

## GOODWILL IMPAIRMENT TESTING UNDER IFRS. PART 2: IMPLEMENTATION

### Introduction

In an earlier note (Part 1: Framework), we set out the framework for goodwill impairment testing under IFRS. In this note, we explain how a company applying IFRS tests purchased goodwill for impairment. Many managers and investors are unhappy with the international financial reporting standard (IAS 36) on this issue. We explore their concerns and summarise the changes to the standard the IASB is proposing to make in response.

### Warning signs of impairment

Companies applying IFRS must test goodwill for impairment annually. Goodwill is not tested directly. It is the cash-generating units (CGUs) to which the goodwill arising on a business acquisition is allocated that are subject to an impairment test. A CGU is considered impaired if its recoverable amount is less than its carrying amount (including allocated goodwill) in the consolidated accounts. What are the 'red flags' that signal a decline in the CGU's recoverable amount and thus its possible impairment?

Red flags can be either external or internal to the company. External red flags are:

- A market-to-book (MTB) ratio of less than one. If a company's market capitalisation falls below the book value of its equity, this may indicate that investors consider the company's net assets – and those of some or all of its CGUs – are overstated.
- A significant increase in market interest rates. A CGU's recoverable amount is the higher of its net fair value (fair value less costs of disposal) or its value in use (present value of estimated future cash flows). A significant increase in interest rates is likely to lower a CGU's value in use directly (estimated future cash flows are discounted at a higher rate) and its net fair value indirectly (a potential buyer will offer a lower price as its funding costs have increased).
- Other adverse changes in the economic environment. A CGU may be impaired as a result of external forces even if the company's overall MTB ratio exceeds one and there has been no significant increase in market interest rates. The CGU's impairment could be the result of increased competition, new technology rendering existing products or processes obsolete, or stricter product safety, environmental or other regulations.

The clearest internal sign of impairment is disappointing financial results. A CGU's financial performance – as measured by operating profit or operating cash flow – may be persistently worse than expected. As a result, management may consider discontinuing certain of the unit's operations or disposing of it completely. These, too, are internal indicators of impairment. A company must check for both external and internal red flags as part of its annual goodwill impairment test (IAS 36, para. 12).

### Calculating value in use

Calculating a CGU's value in use is, in most cases, the most important step in determining its recoverable amount. Its net fair value may not be easily observable. It is unlikely there is an active market for the CGU and fair value may have to be estimated using a discounted cash flow approach similar to that used in value in use calculations.

To ensure consistency in impairment testing – over time and across companies, the IASB specifies the types of cash flows that should be included in the calculation of a CGU's value in use and how the

discount rate should be determined. It also specifies the approach a company should use when forecasting a CGU's future cash flows.

Which cash flows should enter the value in use calculation? First, they should be operating or investing cash flows only. Financing flows must be excluded. So, too, are tax receipts and payments. Second, projections of cash flows should be based on maintaining the CGU's performance. Cash flows associated with uncommitted restructurings or asset improvements should be excluded. Third, if there are significant end-of-life cash inflows or outflows – for example, from asset disposals or site restoration costs, these should be included. (IAS 36, paras. 39, 44, 50)

The most difficult part of calculating a CGU's value in use is estimating its future cash flows. Again, the IASB provides a framework that should improve consistency in cash flow estimation. The key features of the framework are:

- Use of financial budgets and forecasts prepared and approved by management. Projections of a CGU's cash flows should be based on a company's own budgets and forecasts. These should cover a period of no more than five years.
- Assumption of steady or declining growth rate in years beyond the budget or forecast period. The assumed growth rate should not exceed the past long-term average growth rate for the markets which the CGU serves or the industries or countries in which it operates (IAS 36, para. 33).

The resulting estimated cash flows should be discounted by a risk-adjusted discount rate. The rate should be pre-tax (IAS 36, para. 55).

### Required disclosures

For investors and other financial statement users, the reporting by a company of goodwill impairment presents a challenge. The key number underlying the impairment loss is the recoverable amount of one or more CGUs and the company's calculation of recoverable amount – especially if it is based on value in use – can be a 'black box'. The purpose of the required disclosures is to help financial statement users verify the reported impairment loss.

The disclosures a company must make with respect to goodwill impairment are of two types: loss-specific disclosures and detailed disclosures about the company's CGUs. Loss-specific disclosures cover: the events leading to the impairment loss; the amount of loss recognised; a description of the CGU (ie product line, business operation, reportable segment); and its recoverable amount (IAS 36, para. 130). A company must also make detailed disclosures for each CGU or group of CGUs *where the goodwill balance is significant* (relative to the total goodwill balance). These include:

- The carrying amounts of goodwill and indefinite-life intangibles allocated to the CGU or group of CGUs;
- The basis on which the recoverable amount of the CGU or group of CGUs is determined (ie net fair value or value in use);
- Where recoverable amount is based on value in use:
  - The key assumption underlying the cash flow projection for the period covered by the financial budget or forecast. Examples are: gross margin; market share; input price inflation; exchange rates.
  - The period over which management budgets or forecasts cash flows – and an explanation if it is more than five years.
  - The growth rate used to estimate cash flows beyond the period covered by the financial budget or forecast.
  - The discount rate applied to cash flow projections.

Similar disclosures are required if the recoverable amount is based on net fair value and fair value is estimated using a discounted cash flow approach.

- The sensitivity of the recoverable amount to a change in the key assumption. This can be gauged by three numbers: (1) the excess of the recoverable amount over the carrying amount; (2) the value of the key assumption; and (3) the amount by which the key assumption must change for the recoverable amount to equal the carrying amount.

Note that these detailed disclosures only apply where the goodwill balance allocated to a CGU or group of CGUs is significant (IAS 36, para. 134). Where goodwill and indefinite-life intangibles are allocated across many CGUs and the amount allocated is not significant, a company need disclose only the *aggregate* carrying amount of the allocated goodwill and indefinite-life intangibles (IAS 36, para. 135).

Mindful of the burden of these disclosure requirements, the IASB allows companies to use, in the current period, the calculations of recoverable amount in the preceding period if (a) the most recent calculation of a CGU's recoverable amount exceeds the carrying amount by a substantial margin and (b) the likelihood that its current recoverable amount is less than its current carrying amount is remote (IAS 36, para. 136).

### **Goodwill accounting rules: implementation problems and proposed changes**

The IASB carried out a post-implementation review (PIR) of its accounting standard on business combinations (IFRS 3) between 2015 and 2020. As part of the review, it investigated whether the rules on goodwill impairment – as set out in the standard on impairment (IAS 36) – were working as intended. It issued a discussion paper in March 2020, gathered feedback from financial statement preparers and users over the following year, and began to write an exposure draft amending the two standards which it plans to publish in the first half of 2024.

The feedback the IASB collected reveals that, on the issue of goodwill, both financial statement preparers and users have problems with existing standards. Preparers are critical of the goodwill impairment tests. They claim that the tests are complex and costly to apply.<sup>1</sup> By contrast, users are critical of both the initial accounting of goodwill in a business combination (IFRS 3) and the testing of its impairment (IAS 36). They point to three areas where the accounting is deficient because the numbers are hard for an external user to verify.

- Initial measurement of goodwill. To calculate goodwill, the acquirer's management must first identify intangibles not on the acquired company's balance sheet and then fair value them and all its other assets. Management can alter the initial amount of goodwill by the way it carries out the intangibles' identification and measurement.
- Allocation of purchased goodwill to CGUs. Some of a company's CGUs may already have high levels of internally generated goodwill. By over-allocating purchased goodwill to these CGUs, the acquirer gains 'headroom', allowing it to reduce or avoid an impairment loss in the future.
- Calculation of recoverable amount. Calculating a CGU's value in use requires estimating its future cash flows and discounting them. Over-optimistic cash flow projections can lift recoverable amount above carrying amount and prevent or delay a goodwill write-down.

Some critics argue that the IASB should abandon its 'impairment-only' approach and re-introduce mandatory amortisation of goodwill alongside periodic testing of CGUs for impairment. Amortisation of goodwill was required under international accounting standards between 1994 and 2004.

The (IAS) Board was not persuaded by the criticisms made by financial statement users of current rules on goodwill accounting. It decided to retain the impairment-only approach to goodwill accounting

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<sup>1</sup> Independent surveys corroborate these findings. For example, a survey of Italian chief financial officers (CFOs) in 2011 found that they perceived IAS 36 requirements to be detailed, complex and subjective and estimating a CGU's recoverable amount became more difficult after the 2008 financial crisis (Mazzi, Liberatore & Tsalavoutas, 2016).

and not to re-introduce goodwill amortisation. It also decided not to change the range of identifiable intangibles recognised separately from goodwill. In addition, it decided to keep its existing CGU-based impairment test. However, it accepted that impairment testing under current rules was complex and costly and proposed the following changes:

- Annual testing of CGUs with goodwill and indefinite-life intangibles for impairment will cease. Testing will only be required where there is an indication that impairment may have occurred. This aligns impairment testing rules for goodwill and indefinite-life intangibles with those for tangible fixed assets.
- A more permissive approach to estimating value in use will be introduced. Companies will be able to:
  - Include cash flows relating to uncommitted restructurings or asset improvements. Value in use need no longer be estimated using 'maintenance' cash flows only.
  - Estimate cash flows and discount rates on a post-tax basis.

These changes should simplify impairment testing and reduce the burden on companies preparing IFRS-based financial statements. The Board did make one concession to financial statement users. It proposed requiring companies to disclose, on the face of the balance sheet, total equity excluding goodwill. Highlighting 'tangible equity' on the balance sheet should help investors and other users better understand a company's financial position, the Board argues.<sup>2</sup>

### *The goodwill amortisation debate*

By its own admission, the Board wrestled over the issue of goodwill amortisation. A significant minority of members supported its re-introduction. They advanced a conceptual argument: in their view, goodwill is a wasting asset. They also offered practical reasons in its favour. An impairment-only approach is likely to result in the overstatement of a company's assets. An impairment represents an unexpected hit to corporate earnings. It is likely to reduce managers' compensation and damage their reputation. Thus, managers have an incentive to delay its recognition by, for example, inflating a CGU's recoverable amount.

Opponents of goodwill amortisation also marshalled conceptual and practical arguments to support their position. Some opponents maintain goodwill is an asset with an indefinite life; others argue that whether it has a definite or indefinite life depends on the nature of the business acquisition. And even if it is accepted that in some acquisitions goodwill is a wasting asset, the amortisation period is arbitrary since it is not possible to estimate the asset's expected economic life reliably. Amortisation thus undermines the usefulness of the corporate earnings number to investors.<sup>3</sup>

What led the Board to conclude the debate and preserve the status quo? One important factor was the position of the FASB. The US accounting standard is similar to the international standard in that goodwill and indefinite-life intangibles are not amortised but, instead, must be tested regularly for impairment. The FASB published a discussion paper on the issue of goodwill accounting in July 2019. In December 2020 it tentatively decided to re-introduce amortisation, a requirement under US GAAP prior to 2001. However, it reversed course in June 2022 and removed the whole project from its technical

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<sup>2</sup> IASB (2020), Discussion Paper DP/2020/1, *Business Combinations – Disclosures, Goodwill and Impairment*, IFRS Foundation: London, March 2020 ([www.ifrs.org/content/dam/ifrs/project/goodwill-and-impairment/goodwill-and-impairment-dp-march-2020.pdf](http://www.ifrs.org/content/dam/ifrs/project/goodwill-and-impairment/goodwill-and-impairment-dp-march-2020.pdf)). The discussion paper also contains proposed changes to the disclosure requirements of IFRS 3 to improve information about business acquisitions and their subsequent performance.

<sup>3</sup> IASB (2023), In brief: *Business Combinations – Disclosures, Goodwill and Impairment*. Project update, IFRS Foundation: London, January 2023 ([www.ifrs.org/content/dam/ifrs/project/goodwill-and-impairment/inbrief-businesscombs-jan2023.pdf](http://www.ifrs.org/content/dam/ifrs/project/goodwill-and-impairment/inbrief-businesscombs-jan2023.pdf)).

agenda, effectively rejecting amortisation.<sup>4</sup> The IASB is committed to working towards convergence of international standards and US GAAP, so the FASB's June 2022 decision was highly influential in persuading Board members to retain its impairment-only approach.

*Are goodwill impairments timely? Some research findings*

Following its post-implementation review of business combinations, goodwill and impairment, the IASB did more than reject goodwill amortisation. Board members also decided not to change the approach to impairment testing set out in IAS 36. Their decision was influenced by recent research findings. As we have already noted, critics argue that the impairment-only approach in IAS 36 and its US counterpart (SFAS 142) leads to earnings and asset overstatement because impairments are not recognised in a timely way. However, recent research indicates that impairments are timely in countries where there is a high level of enforcement of financial reporting rules. We summarise the findings of three studies that illustrate how our understanding of the impact of current impairment rules has changed over the past two decades.<sup>5</sup>

Much of the empirical research on goodwill impairment focuses on US companies. One much cited study – by Li & Sloan (2017) – compares the timeliness of goodwill impairment in two different periods. An impairment is considered timely if it is recognised in the accounts in the same period that the underlying economic impairment occurs. During the first period, 1995-2000, US GAAP required listed companies to both amortise goodwill and test it (and the reporting unit to which it was allocated) regularly for impairment. During the second period, 2004-2011, an impairment-only regime was in place.<sup>6</sup> The authors find that, among the US companies they investigate, impairments were less timely in the second period than in the first. It appears that managers exploited the greater accounting discretion that an impairment-only regime gave them, to delay writing down goodwill.

Is the US experience unusual? André, Filip & Paugam (2016) compare goodwill impairments made by a large sample of US and EU companies between 2006 and 2015. US and EU accounting rules on impairments were similar during this period as EU listed companies were required to apply international financial reporting standards (IFRS) from 2005. Like Li & Sloan, André and his fellow authors test companies' accounting impairments against signs of economic impairment such as (pre-impairment) operating losses or depressed market capitalisation (ie market-to-book ratio less than one). They find that European companies were slower to respond to signs of economic impairment. Moreover, where there were such signs, US firms wrote off a higher proportion of their goodwill balance.<sup>7</sup>

In their 2016 study, André, Filip & Paugam implicitly assume European companies operate under the same regulatory regime. However, there is no Europe-wide regulatory agency equivalent to the SEC in the USA. Thus, even though all EU-listed firms had to apply IFRS from 2005, the standards were enforced by national regulators. Glaum, Landsman & Wyrwa (2018) reason that differences in enforcement across

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<sup>4</sup> FASB, Tentative Board Decisions, 06/15/22 Board Meeting, *Identifiable Intangible Assets & Subsequent Accounting for Goodwill*.

<sup>5</sup> The research papers cited investigate the timeliness of goodwill impairment at the company level only. Researchers do not have access to impairment data for individual operating units (e.g. cash generating units or, in the case of US GAAP, reporting units) within a company.

<sup>6</sup> FASB, Statement of Financial Accounting Standards 142: *Goodwill and Other Intangible Assets*. In 2001, SFAS 142 replaced Accounting Principles Board Opinion 17 (*Intangible Assets*) and SFAS 121 (*Accounting for the Impairment of Long-Lived Assets*) which had been in force in the 1995-2000 period. The authors excluded the years 2001-2003 from their study since companies were transitioning to the new accounting standard in this period.

<sup>7</sup> Note that the period 2006-2015 covers the financial crisis of 2008-9. Although the authors exclude financial institutions from their sample, the crisis affected non-financial firms, too. US levels of goodwill fell earlier (2008 vs 2009-11 for European firms) and more sharply.

countries might affect the timeliness of goodwill impairments. They investigate the goodwill impairment decisions of a large sample of IFRS-applying firms, both financial and non-financial, drawn from 21 countries between 2005 and 2011. (5 of the countries were non-European.) They classify countries as either high or low enforcement based on an index of the strength of public enforcement of financial reporting and auditing regulations.<sup>8</sup> They find that in high enforcement countries goodwill impairments were timely while in low enforcement countries they were not. They use, as an indicator of economic impairment, stock market returns rather than financial measures such as operating losses or the MTB ratio. They also find that goodwill impairments were timely even in low enforcement countries for non-financial companies with high institutional ownership. Thus, for these firms, institutional owners act as private enforcers of financial reporting and auditing regulations.<sup>9</sup>

The level of enforcement in a country can change over time – and, in the process, can alter the timeliness of goodwill impairments. In an extension of their 2017 study, Li & Sloan investigate the impact of modifications of US goodwill accounting rules in 2011 that eased impairment testing procedures.<sup>10</sup> They find that, over the years 2011-2015, goodwill impairments became *timelier*. In fact, there was no significant difference in timeliness between the pre-impairment-only period (1995-2000) and 2011-2015. The authors attribute the improvement in timeliness to a change in approach by the SEC. Following the financial crisis in 2008-9, the US securities regulator began to challenge the financial reporting of companies where signs of economic impairment had been ignored.

The research cited above helps explain why the IASB and the FASB decided not to make substantive changes to the accounting rules on goodwill impairment testing, following the post-implementation reviews in the late 2010s. The research indicates that goodwill impairment is timely when the accounting rules are properly enforced. The two boards are responsible for the setting of the rules, not for their enforcement.

## References

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<sup>8</sup> The index was devised by Brown, Preiato & Tarca (2014). It has 15 components, nine relating to audit and six to accounting standards enforcement. The audit section of the index includes components for auditor training, professional quality assurance, auditor rotation, auditor oversight and litigation risk. The enforcement section of the index includes components for each of the following: existence of an enforcement body, its resources, level of activity and enforcement actions.

<sup>9</sup> The number of financial firms in the sample was too small for the impact of institutional ownership in low enforcement countries to be observed.

<sup>10</sup> FASB (2011), Accounting Standards Update (ASU) 2011-08, '*Intangibles – Goodwill & Other (Topic 350): Testing Goodwill for Impairment*'.