairments are also more common when an industry-wide event occurs and other entities are seen to be recording write-offs.

48. One analyst commented that generally, aside from 'big bath' years and extreme events, management's KPIs result in motivation to delay or smooth impairments over a longer period. Others however agreed with the sentiment above that management KPIs tend to exclude 'one-off' or 'non-cash' items, and accordingly management are not genuinely held accountable for impairments. Another explained that it is much more important to get the impairment 'right' rather than to record it earlier, especially in cases where the indicators of impairment can be attributed to a timing issue and there is subsequently a recovery – in these cases it would have been better to wait.

49. Several of the respondents acknowledged that the two issues at play appear to be that the impairment testing process needs to be simplified, and that goodwill is being impaired too late. Respondents recognised that these issues are mutually exclusive and it was difficult to come up with suggestions that addressed both of these concerns.

Is 'shielding' really an issue?

50. Goodwill recognised in a business combination represents the future economic benefits – or 'synergies' – arising from other assets acquired that are not otherwise identified and separately recognised. By nature, goodwill does not generate independent cash flows, therefore, it will always be tested for impairment as part of the CGU or group of CGUs that are expected to benefit

from the synergies identified at the time of acquisition. The standard requires that goodwill be allocated at the lowest level within the entity at which the goodwill is monitored for internal management purposes, and not be larger than an operating segment determined in accordance with IFRS 8 *Operating Segments*.

51. A universal discussion point in the goodwill and impairment debate relates to the question of whether testing for goodwill impairment at a CGU or group-of-CGUs level has the effect of 'shielding' companies from impairments that ought to be taken. During phase 1, responses to this were mixed; some respondents acknowledged this view while others asserted that shielding becomes irrelevant in a truly integrated business. One preparer challenged the notion that impairments are being 'shielded' by internally generated goodwill from management's activities post-acquisition and questioned how management would differentiate between that and the actual synergies that the goodwill represented in the first place. It has also been observed that although analysts have access to information at the segment level rather than the detailed CGU-level information used by management, the market is still able to anticipate impairments at the CGU-level, which is arguably contrary to the concept of shielding and more indicative of a difference in assumptions used.

52. Three respondents – one preparer and two analysts – separately suggested that impairment testing should be required at a level other than the operating segment, indicating this is especially important where one business is acquired for strategic purposes and subsidises another business in a different segment. Practically, this might result in goodwill being tested for impairment at a level higher than an operating segment. Another respondent stated that the requirement to test the goodwill at the level which management monitors goodwill for internal reporting purposes[5] is vague and difficult to apply.

53. A number of respondents cited statistics regarding the likely 'failure' of a business acquisition. The citation varied, but the consensus was that between 50 and 90% of all business acquisitions would 'fail' in the five years following the transaction using standard business metrics. However, we do not see a similarly high rate of impairments in the five years following a transaction. Many respondents suggested that individual businesses were being tested immediately post acquisition, and then on an ongoing basis as part of larger CGUs that have headroom, creating an instant 'shield' for the newly acquired business in case it did not perform as expected.

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[5] As prescribed by IAS 36.80(a)

54. Based on these discussions, it appeared that the real issue with 'shielding' relates to the fact that the Standard can be interpreted in a way that allows goodwill to be allocated at the time of acquisition to a CGU with existing headroom, therefore allowing entities to 'future-proof' their results. This was a key discussion point in phase 2 and is discussed below commencing from paragraph 102. These observations formed the basis of our phase 1 recommendation to conduct further research into the appropriate allocation of goodwill.

The actual and perceived value of impairment information to the market

55. Opinions on this topic were varied, and many analysts explained that under the existing requirements, recording an impairment is treated as a confirmatory event rather than providing new information to the market. Analysts explained that at a high level there are two key ways of assessing results, based on either assets or available cash flow information. Most analysts interviewed use the cash flow approach along with their observations of the issues facing the industry as a whole and therefore place less importance on goodwill and impairment disclosures, with one analyst labelling them ‘yesterday’s news’.

56. From a preparer’s perspective, there was little consistency in the perception of analyst’s interest in an impairment balance or disclosure. One preparer’s expectation was that impairment of goodwill is totally disregarded, and that analysts either exclude goodwill overall or disregard impairment as a non-cash item. Interestingly, a number of analysts discredited this, saying that even though impairments rarely come as a surprise to a savvy analyst, an amount sitting in impairment – and similarly other ‘non-cash items’ such as depreciation and amortisation – are a genuine business cost. If these adjustments imply the value is being worn out, then there is a genuine expense to the business which should be recorded in the profit or loss, and not below the Earnings Before Interest Tax and Depreciations and Amortisation (EBITDA) line. These analysts elaborated that claims by management that impairments are a ‘non-cash’ item are not entirely accurate, as the goodwill recognised in balance sheets was often acquired using cash and if that value is no longer supported, then there was a genuine cash outflow occurring in the past that has not provided the business with a commensurate benefit.

What are the frustrations and limitations identified in current impairment testing?

Requirements for calculating ViU are restrictive and driven by anti-abuse concerns

57. Generally, preparers asserted that the requirements underlying the ViU model are reactive and driven by anti-avoidance concerns, which has resulted in a ViU concept that is far removed from

its conceptual foundations. Both preparers and analysts recognised there may be situations where the value of a certain asset is greater to a business than it is to the market, which is why ViU continues to be used despite these frustrations.

EFRAG proposal: Allow consideration of cash flows from future restructurings in the ViU

58. While preparers fully supported this proposal, analysts were more wary. It was generally agreed among preparers that that the artificial adjustments currently required to remove restructurings or asset enhancements from a ViU model are arbitrary and do not allow management to present an accurate picture. Where analysts disagreed, it was on the basis that the cash flow impact of the restructures can be unrealistically positive and the value accretive nature of restructurings is often not borne out in practice. Respondents did not suggest a methodology for assessing the likelihood of the predicted cash flows.

59. Nonetheless, all respondents were consistent in agreeing that if this proposal was adopted there should be strict safeguards, and auditors should be prepared to robustly challenge the inputs. This suggestion was explored again in phase 2, with similar results. Refer to paragraph 96 below for the discussion.

EFRAG proposal: Allow the use of a post-tax rate in the ViU calculation

60. Respondents fully supported allowing the use of a post-tax discount rate. It was widely acknowledged that the existing requirement cannot be applied in practice – primarily because valuation experts cannot readily derive pre-tax discount rates and accordingly preparers have been forced to develop practical work-arounds to address the requirement. Respondents explained that the only practical application of the pre-tax requirement in IAS 36 is to complete the test on a post-tax basis and then derive a notional pre-tax rate to be used only for disclosure purposes.

Impairment testing is not performed consistently between entities

EFRAG proposal: Allow only a single calculation approach

61. Although EFRAG proposed that only one approach (either ViU or FVLCD) be allowed to determine the recoverable amount of an asset or CGU, the majority of respondents expressing a view in phase 1 did not support this on the basis that both ViU and FVLCD are considered relevant in the process. In addition both are adopted widely meaning the removal of either one would attract

significant opposition. Interestingly participants in phase 2 of the project were more responsive to this suggestion, refer to the discussion below commencing at paragraph 90.

Valuation and recognition of intangible assets in an acquisition is highly judgemental

IFRS Proposal: Allow indefinite-lived intangible assets to be included within goodwill

62. There were mixed responses to this proposal, however most respondents who had an opinion on this were supportive of retaining the current requirements of IFRS 3.

63. Two respondents outlined that separate recognition is a long and difficult process and results in debates with auditors, regulators and valuers. From an analyst and investor perspective, the transaction value is of most interest but the assumptions underlying the allocation to tangible and intangible assets require much judgement. While for tangible assets this can be a straightforward process, for intangibles the value to be assigned can become highly judgmental.

64. A number of respondents believed separate recognition is valuable for certain types of assets – referencing patents and brands – but for others – customer lists being the most commonly cited example – separate recognition does not provide meaningful information. One analyst suggested that the standard requires certain intangibles to be split out ‘as if they mean something’, with the clear implication that in their opinion the split amongst intangible assets was not meaningful.

65. One of the analysts interviewed suggested that more disclosure should be made of the valuation techniques used to arrive at these amounts.

66. One respondent agreed with the IFRS proposal of allowing indefinite-lived intangible assets to be included within goodwill and explained that that under the current requirements, an entity that grows organically will show higher profitability than an identical organisation that grows through acquisition due to the amortisation charge on acquired intangibles.

67. There were no recommendations to the Board in light of these results and therefore this topic was not explored further in phase 2.

Phase 2

What is the perceived purpose of impairment testing?

68. This is arguably the primary question underpinning the debate at an international level, albeit one that has not been explicitly discussed in much of the formal research to date. In light of this the authors asked participants about their perception of the purpose of the impairment test.

69. On one hand, the disclosure requirements currently being considered by the IASB as a solution imply that many consider the impairment test a mechanism for assessing management's decision making in respect of past acquisitions. In contrast, others suggest that the impairment test does not and should not explicitly look at goodwill from previous individual business acquisitions, but instead it contributes to a conclusion as to whether the overall balance sheet is recoverable. In other words, recording an impairment expense is unnecessary when the value of the asset is supportable within the balance sheet as a whole.

70. The current impairment testing requirements fall in the middle ground between these two views. The requirement to test at a CGU level provides impairment information at a level more granular than that of the overall balance sheet. That is, the test is aimed at determining whether a CGU asset's overall value is recoverable. Furthermore, where a past individual business acquisition is considered a CGU in its own right, the impairment testing of that CGU may provide information as to the outcomes from that business acquisition. However, where some of the goodwill has been allocated to other CGUs, or the business is tested within a larger CGU, the information loses its direct relationship to the economics of the underlying business acquisition.

71. Analysts who had strong convictions on this topic all broadly explained that the test should not be used as a mechanism for assessing the relative success of a business acquisition. Having said that however, several analysts independently explained that the balance sheet overall is interpreted as the store of past management decisions or a historical 'scorecard' of assessing management's ability to effectively allocate resources. In combination with tangible value, it is representative of the price paid by management for assets. The return on invested capital from these purchases is one way to measure the success of management decisions. A number of participants commented that from their perspective the balance sheet is the third most important financial statement, with information from the profit and loss statement and cash flow statement being considered more informative.

72. This aligns with observations made during phase 1 outreach. While preparers of financial statements tend to assume that analysts disregard goodwill impairment as a non-cash item – and normalise it out of metrics such as earnings per share (EPS) – analysts consistently discredit this concept, explaining that goodwill exists because of a historical cash outflow and therefore an impairment indicates a devaluation of something 'purchased', and should be treated with sufficient gravity. This was consistent in both phase 1 and 2 feedback.

73. To the suggestion that impairment should instead be considered in a broader sense, as an overall reasonableness test, rather than being acquisition-specific, almost all participants disagreed, sharing the conviction that this method would allow ineffective acquisitions to be supported by subsequently internally-generated goodwill and other, more successful, acquisitions.

74. When responding to the question of what the test does or should represent, participants also offered views on what the test does not or should not represent.
    a. Given that the valuation process underpinning the impairment test can only result in decrements, it cannot be used as a proxy for measuring success. Recognition of an impairment can indicate failure and absence of an impairment can indicate a business is in line with predictions made during the pricing process, however fundamentally it cannot measure success.
    b. Despite current accounting standards implying that the amount determined during an impairment testing exercise should represent 'fair value', all preparers interviewed indicated that this is not reflective of practice. Full business valuations occur as part of business acquisitions, and in contrast, the impairment model is, at most, a determination of a recoverable amount, not a valuation exercise, and should not be treated as such.

75. Based on the feedback received it is clear that there is wide diversity in opinion on this topic. For this reason, clarification of the purpose, and what it is – and is not – expected to achieve has been included as a recommendation later in this section.

76. During this part of the discussion, several participants discussed the topic of goodwill amortisation. Whether goodwill should be amortised or subject to impairment testing and the appropriate treatment of internally generated intangibles has been a controversial issue.

77. While there is undeniably a school of preparers who support the amortisation argument, it was often noted that the purpose of acquiring goodwill was to support the growth of a business and it could not reasonably be presumed that this asset wears out over time. Furthermore, participants who believed the asset did wear out over time were sceptical that it wears out evenly over time, which is arguably the implication of an amortisation process. Where preparers supported the argument, their reasons were based on conceptual arguments – for example because goodwill is replaced by internally generated goodwill over time – and/or because information provided by an impairment-only approach has limited use – rather than because of a strong conviction that amortisation with impairment would provide the market with better information than an impairment-

only approach. Some analysts explained that knowing management's assessment of the useful life of goodwill might be informative.

78. **Recommendation to IASB: Update the impairment testing requirements to include greater clarity as to the purpose of the impairment test, including guidance on what the test is and is not expected to achieve.**

How should the impairment test be performed?

Information used by analysts

79. Preparers and analysts have long noted that in many cases the share market does not respond when an impairment is announced, which arguably implies that analysts are able to anticipate impairments and adjust projections accordingly before they are recognised. The authors were particularly interested in analyst's perception of this phenomenon.

80. In opening this discussion, one analyst offered a helpful explanation of the different roles of buy-side and sell-side analysts in assessing value of investments. It was explained that a sell-side research analyst's role is to follow a number of companies, generally within a particular industry and provide regular updates to clients. This process involves modelling forecasted financial results and gathering information from customers, suppliers, competitors and other sources with knowledge of the industry. Those pieces of information will be collated to determine an estimated asset value. To round out this discussion, it was explained that buy-side analysts generally work for institutional investors such as superannuation funds. These individuals similarly perform research, and a key input to that research will be the information provided by sell-side analysts. The information will be used to make targeted and proprietary recommendations to the managers of the fund that employs them which will also give consideration to how well the investment coincides with the strategy of the individual fund.

81. Both buy side and sell side analysts are continually making judgments about the value of listed companies based on the information at hand. These judgments take into account a wide range of factors and possible asset write-downs are only one component of the many considerations that ultimately influence a company's share price.

82. The authors followed up with questions of how analysts complete their assessments including the inputs that are used, where they are sourced and what qualitative information is overlaid. Participants provided a wide range of responses, however the following overarching themes emerged consistently.

83. When assessing performance of a business, it appears that net operating cash flows and earnings (EBIT or EBITDA) are favoured in the first instance and the overall valuation model can be based on the Capital Asset Pricing Model (CAPM), Discounted Cash Flow (DCF) analysis, Price/Earnings (P/E) ratio or a multiple of Earnings Before Interest Tax Depreciation and Amortisation (EBITA). For forecasting purposes, inputs can include both the entity's disclosed assumptions – such as discount rate and – and the analyst's own expectations. Where an input is externally available – for example a commodity price – in the absence of convincing information to the contrary, the analyst will presume the external information more relevant than the assumption disclosed by the entity. In most cases the effect of items such as commodity prices and foreign exchange rates in forecasted cash flows will be considered by analysts having regard to the forward rates, whereas specifically in respect of translating resulting balances from a foreign currency, IAS 36 requires the use of a spot rate.

84. Impairment information disclosed and/or recognised in the financial statements is used by analysts as a component of the considerations that go into their assessment of value. As mentioned above, the analyst can apply their specific adjustments to management assumptions to create their own proprietary valuation for the asset. Where disclosed, the assumptions and methodology disclosed in the financial statements are useful for identifying points of difference.

85. In certain industries, such as extractives, assessment can be completed at a relatively disaggregated level, such as an individual mine site. This is facilitated by disaggregated supplementary information – often available as part of the operational reports or investors presentations – being available at the same level as the CGU analysis. In other industries often the CGU analysis, segment disclosures and supplementary information do not align in a meaningful or useful way, leaving it necessary to default to a segment-level approach at a minimum.

86. Analysts indicated that their activities range from full quantitative style analyses – for example on specific mining projects – to more limited qualitative assessments. The activities undertaken vary according to:
    a. the size of the investment house and the portfolio of investments followed;
    b. the purpose (buy-side or sell-side analysis); and
    c. the size of the entity under consideration.

87. The authors asked follow-up questions regarding other factors that influence the view of value taken by analysts. In addition to quantitative calculations, a substantial amount of qualitative assessment is overlaid, including the following:
    a. discussions with management, market and other stakeholders;

b. third-party research such as channel checking[6];
c. management's perceived credibility, which can be eroded by poor decision-making or ambiguous declarations; and
d. directors' reputations, which can be affected by a history of unsuccessful acquisitions.

88. Although one of the goals of the research was to establish if analysts' feedback in this area could offer insight into potential amendments to IAS 36, the authors cannot immediately see how these additional qualitative factors can be built into the accounting requirements. Analyst's assessments primarily centre on re-estimation of future cash flows and – with the exception of any qualitative overlay that is applied – any differences arise between that and the entity's own result are most commonly due to use of different assumptions, discussed further in the next section.

89. Analysts also offered a number of explanations as to why the assumption that the market can 'predict' impairments may be flawed.
    a. It is not possible to assess the opposite outcome - i.e. where the market predicts an impairment that does not occur. Therefore the number of confirmatory results may be misleading.
    b. A period of share price stability after an impairment announcement should not be taken to mean that the impairment was expected. At most this should be interpreted as an event not impactful enough to affect price, in the context of all other factors.
    c. Both the impairment test and lodgement of full financial statements are only required once a year, and therefore it is expected that the market would be more responsive to information released during the intermediate periods. Two analysts separately articulated that there is more art than science in being able to value an impairment as quickly as it arises.

Accounting Models – Value in Use versus Fair Value Less Costs of Disposal

90. In practice, many companies use a discounted cash flow calculation (DCF) to determine the recoverable amount under both the FVLCD and ViU methodologies, the difference being that FVLCD uses a market participant perspective and ViU uses a management perspective.

[6] A channel check is third-party research on a company's business based on collecting information from the distribution channels of the company.

91. The merits of each method were discussed widely in the workshops. FVLCD can be based on transaction prices in the market when available – enhancing its reliability – although it was acknowledged that these are not generally accessible. It is also often used because it allows an entity to consider the impact of a future restructuring to which a preparer is not yet committed to under other thresholds[7] or the impact of asset enhancements.

92. The use of ViU is intended to reflect the value expected to arise from continuing use of an asset and its disposal in the future and not the value expected to arise from an hypothetical immediate sale which management does not intend to make. Nonetheless, such an approach is often criticised due to the subjectivity of the assumptions used by preparers. It is argued that ViU model can be prepared in a way that could delay the recognition of impairment value.

93. Broadly, feedback on the suggestion to remove one option was consistent with conclusions reached in phase 1. There is the perception that too often in practice FVLCD is currently used to get around the restrictions in ViU, but insufficient effort is applied to determine whether the output is genuinely representative of fair value. Others challenged this however, noting that in the absence of an active market, independent verification would be difficult to obtain.

94. There was support among this group for requiring or allowing only one method on the basis that it could simplify the impairment test. The authors learned that analysts rarely distinguish between information provided under each model and preparers found the ViU model unnecessarily restrictive in its application. However most participants supported redefining the base principles around ViU rather than removing the ViU option all together.

95. Overall, if the standard were to prescribe a single measure, instead of IAS 36's 'higher of' method, participants agreed that further research would be required to determine its optimum form. Specific suggestions are outlined below, all of which are consistent with preliminary feedback received in phase 1.
    a. The standard makes an arbitrary distinction between the methods, emphasised by the restrictions on ViU. It is expected that where a discounted cash flow model is used the methodology should be the same, the only difference between the two would be present market conditions, which should be factored in for disposal purposes only.
    b. If the restrictions on ViU were freed up so that management could use its genuine business assumptions, the FVLCD option would become irrelevant in most cases. Where management intends to keep using an asset, ViU is the most appropriate set

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[7] IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* contains strict guidance clarifying when an entity is considered, for accounting purposes, to be committed to a restructuring.

of assumptions to use and FVLCD should be reserved for those assets genuinely on a disposal plan.

96. In phase 1 the authors explored a proposal published by the EFRAG which would allow cash flows from future restructurings in ViU calculations. Refer to the detailed discussion above at paragraph 58. Consistent with phase 1, in phase 2 responses were similarly mixed.

97. In general, where analysts disagree with this proposal it is on the basis that the cash flow impact of the restructures can be unrealistically positive and the value accretive nature of restructurings is often not borne out in practice. One analysts noted that in practice, while analysts factor expected impairments into their view of value earlier than they occur, the opposite is true for restructurings. That is, the positive cash flows attributable to a "cost-out" project are only considered by analysts when they have been proven in practice, rather than when they are announced.

98. Nonetheless, all respondents agreed that adoption of this proposal would require strict safeguards. For example, the 'highly probable' guidance in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* paragraph 8 could be used as a basis for determining management's commitment to the restructure, as follows:

> *For the restructure to be highly probable, the appropriate level of management must be committed to a plan to implement the restructure, and an active programme to complete the plan must have been initiated. In addition, the restructure should be expected to qualify for recognition under para 72 of IAS 37 within one year from the testing date, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the restructure is highly probable.*

99. Both preparers and analysts alike warned that terms such as 'highly probable' and 'virtually certain' have limitations in practice due to an inconsistent understanding and application of the meaning of such terms.

100. As mentioned previously, during the workshops the authors learned that analysts do not place value on the disclosure of management's distinction between ViU and FVLCD when making their assessments. Similarly, in each session the analysts were also asked if they themselves make a distinction between 'current use' and 'highest and best use' when making their external assessments. A number of analysts gave examples of scenarios where this can be relevant, for example a retailer with modest revenue located in a prime real estate position, but no intention to realise the value in the property. This has become increasingly relevant following the recent explosion of online retailing. Analysts consistently explained that unless they can identify a

catalyst for this alternative 'highest and best use' value to be unlocked within the investment holding period – generally 3-5 years – it will not be factored in to their assessment of value.

101. **Recommendation to IASB: Perform further research on a modified single model approach, with specific amendments to:**
    a. **remove the existing restrictions on Value in Use (ViU) regarding future restructurings and asset enhancements and replace those restrictions with guidance on when it would be reasonable to include such cash flows in an impairment model,**
    b. **allow the use of a pre-tax discount rate;**
    c. **reserve the use of the Fair Value Less Costs of Disposal (FVLCD) model for assets expected to be disposed of within the following financial reporting period; and**
    d. **permit the use of market-based assumptions within the cash flow model, such as forward curves for commodity prices and foreign exchange rates.**

At what level of aggregation should the test be performed?

102. In a similar manner to phase 1, participants acknowledged the 'shielding' effect, explaining that in pure financial accounting terms shielding contradicts the principle of not recognising internally generated goodwill and it therefore allows a 'backdoor method' of recognising internally generated goodwill up to the point of goodwill acquired. Those who took this view however also recognised that shielding is a by-product of the integration process and therefore is expected as part of owning a portfolio of businesses.

103. In response to the questions raised, the authors learned that while in phase 1 some respondents independently suggested that goodwill should be tested at a level higher than the CGU – essentially the segment level discussed in paragraph 50 – in phase 2, participants across all categories were generally supportive of the current level of allocation. Their reasons were that a more detailed view – for example, to force testing at the more-disaggregated individual CGU level – would be burdensome to complete and potentially require arbitrary allocations to some business units that genuinely rely on others to derive results. While a more aggregated view – for example at the reportable segment level – would likely emphasise the perceived shielding effect outlined above and result in less useful information in the market.

104. In addition, it was commonly accepted that it is normal for a business to be acquired for strategic purposes and be subsidised by another group of assets. As an outcome of this, it is expected that businesses in isolation may be considered to perform 'poorly', however as mentioned above, in

the absence of other factors this is generally an acceptable by-product of owning a portfolio of businesses, and would not individually influence an investor's decision to buy or sell.

105. Interestingly, respondents' grievances with the current standard lie not necessarily in the methodology but in the application. It was widely agreed that the 'level that reflects the way an entity manages its operations and with which the goodwill would naturally be associated' – as currently prescribed by IAS 36, paragraph 82 – is conceptually the most effective level for testing. However, these comments were accompanied by a consensus that lack of clarity in the standard renders this requirement difficult to interpret and implement, requiring a high degree of subjectivity and resulting in diversity in application. Further, the concept of a 'cash generating unit' is considered an artificial construct and participants argued that the operating-segment-level-ceiling imposed by the standard is an anti-avoidance mechanism which forces a result that is not truly aligned with how the business is managed. This is despite the guidance permitting completion of the test at a 'group of CGUs' level, fundamentally intended to align with management's internal reporting.

106. It appears there is potential benefit in further research regarding the specific source of these grievances, to understand where the application of the standard results in a divergence from internal reporting, and on that basis, consideration of how the guidance could be re-drafted to support this intention. The standard could be both improved and simplified by fully aligning impairment testing with the level at which an entity's results are viewed and decisions made internally, and redrafting the existing guidance as to what constitutes a CGU or relevant group of CGUs to emphasise this objective. This has been included as a recommendation at the end of this section. Participants agreed that the main driver to allocate goodwill should be internal decision-making, which would be bespoke for each entity.

107. Additional suggestions for amendments to the standard were made, as follows.
    a. The standard is not written in a logical format and readers are required to revert to appendices to access key requirements. The authors note that it has been 21 years since the standard was introduced. If the standard were written in the language and format of more recent accounting standards, it may provide greater clarity.
    b. The standard includes guidance on using management-approved budgets, separate to the suggestion that added weighting must be given to external evidence and a holistic reading of the standard is required to fully understand both points.
    c. There is limited guidance on how an entity should factor risk into cash flow projections.

108. **Recommendation to the IASB: Enhance the functionality of the standard in respect of allocation of goodwill to CGUs. Perform further research on how the current requirements align with how an entity's results are viewed and decisions made internally. In light of those results, redraft the existing guidance as to what constitutes a CGU or relevant group of CGUs to clarify and provide support to this objective.**

Disclosure

109. Users are particularly interested in assessing the relative success of a particular business combination, understanding assumptions and projections that formed the basis for the valuation – and hence support the goodwill figure, and assessing the accountability of management.

110. According to the IASB's current work plan, the current focus of the goodwill and impairment project appears to lie in divorcing the impairment test from assessment of the perceived 'success' of an acquisition by exploring ways to improve disclosure requirements and enable investors to separately assess whether after the acquisition, the acquired business is performing as predicted.

111. Broadly, analysts supported the IASB's proposed disclosure of synergies – or in other words, justification of the premium paid – together with operational targets supporting the purchase consideration and, subsequently, a look-back on the actual performance. On this basis it has been included as a recommendation at the end of this section. This would, however need to be implemented with given consideration to some general concerns which were raised, relating to:
    a. commercial sensitivity, leading to a propensity to disclose generic information only;
    b. the need to achieve agreement with auditors on expected synergies, where disclosures will be based on these in the future;
    c. practicality of tracking acquisitions after a period of time, specifically where genuine integration has occurred; and
    d. relevance of information, particularly where the entity operates in a fast-paced industry, or is likely to be affected by digital disruption – there is little value in holding companies accountable to ventures they have already stepped away from.

112. Preparers suggested if this approach was adopted, the information may be most appropriately contained in the management commentary rather than in the notes to the financial statements. It is also evident that there will be no 'one-size-fits-all' approach and entities may appreciate flexibility to present the information in a range of different ways depending on the facts and circumstances of different acquisitions.

113. While these suggestions were met with openness from analysts, there was an overarching feeling that although more disclosure is always appreciated, it's not clear what effect these disclosures will have on the impairment test and whether it would result in a noticeable shift in behaviour or more timely recognition in the financial statements. The belief is that management would be just as reluctant to disclose negative results in the look-back analyses as they are currently about recording an impairment.

114. Preparers are conscious that existing disclosure requirements are significant and the cost of compliance has increased exponentially in recent years. There is a strong feeling that any increase in disclosures would need to be offset by simplification in the impairment test overall, which it was acknowledged could be achieved by the recommendation made in paragraph 101.

Disclosure of 'key assumptions'

115. During phase 1 research, the following feedback was received:

> *[Preparers should disclose] more about what constitutes a 'key assumption', with the specific observation being that the key assumptions are in fact the inputs to the statistic (i.e. why have certain growth and discount rates been chosen) rather than the statistic itself.*

Not surprisingly, analysts again explained that there is a consistent gap between their expectations and those 'key assumptions' that are actually disclosed. While discount rate and growth rate are often disclosed, the following were also offered by analysts as being considered 'key assumptions' that are not disclosed, where applicable:

a. EBITDA margin
b. Interest paid
c. Investment rate
d. Capital expenditure
e. Expected life

116. While these were offered by analysts as common omissions it was with the caveat that some of these may not at all be 'key assumptions'. Key assumptions are considered those to which the CGU or group of CGUs' recoverable amount is most sensitive. On this basis an input may not be 'key' because it is not relevant for the industry, or because it does not have a material impact across a large range. Further, the practice of identifying a few inputs and disclosing the impact in isolation, regardless of whether they are relevant, or not is rarely helpful. It is clear that preparers require further guidance to assist in determining what their key assumptions are, and to encourage

wider disclosure. For these reasons this has been included as a recommendation at the end of this section.

117. Interestingly, on the subject of requiring commentary as to why a particular value was chosen and how it was derived, analysts were less inclined to see the value. Again, it is clear that users will take any incremental information offered, however there was general consensus that to give real insight on complex inputs the level of disclosure will be significant and likely to contain commercially sensitive information.

118. Respondents generally considered that information as to whether an input was based on internal or external data was useful. They further noted that it would be particularly useful if entities disclosed any differences between the inputs they have used and publicly available data – for example, estimates of commodity prices.

119. Respondents noted that further consideration should be given to whether an entity should be required to make disclosures annually, or only when specific impairment risks had been identified.

Disclosure of sensitivity analysis

120. Key assumption sensitivity analysis is a current requirement for goodwill impairment testing. Under the current requirements, if a reasonably possible change in a key assumption would cause the CGUs or group of CGUs' carrying amount to exceed its recoverable amount, an entity is required to disclose[8]:
    a. the amount by which the recoverable amount exceeds the carrying amount;
    b. the value assigned to the key assumption; and
    c. the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the recoverable amount to be equal to its carrying amount.

121. In practice, many entities will fulfil this requirement by simply disclosing that there is sufficient headroom such that a reasonably possible change in assumption would not lead to an impairment. However it should be acknowledged that the term 'reasonably possible change' is highly subjective and difficult for a user to predict and/or interpret. It was consistently agreed that, combined with the skeletal approach to disclosing key inputs, the disclosure is poorly presented and lacking any real analytical value.

[8] IAS 36.134(f)

122. Given that the core definition of a key assumption refers to its sensitivity in the context of the calculation performed, a quality disclosure in this area would involve a preliminary exercise to determine the ‘key assumptions’, as outlined in the previous section and then disclosure of the amount by which each would need to change before an impairment was identified. This would give consideration to the flow-on effect of any individual change, for example, a sustained change in interest rates will affect the risk-free rate built into a discount rate and is also expected to have a commensurate effect on the price index which might underpin the growth rate used.

123. Analysts conceded that in order for this information to be truly useful, a fully dynamic impairment model would be required, which is often not practical. Where included, the disclosures give a high-level sense of the ‘safe’ range of each input, and whether the outcome would be ‘better or worse’ were a particular result to eventuate. However, when the question is 'by how much' the authors learned that analysts expect investors to turn to them for an assessment of the quantitative application of that information, rather than relying on the limited information available from the financial statements.

124. **Recommendation to IASB: Given the importance placed by users on disclosure of assumptions, implement the following enhanced disclosure proposals:**

    a. **further guidance on the definition of a key assumption to encourage wider disclosure; and**

    b. **qualitative disclosure of expected synergies supporting the premium paid on acquisition.**

Appendix A: Extract of background information provided to stakeholders in Phase 1

Summary of recommendations

1. **Goodwill shielding**

   1.1. **Headroom approach (IFRS proposal)**

   Addresses shielding caused by decreases in recoverable amount that are absorbed by unrecognised headroom. Compare total headroom at the current impairment testing date with headroom at the previous testing date. A decrease in total headroom indicates an impairment (rebuttable presumption).

   1.2. **Accretion approach (EFRAG proposal)**

   Addresses shielding caused by the consumption and re-creation of goodwill through management's activities and spending. Entities would annually add an accretion amount to a CGU's carrying amount or deduct it from the CGU's recoverable amount. Accretion is determined by applying a discount rate to the opening balance of goodwill.

2. **How to allocate goodwill to CGUs**

   2.1. **Include specific guidance how to allocate goodwill to CGUs (EFRAG proposal)**

   Standard would include commentary on permissible allocation methods and how they should be applied.

   2.2. **Require disclosure of the composition of goodwill (EFRAG proposal)**

   Track goodwill by each acquisition and disclose a reconciliation of total goodwill allocated to each CGU.

3. **When to determine the recoverable amount**

   3.1. **Introduce an optional 'Step Zero' (EFRAG proposal)**

   Allow qualitative assessment of the likelihood of an impairment loss prior to testing. Determine recoverable amount only when the likelihood of impairment is remote.

4. **How to determine the recoverable amount**

   4.1. **Allow only a single calculation approach (EFRAG proposal)**

   The requirements would be simplified, allowing only one method, either VIU or FVLCD.

   4.2. **Allow consideration of cash flows from future restructurings in the VIU (EFRAG proposal)**

   Permission to account for future restructurings if specified criteria are met.

   4.3. **Allow the use of a post-tax rate in the VIU calculation (EFRAG proposal).**

   Allow an election between a pre-tax or post-tax calculation and require disclose of the basis chosen.

5. **Valuation and recognition of intangible assets in an acquisition**

   5.1. **Retain current requirements of IFRS 3 (IFRS proposal);**

   5.2. **Require disclosures similar to those in IFRS 13 (IFRS proposal);**

   5.3. **Allow indefinite-lived intangible assets to be included within goodwill (IFRS proposal); or**

   5.4. **Segregate intangibles into 'wasting' and 'organically-replaced' assets and require only separate recognition for wasting assets (IFRS proposal).**

DRAFT FOR DISCUSSION

Appendix B: Responses to the proposed alternative testing approaches being debated at the time of Phase 1 Research

IFRS Proposal: Headroom approach

1. The 'headroom approach' aimed to address shielding caused by decreases in recoverable amount that are absorbed by unrecognised headroom. This proposal involved comparing total headroom at the current impairment testing date with headroom at the previous testing date, with a rebuttable presumption that decreases in total headroom indicates an impairment.

2. Respondents generally understood how this approach would address the issue relating to timeliness of impairments and agreed that management activities post-acquisition can result in internally generated goodwill. As a result, this internally generated goodwill can shield poor performance of acquirees and therefore prevent the recognition of impairments that would otherwise be recorded. However, as noted elsewhere within this research, opinions are varied as to whether this is necessarily problematic for acquisitions that are genuinely integrated into a CGU, as the investor has invested in the CGU as a whole. Several respondents suggested that tracking historical headroom would become complex when the entity undertakes further acquisitions or restructurings.

3. Several respondents highlighted that the approach would require complete agreement on the amount of headroom each year, an area where – in instances of ample headroom – the exact value may not currently be scrutinised or challenged. In general, although respondents understood the logic for the approach they believed it would add significant workload without necessarily materially improving impairment testing outcomes. Many respondents including both preparers and analysts were vocal in their disagreement with the proposed model as a solution to current impairment testing requirements, as such an approach goes further than addressing the carrying value of amounts on the balance sheet, which was perceived by participants as the current purpose of impairment testing.

EFRAG Proposal: Accretion approach

4. The accretion approach was designed to address apparent shielding caused by the consumption of and then re-creation of goodwill through management's activities and spending. Entities would annually add an accretion amount to a CGU's carrying amount or deduct it from

the CGU's recoverable amount. Accretion is determined by applying a discount rate to the opening balance of goodwill.

5. As noted above, respondents had varying degrees of buy-in to the underlying issue that this solution was developed to address. However, most of the respondents did not support EFRAG's goodwill accretion approach as it would only add complexity and subjectivity to the goodwill impairment model, with most respondents believing the result was somewhat arbitrary, and represented pseudo-amortisation. It was also suggested that while this solution could work for large entities that have strong valuation expertise, it would be difficult for smaller entities to meaningfully implement and then explain to users. It was again acknowledged that further acquisitions and/or restructurings would make this complex.
6. There were no recommendations to the Board in light of these results and therefore this topic was not explored further in phase 2.

Appendix C: Extract of information booklet provided to participants in Phase 2

Purpose of goodwill impairment testing

The fundamental purpose of goodwill testing has been the source of recent discussion at both a local and international level. It has been said that goodwill impairment testing should be separated from assessing the success of an acquisition, and that the impairment test should not explicitly look at goodwill from previous individual business acquisitions, but instead consider whether the overall balance sheet is reasonable.

1. Do you agree with the above statement?
2. Do you believe separating the impairment test from assessment of the success of a particular acquisition could result in more useful information in the market? *Note: Potential disclosures will be discussed below at question 12.*

External assessments of value

In many cases, the share market does not respond when an impairment is announced, which implies that analysts are able to anticipate impairments and adjust projections accordingly before they are recognised.

3. Do you agree with the above statement? If so, in your opinion, how does this occur?
4. What recommendations can we make about improving the impairment testing process through incorporation of some of these strategies? Are there external factors used that could be incorporated into a standard?
5. Do you make a distinction between highest and best use when making value assessments? Would you apply different assumptions depending on whether an asset is valued for continuing use or sale?
6. Do you see value in any or all of the following suggested updates to IAS 36?
    a. A single, discounted cash flow methodology for both VIU and FVLCD
    b. Inclusion of cash flows from future restructuring and enhancements, but with management assumptions for VIU and market-participant assumptions for FVLCD
    c. Use and disclosure of the post-tax discount rate rather than the pre-tax discount rate.

Cash-generating units

A common theme in the international debate is the question of whether testing for impairment at a CGU-level has the effect of ‘shielding’ companies from impairments that ought to be taken. In Phase

1 of our research, responses to this were mixed, with some taking this view and others believing that once the business is fully integrated the ‘shielding’ effect from other parts of the business is not relevant to investment decisions. To further our understanding of the different viewpoints we would be interested in your opinion on:

7. The granularity of the current impairment testing requirements.
8. Whether moving to a segment level would be a simplification to the process. Do you believe it would result in fewer impairments? If so, what compensating information would be required?
9. Possible impediments to testing at higher level than a CGU.
10. Whether impairments (or lack thereof) are driven by CGU identification or the underlying assumptions used?
11. Whether there is value in undertaking further research on optimal methods of goodwill allocation to CGUs that could address current concerns.

Disclosure

Following on from questions 1 and 2: The IASB Board has recently directed its staff to explore possible improvements to disclosures aimed at enabling investors to assess whether a business combination was a good investment decision and whether, after the acquisition, the acquired business is performing as was expected at the time of the acquisition.

12. Do you believe this could be addressed through:
    a. Disclosure of key metrics; and/or
    b. A look-back analysis on those synergies expected at acquisition date in respect of individual acquisitions.

In June 2018 as part of the AASB Board’s response to Phase 1 of this project, the Board specifically considered additional disclosure requirements for the method used to determine VIU or FVLCD, such as a sensitivity analysis for all impairment tests and look-back analysis to assess forecasting accuracy.

13. Do you believe any or all of the following disclosures would be useful to the market?
    a. A clearer definition of what constitutes a ‘key assumption’.
    b. A requirement to disclose the selection rationale for and inputs into the key assumptions, rather than just the numeric value attributable to those assumptions.
    c. Sensitivity analysis considering the point at which a change in key assumptions would cause impairment.
    d. Sensitivity analysis for all assets subjected to impairment testing, rather than only for goodwill.