

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Goodwill and Impairment – Updated headroom approach

Issues Paper

Purpose of this paper

- 1 The purpose of this paper is to obtain EFRAG TEG members views on the IASB tentative decision to use the unrecognised headroom of a cash-generating unit (CGU) (or group of CGU's)¹ as an additional input in the impairment testing of goodwill.
- 2 At its meeting in December 2017, the IASB tentatively decided to support the IASB Staff proposal on the 'updated headroom approach' for goodwill impairment testing. Eleven IASB members agreed and three disagreed with this decision.

Background

- 3 As part of its research project on Goodwill and Impairment, the IASB has been discussing ways to improve the effectiveness of goodwill impairment testing to address investor concerns that goodwill impairment is recognised too late in the financial statements.
- 4 In 2017, the IASB discussed an IASB Staff proposal for a pre-acquisition-headroom approach that aimed at addressing the delay in goodwill impairment. IASB members agreed that the shielding effect of unrecognised headroom (the excess of the recoverable amount over the carrying amount of a CGU) delayed goodwill impairment and was generally supportive of the IASB Staff proposal.
- 5 However, the IASB expressed concerns with the lack of 'remeasurement' of the pre-acquisition headroom as the approach ignored increases in the headroom that accumulated after the acquisition. To address these concerns, the IASB Staff developed an updated headroom approach which the IASB discussed at its meeting in October and December 2017.
- 6 EFRAG TEG and EFRAG CFSS members had mixed views on the pre-acquisition approach². Some members thought the approach had conceptual merits and may be the right solution to eliminate the risk of overpayments being recorded within goodwill. However, there were concerns that the additional layer of calculation required by the approach would add cost and complexity to the impairment test and

¹ This paper refers to a CGU or group of CGU's as simply a CGU.

² EFRAG TEG members discussed the pre-acquisition headroom approach at the EFRAG TEG-CFSS meeting in September 2017 and at the Accounting Standards Advisory Forum (ASAF) in September 2017. EFRAG TEG members first discussed the PH approach at its meeting in May 2017.

similar to IASB members questioned whether having a one-off consideration of the pre-acquisition headroom at acquisition date, without subsequent measurement/update, was worth the additional cost.

Why does the current goodwill impairment test not work?

- 7 Research conducted by the IASB Staff identified that management optimism and the shielding effect from goodwill impairment created by unrecognised headroom of a CGU were the main factors for the delay in the recognition of goodwill impairments under the current model. These two factors are discussed in more detail below.

Management optimism

- 8 Management having a high level of optimism about future cash flows associated with the CGU to which goodwill is allocated, was cited by some investors and auditors as a main reason for delays in recognising impairment of goodwill. In its discussions, IASB members concluded that this was an issue of discipline and enforcement and not a conceptual matter that can be solved through standard-setting.

Shielding effect of unrecognised headroom

- 9 The issue is that the unrecognised headroom provides a buffer that shields acquired goodwill from impairment. The shielding effect arises at the acquisition date and subsequently:
- (a) *Pre-acquisition headroom* - when acquired goodwill is allocated to an existing business, the pre-existing headroom of that existing business provides a shield protecting acquired goodwill from impairment at the date of the business combination; and
 - (b) *Post-acquisition headroom* - in periods after the business combination, headroom generated after the date of the business combination also provides a shield against impairment of goodwill. This is the case regardless of whether the acquired goodwill is merged into a pre-existing CGU or is kept separate, in case the entity builds up self-generated goodwill and other intangible assets that are not recognised under IFRS Standards.³
- 10 The unrecognised headroom or headroom includes the following that are not recognised in the IFRS financial statements - (1) internally-generated goodwill, (2) any unrecognised assets such as internally generated intangibles that do not meet the recognition criteria and, (3) any difference between carrying amounts and recoverable amounts of other assets in the CGU that are not measured at a current value.
- 11 The IASB acknowledged that in many cases, the overall shield could be huge, resulting in a significant delay in goodwill impairment recognition. For this reason, most IASB members tentatively agreed that the updated headroom approach, which addresses both pre-acquisition headroom and subsequently generated headroom,

³ When revising IAS 36 in 2004 to remove amortisation of goodwill, the IASB concluded that acquired goodwill will always be shielded from impairment by internally generated goodwill because it is not possible to measure separately goodwill generated internally after a business combination and to factor that measure into the impairment test. Therefore, the IASB took the view that the objective of the goodwill impairment test could at best be to ensure that the carrying amount of goodwill is recoverable from future cash flows expected to be generated by both acquired goodwill and goodwill generated internally after the business combination. (See paragraph BC135 of the Basis for Conclusions on IAS 36.)

presented a good solution to address this issue. The IASB did not support the reintroduction of amortisation (see agenda paper 08-03 for this session).

Mechanics of the updated headroom approach

- 12 The unrecognised headroom is the difference between the recoverable amount of a CGU and its carrying amount including goodwill.
- 13 Under the updated headroom approach, any unrecognised headroom of a CGU is recalculated every time the goodwill impairment test is performed and added to its carrying amount to determine whether there is an impairment – i.e. when the recoverable amount of the CGU is lower than its carrying amount. This will happen when the headroom decreases.

Attribution of impairment under the approach

- 14 The first step is to calculate the unrecognised headroom of the CGU to which goodwill was allocated.
- 15 Consider the following example - Company X tests goodwill for impairment regularly at the annual reporting date. Company X has a CGU Z that includes goodwill acquired in a past business combination. The recoverable amount and the carrying amount of the net assets of CGU Z at two reporting dates are as follows (assume that there is no change in the level of business activity):

In currency units (CU's)	31/12/20X1	31/12/20X2
Acquired goodwill	100	100
Other net assets	525	510
Carrying amount (A)	625	610
Recoverable amount (B)	730	695
Unrecognised headroom (A-B)	105	85
Goodwill impairment in year 2		20

- 16 Under the current goodwill impairment test in IAS 36, the impairment loss of CU20 would be absorbed entirely by the unrecognised headroom (CU105).
- 17 Under updated headroom approach, the decrease in the unrecognised headroom represents an impairment loss in CGU Z and **is deducted from acquired goodwill** to the extent that it is attributable to the acquired goodwill.
- 18 The IASB December 2017 agenda paper (18C) noted that the decrease in the headroom could be attributed in two ways:
 - (a) always attributed to acquired goodwill, ie all decreases in total headroom are recognised as an impairment loss on acquired goodwill; or
 - (b) presumed to be attributable in full to acquired goodwill unless the entity rebuts that presumption on the basis of specific evidence that the all or part of the decrease is not attributable to acquired goodwill.
- 19 The rebuttable presumption approach in (b) above, would work better when it seems evident that the impairment loss is not related to the acquired goodwill.

- 20 The IASB discussed the two attribution approaches in paragraph 17 and indicated greater support for attributing all decreases in the unrecognised headroom to goodwill. The fact that unrecognised headroom and acquired goodwill are combined means they become largely indistinguishable and changes in estimates of inputs such as growth rate, expected returns, discount rate etc not only affect the unrecognised headroom but also acquired goodwill. The EFRAG Secretariat observes that the IASB has not discussed the attribution of goodwill impairment losses when an entity has goodwill from more than one acquisition.

Responses to EFRAG's DP

- 21 Some respondents to the EFRAG DP did not support the proposed 'accretion' method on the basis that they do not agree that goodwill is consumed over time. These respondents might argue that the updated headroom approach tries to reflect consumption, and therefore not support the approach. Others might argue that if the objective of the IASB tentative proposal is to reflective consumption, then reintroducing goodwill amortisation will be more cost-effective.

EFRAG Secretariat preliminary view

- 22 We think that the updated headroom approach has merits to reduce the shielding effect on goodwill impairment created by unrecognised headroom. The approach will result in goodwill impairment being recognised earlier.
- 23 The EFRAG Secretariat's preliminary view is that this approach is not overly complex to apply, as the only additional input in the goodwill impairment test is the recoverable amount of the CGU (or group of CGU's) used to determine the headroom. A decrease in the headroom represents an impairment of goodwill. This process is repeated on an annual basis, or every time the impairment test is performed, until the goodwill balance is zero.
- 24 Regarding the attribution of the impairment, the preliminary view of the EFRAG Secretariat is that the application of the rebuttable presumption discussed above in paragraph 18(b) would be highly subjective, given the difficulty to distinguish between impairment of acquired goodwill and impairment of headroom. This difficulty may lead to entities arguing that decreases in the headroom are unrelated to acquired goodwill and avoid goodwill impairment.
- 25 Overall, we think that the IASB tentative preferred allocation is consistent with the requirement in paragraph 104 of IAS 36 to first reduce the carrying amount of any goodwill allocated to the CGU (or group of CGU's), and then to other assets. An alternative could be to attribute the impairment loss based on a pro-rata approach. At this stage, the IASB has not discussed in detail the attribution of the impairment loss (for example how the impairment should be attributed to multiple goodwill balances and whether other assets will be affected).
- 26 However, there might be cases when decreases in the headroom do not relate to acquired goodwill. One of the respondents to EFRAG's DP thought that a decrease in the headroom may be related to the internally generated goodwill of the pre-existing business rather than to the acquired goodwill. Therefore, always requiring decreases in the headroom (both pre and post-acquisition) to be attributed to acquired goodwill may result in some inappropriate outcomes.

Costs of applying the updated headroom approach

- 27 During its discussions, IASB members questioned whether the updated headroom approach would significantly increase the cost and complexity of goodwill impairment testing.

- 28 The IASB Staff do not think that the approach would add complexity because it only adds one input (the unrecognised headroom) to the existing equation of impairment testing. Furthermore, information on the recoverable amount would generally be available as it is already calculated annually for testing of impairment.
- 29 However, the IASB Staff noted that there will be some additional costs in cases when the calculation of recoverable amount will need to be calculated more precisely than is currently done. For example, under the current model in IAS 36 a precise single value would be determined only when the bottom-end of the recoverable amount range is less than a CGU's (or group of CGU's) carrying amount.
- 30 In summary, the IASB Staff identified the following cases when an entity would have to carry out additional tasks for calculating the unrecognised headroom:
- (a) for an existing CGU that does not contain goodwill and to which newly acquired goodwill has been allocated for the first time, the entity would need to determine the recoverable amount of the existing unit just before the business combination—the pre-combination unrecognised headroom would be used as the input when performing impairment testing of goodwill of the unit for the first time after the business combination;
 - (b) for a CGU that is partially disposed of (and for which not all previously acquired goodwill is derecognised), the entity would need to determine the recoverable amount of the unit immediately after the disposal—the post-disposal unrecognised headroom would be used as the input at the next impairment testing; and
 - (c) for a restructured CGU, the entity would need to determine the recoverable amount of the unit immediately after the restructuring—the post-restructuring unrecognised headroom would be used as the input at the next impairment testing.
- 31 Overall, the majority of IASB members generally agreed with the IASB Staff that the application of the updated headroom would not add too much complexity and that the cases listed in paragraph 29 above would result mainly in one-off costs and that entities would in many cases be able to use previous calculations of recoverable amount or update them without significant cost.

EFRAG Secretariat preliminary view

- 32 As explained in paragraph 29 above, the EFRAG Secretariat notes that entities will incur additional costs when they need to determine the recoverable amount for the first time or with more accuracy. Entities might also incur additional costs in order to track each individual acquired goodwill in cases of reorganisations and sales of part of the CGU's. At this stage, without further analysis we cannot comment on whether applying the updated headroom approach will entail any significant additional costs.

Illustrative examples

- 33 The examples below illustrate the application of the updated headroom approach in the following cases:
- (a) Acquisition date;
 - (b) Reorganisation; and
 - (c) Additional acquisition.

Illustrative example 1 – Acquisition date

- 34 The following example is a modified version of example 1 in appendix B of the December 2017 IASB agenda paper 18C. Monetary amounts are denominated in 'currency units CU'.
- 35 Company Y acquired 100 per cent of Company X on 1 July 20X0 and recognised goodwill of CU100 which is allocated to CGU A. On this date, CGU A has a carrying amount of CU200 and a recoverable amount of CU350. The unrecognised pre-acquisition headroom on 1 July 20X0 is therefore CU150 (CU350 – CU200).
- 36 The following paragraphs illustrate the outcome of the impairment test at reporting dates 31 December 20X0 – 31 December 20X3.

Company A performs the annual impairment test on 31 December 20X0:

- (a) On this date, CGU A has a carrying amount of CU520 (including goodwill of CU100) and a recoverable amount of CU680. The updated unrecognised headroom at 31 December 20X0 has increased to CU160 (CU680 – CU520).
- (b) Company A compares its total carrying amount of CU670 (including the unrecognised headroom of CU150) to the recoverable amount of CU680 to determine whether an impairment has occurred.
- (c) At this date there is no goodwill impairment as the recoverable amount is higher than the total carrying amount.

Company A performs the annual impairment test on 31 December 20X1:

- (d) On this date, CGU A has a carrying amount of CU510 (including goodwill of CU100) and a recoverable amount of CU 640. Company
- (e) A compares its total carrying amount CU670 (including the carrying forward unrecognised headroom of CU160) to the recoverable amount of CU640 at 31 December 20X1. The recoverable amount is lower than the total carrying amount by CU30, **resulting in an impairment of CU30 that is attributed to goodwill**. The goodwill balance at 31 December 20X1, after impairment, is CU70.
- (f) Under the current goodwill impairment model, no goodwill impairment would be recognised as the recoverable amount would be higher than the carrying amount by CU 130 (CU640 – CU510). This is because of the shielding effect created by the unrecognised headroom of CU160.
- (g) The (updated) unrecognised headroom at 31 December 20X1 remains the same at CU160 (CU 640– (CU410+CU70)). This amount is carried forward to the goodwill impairment test performed in year 20X2.

Company A performs the annual impairment test on 31 December 20X2:

- (h) On this date, CGU A has a carrying amount of CU500 (including goodwill of CU70) and a recoverable amount of CU 650.
- (i) Company A compares its total carrying amount CU660 (including the carried forward unrecognised headroom of CU160) to the recoverable amount of CU650. The recoverable amount is lower than the total carrying amount CU10, **resulting in an impairment of CU10 that is attributed to goodwill**. The goodwill balance at 31 December 20X1, after impairment, is CU60.

*Goodwill and impairment – Updated headroom approach
Issues Paper*

- (j) Under the current goodwill impairment model, no goodwill impairment would be recognised in 20X2 as the recoverable amount would be higher than the carrying amount by CU 150 (CU650 – CU500).
- (k) The (updated) unrecognised headroom at 31 December 20X2 remains the same at CU160 (CU 650 - (CU430+CU60)) and is used in the goodwill impairment test calculation in 20X3.

Company A performs the annual impairment test on 31 December 20X3:

- (l) On this date, CGU A has a carrying amount of CU550 (including goodwill of CU60) and a recoverable amount of CU 580.
- (m) Company A compares its total carrying amount CU710 (including goodwill of CU60 and the carrying forward unrecognised headroom of CU160) to the recoverable amount of CU580 at 31 December 20X3. The recoverable amount is lower than the total carrying amount by CU130, resulting in an **impairment of CU130, of which CU60 is attributed to the remaining goodwill** balance (making goodwill zero). The unrecognised headroom balance of CU90 is no longer required under the IASB approach discussed so far.
- (n) Under the current goodwill impairment model, no goodwill impairment would be recognised as the recoverable amount would be higher than the carrying amount by CU30 (CU580 – CU550).

37 The outcome in example 1 can be summarised as follows:

CGU A	31 December (amounts in CU)			
	20X0	20X1	20X2	20X3
Other net assets [a]	420	410	430	490
Goodwill [b]	100	100	70	60
Carrying amount [a+b]	520	510	500	550
Unrecognised headroom ⁴	150	160	160	160
Carrying amount + Unrecognised headroom [c]	670	670	660	710
Recoverable amount [d]	680	640	650	580
Impairment loss [c-d]	-	30	10	60 ⁵
Goodwill after impairment [e]	100	70	60	-
Updated (unrecognised) headroom [d-(a+e)]	160	160	160	90

⁴ At date of previous impairment test.

⁵ Of the 'actual' impairment loss of CU130, CU 60 is allocated to goodwill which is written off to zero.

Illustrative example 2 - Reorganisation

Fact pattern

- 38 The following example is the same as example 2 of appendix B of the December 2017 IASB agenda paper 18C.
- 39 Company X decides to reorganise CGU A, dividing it into two CGU's, which are smaller CGU A and new CGU C.
- 40 On 1 July 20X4, Company Y splits the assets between CGU A and new CGU C and determines the recoverable amount of the two units. The table below summarises the various amounts:

[Monetary amounts are denominated in 'currency units (CU)']

	CGU A	CGU C
Carrying amount after reorganisation excluding goodwill (a)	300	120
Acquired goodwill (b)	40	20
Carrying amount of the unit (c = a + b)	340	140
Recoverable amount (d)	440	190
Unrecognised headroom (d – c)	100	50

- 41 The carrying amounts (excluding goodwill) and the recoverable amounts of the smaller unit A and new CGU C at the subsequent annual reporting dates are as follows:

	31 December		
	20X3 CU	20X4 CU	20X5 CU
Unit A			
Carrying amount excluding goodwill	300	290	280
Recoverable amount	420	415	385
Unit C			
Carrying amount excluding goodwill	130	140	145
Recoverable amount	210	225	240

Applying the updated headroom approach

- 42 The calculations used in the impairment test of goodwill allocated to unit A are as follows (amounts are in currency units (CU)):

*Goodwill and impairment – Updated headroom approach
Issues Paper*

Unit A	31 December		
	20X3 CU	20X4 CU	20X5 CU
Carrying amount excluding goodwill (a)	300	290	280
Acquired goodwill before impairment at this date (b)	40	20	20
Carrying amount [a+b]	340	310	300
Unrecognised headroom at previous test date	*100	100	105
Carrying amount + Unrecognised headroom (c)	440	410	405
Recoverable amount (d)	420	415	385
Impairment loss [c–d]	20	-	20
Goodwill after impairment (e)	20	20	-
Unrecognised headroom at this date [d–(a+e)]	100	105	#105

* Unrecognised headroom on reorganisation.

This information is no longer required because the carrying amount of goodwill is now zero, and so Company X will no longer be required to calculate recoverable amount on an annual basis

43 Company X concludes that all of the loss is attributable to acquired goodwill. Consequently, it recognises **an impairment loss on goodwill of CU20 and CU20** for the years ended 31 December 20X3 and 31 December 20X5 respectively.

44 The calculations used in the impairment test of goodwill allocated to unit C are as follows:

CGU C	20X3 CU	20X4 CU	20X5 CU
Carrying amount excluding goodwill (a)	130	140	145
Acquired goodwill before impairment at this date (b)	20	20	20
Carrying amount [a+b]	150	160	165
Unrecognised headroom at previous test date	*50	60	65
Carrying amount + Unrecognised headroom (c)	200	220	230
Recoverable amount (d)	210	225	240
Impairment loss [c–d]	-	-	-
Goodwill after impairment (e)	20	20	20
Unrecognised headroom at this date [d–(a+e)]	60	65	75

* Unrecognised headroom on reorganisation

Illustrative example 3 – Additional acquisition

Fact pattern

45 On 1 July 20X3, Company X acquires 100 per cent of Company Q for CU400. Company Q's net identifiable assets have a fair value of CU200. Consequently, Company X recognises goodwill of CU200.

46 Company X concludes that the assets of Company Q will generate cash flows together with Company X's existing unit B. Consequently, all of the acquired assets

*Goodwill and impairment – Updated headroom approach
Issues Paper*

and goodwill are allocated to the larger unit B. The following table summarises the various amounts before and after the acquisition of Company Q.

[Monetary amounts are denominated in 'currency units (CU)']

Unit B	Before acquisition	Added on acquisition	After acquisition
Carrying amount excluding goodwill	320	200	520
Acquired goodwill	110	200	310
Carrying amount of the unit	430	400	830

- 47 The carrying amount (excluding goodwill) and the recoverable amount of the larger unit B at subsequent annual reporting dates are as follows:

	31 December		
	20X3 CU	20X4 CU	20X5 CU
Carrying amount excluding goodwill	530	520	525
Recoverable amount	870	865	840

Applying the updated headroom approach

- 48 The calculations used in the impairment test of goodwill allocated to unit B are as follows:

	31 December		
	20X3 CU	20X4 CU	20X5 CU
Carrying amount excluding goodwill (a)	530	520	525
Acquired goodwill before impairment at this date (b)	310	310	310
Carrying amount [a+b]	840	830	835
Unrecognised headroom at previous test date	*25	30	35
Carrying amount + Unrecognised headroom (c)	865	860	870
Recoverable amount (d)	870	865	840
Impairment loss [c–d]	-	-	30
Goodwill after impairment (e)	310	310	280
Unrecognised headroom at this date [d–(a+e)]	30	35	35

* Unrecognised headroom as at 31 December 20X2 (see the table in paragraph B9)

- 49 Company X concludes that all of the loss is attributable to acquired goodwill. Consequently, it **recognises an impairment loss on goodwill of CU30** for the year ended 31 December 20X5.
- 50 The EFRAG Secretariat observes that the IASB has not discussed the attribution of goodwill impairment losses when an entity has goodwill from more than one acquisition.

Questions for EFRAG TEG members

- 51 Do you think the updated headroom approach could improve the effectiveness of the impairment test?
- 52 Do you have any comments or feedback on the analysis of the two approaches on the attribution of impairment discussed in paragraph 17? Is there another approach that you could suggest?
- 53 At this stage, do you have any comments or suggestions on improving the mechanics of the updated headroom approach?