DUFF & PHELPS

EFRAG

January 31, 2018

Response to Questions to Constituents

Goodwill impairment test:
Can it be improved?

Discussion Paper – June 2017

DUFF & PHELPS

EFRAG
35 Square de Meeûs
1000 Brussels
Belgium

January 31, 2018

Re: EFRAG Discussion Paper (June 2017)
Goodwill Impairment Test: Can it be Improved?

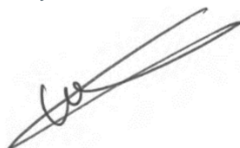
Dear Madams,
Dear Sirs,

Duff & Phelps appreciates the opportunity to provide input on the above-referenced Discussion Paper.

Our valuation advice, particularly with regards to financial reporting, is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions for applying IAS 36 and IFRS 3.

We would be pleased to further discuss our comments with the EFRAG representatives. Please direct any questions to either of us via the contact information set forth below.

Sincerely,



Yann Magnan

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GENERAL COMMENTS

We appreciate EFRAG's role in engaging with European constituents and providing input into IASB's work.

Our comments on the items set forth in EFRAG's Discussion Paper ("DP") are made from the perspective of a valuation consulting firm. We have not evaluated the merits of alternative models for the goodwill impairment test and the accounting for goodwill.

QUESTION 1 HOW AN ENTITY SHOULD ALLOCATE GOODWILL

In paragraphs 2.3 to 2.22 of Chapter 2, EFRAG discusses additional guidance on the allocation of goodwill to CGUs.

Duff & Phelps Comments

We believe that there are three possible scenarios in the allocation of various components of purchased goodwill:

- **Scenario 1**: Allocation to acquirer CGU(s), whereby the pre-existing business is expected to benefit from the acquisition, but <u>will **not** be</u> assigned any assets or liabilities from the transaction. This type of benefit is generally described as 'synergies' from the acquisition.
- **Scenario 2**: Allocation to acquirer CGU(s), whereby the pre-existing business is expected to benefit from the acquisition, and additionally, the acquirer CGU(s) <u>will be</u> assigned assets or liabilities from the transaction. This type of benefit is also generally described as 'synergies' from the acquisition.
- **Scenario 3**. Allocation to CGUs (whether existing acquirer CGU(s) or newly formed CGU(s)) that will house the newly acquired business (or a portion thereof) and the related assets and liabilities acquired in the business combination. This future benefit, given that it is driven off the fair value of the acquired business, can be described as 'implied' or 'implicit' goodwill related to such purchased business.

Based on the ways in which the expected benefits/goodwill manifest in the three scenarios above, one could generally say that:

- To estimate the benefits that accrue to the pre-existing acquirer CGUs in Scenarios 1 and 2 above, one could consider a 'with-and-without' assessment of the value of the CGU(s) pre- and post-combination, or, a direct identification and quantification of these benefits.
- To estimate the amount of goodwill allocated in Scenario 3 above, a 'direct' assessment would be appropriate, which is also a byproduct of a purchase price allocation (PPA) analysis of the acquired business.

We believe that the examples shown in the DP allude to the above variations. For example:

- The illustration in par. 2.10 of the DP captures the goodwill from Scenario 3 above, and is equipped to handle the benefits identified in

Scenarios 1 and 2, although the latter two are not explicitly addressed by the example. Furthermore, the example does not contemplate direct identification or quantification of the benefits that would arise in Scenarios 1 and 2.

- The illustration in par. 2.12 only captures goodwill from Scenario 3 above.

We have provided further specific comments below.

Q1.1 Do you agree with the additional guidance on how an entity should allocate goodwill?

EFRAG has stated that it agrees with the principle in IAS 36 that the main driver to allocate goodwill should be the management's analysis of the expected synergies; however, it believes that that IAS 36 could provide some guidance on the allocation methods to be used (2.9). For that purpose, EFRAG puts forth two different allocation proposals, with illustrative examples.

Duff & Phelps Comments

Approach 1

The first approach (par. 2.9 – 2.10) proposed by EFRAG is articulated around the notion that goodwill allocated to CGUs should be based on the difference between the acquirer's CGUs fair value before and after the business combination.

The advantage of this approach is that it can address a range of circumstances, including when benefits from the business combination are expected to be realized by CGUs to which no acquired assets and liabilities are assigned.

In the specific example shown (par. 2.10), acquired net assets are in fact allocated to both CGU A and CGU B. By examining the pre-acquisition fair value of the acquirer's CGU A and CGU B and their post-acquisition fair values, inclusive of the acquired business, one could be capturing both: **(a)** any synergies paid for in the purchase price that accrue to the pre-existing/pre-acquisition CGU A and CGU B (i.e. Scenario 2 earlier), and **(b)** the implied goodwill of the acquired business (i.e. Scenario 3).

It is important to note, however, that to implement Approach 1, a determination of both the pre- and post-acquisition fair value of the CGUs, as implied by the example, is not needed. Rather, one could directly quantify the synergies that would be realized outside the of acquired (target) business at the pre-existing CGUs. This can address component **(a)** above, and specifically assign that portion of the purchase price to the respective CGUs. Then this would be supplemented with a "direct" approach to identifying the

implicit goodwill of the acquired business, resulting from the PPA on the target and its fair value, which is represented in **(b)** above[1].

Since the acquired goodwill allocation to the acquirer's CGUs should be performed at the acquisition date, an analysis of the deal projections would provide insight as to the nature of any expected synergies and improvements, and where in the CGU structure they can be realized. This allows for a direct estimation of these benefits. Since this type of analysis of the projections and the underlying assumptions is an integral part of performing the purchase price allocation, **this approach could meet both the improvement and simplification objectives that EFRAG has referenced**.

It is also worth noting that the approach as presented does not explicitly demonstrate how it can accommodate the allocation of goodwill to a CGU to which no assets and liabilities from the acquisition are assigned. If a third 'CGU C' were added that showed the pre- and post-acquisition fair value of CGU C, but without an allocation of net assets, then the difference would be representative of the synergies assigned to CGU C. Our observation above would still hold here as well, in that these synergies can be directly quantified without the need to perform the pre- and post-acquisition valuations.

Approach 2

Alternatively (par. 2.11 - 2.12), EFRAG considers that "entities could be allowed to allocate the goodwill on the basis of the difference between the fair value of the portion of the acquired business to be included in a CGU and the fair value of the net assets of the acquired business that have been assigned to a CGU". EFRAG further indicates that, "in most cases, this method would result in goodwill being allocated based on where the net assets of the acquiree have been assigned and exclude other CGUs that might be affected indirectly by the combination".

Duff & Phelps Comments

We think that Approach 2 can be applied in a narrower set of circumstances compared to Approach 1, as it does not explicitly capture any synergies that may be realized by the *pre-existing business* in an acquirer CGU, regardless of whether or not net assets from the acquisition were assigned to such acquirer CGU (i.e., Scenarios 1 and 2 discussed in our introductory comments.)

Otherwise, as a 'direct' goodwill allocation approach, Approach 2 will appropriately capture the implicit goodwill associated with the acquired business. Most practitioners use Approach 2, as this is the most common scenario, and is a good "basic" approach. Note that this approach can also be supplemented by an analysis of the purchase price and specific identification of synergies, discussed earlier.

[1] Approach 2 in par. 2.12 of the DP also captures this element of goodwill.

Practical View of Goodwill Allocation

We think that a practical and effective approach to goodwill allocation starts with understanding the assumptions in the acquirer's projections for the target, and identifying the synergies expected from the business combination. These are incremental to the standalone value of the target business, and are often referred to as a "control premium" or a "market participant acquisition premium" or "MPAP"[2].

The economic benefits underlying an MPAP ultimately manifest in two ways: (1) enhanced cash flows (e.g., operational improvements); or (2) lower required rate of return (e.g. financing optimization). The analysis of MPAP allows for a direct estimation of the benefits, along with where they are expected to be realized (i.e., which pre-existing CGUs, or a group of CGUs, are expected to receive the benefit, regardless of whether assets and liabilities are ascribed to those CGUs). This would be one element of the goodwill allocation that comprises genuine "synergies". This portion of the purchase price is identified and specifically assigned to various CGUs.

Separately, the PPA analysis (on the remaining purchase price) that would be performed for the target would yield the implicit goodwill of the acquired business. This part of the goodwill allocation would be driven by where the acquired business (or portions thereof) and accompanying acquired net assets are allocated.

* * *

It should be noted that the foregoing analysis is conducted in conjunction with understanding which synergies and elements of the projections are market-participant in nature or buyer-specific. While buyer-specific synergies would indirectly be assigned to goodwill, market participant synergies may end up being reflected either in goodwill or in an identifiable intangible asset. For example:

- Enhanced pricing power (if available to market participants upon acquisition of a competitor, and if reflected in the purchase price of the target) may benefit a pre-existing CGU or group of CGUs of the acquirer, and may be allocable to such as acquired goodwill.
- The ability to cross sell a complementary product of the buyer into the target's acquired customers (if available to market participants and included in the purchase price) may accrue to the value of the acquired customer relationships, an identifiable intangible asset.
- Market participant cost savings that would improve the cost structure at the target and lead to increased margins may be reflected in the value of the acquired identifiable intangibles.

[2] *The Measurement and Application of Market Participant Acquisition Premiums*, The Appraisal Foundation, 2017: https://appraisalfoundation.sharefile.com/share/view/sf6c518cbd8a41df9. As noted in the document, the concepts may be applicable to certain aspects of valuations under IAS 36. The term MPAP is used to (1) emphasize the importance of market participants' perspective when measuring fair value, and (2) to distinguish this premium from the more general notion of control premiums.

The above discussion also serves to demonstrate that *synergies are not necessarily equal to goodwill, and do not always end up recorded in goodwill*, but may at times be captured in an identifiable intangible asset.

And likewise, *goodwill is not comprised solely of synergies*. We think that some confusion may arise from misunderstanding the nature of goodwill and a perception that the goodwill allocation is solely based on synergies; goodwill itself comprises more than synergies. Goodwill includes the following main elements:

- Assets that do not meet the recognition criteria (e.g., assembled workforce);
- Future yet-to-be created intangible assets (e.g., future IP, future customer relationships);
- Going concern or "core goodwill";
- Market participant synergies from the business combination that are not captured in the fair value measurement of the acquired assets;
- Buyer-specific synergies;
- An overpayment (i.e. purchase price that is not economically supported by cash flows at either the target or the acquirer), although this occurs rarely.

Many of the above elements are captured in the "direct" method of goodwill allocation, while others could be allocated on a "with-or-without" approach via identification of the specific synergy. Except for the last item on the above list, characterizing goodwill as expected future benefits may generally be more appropriate.

Q1.2 Do you have any other suggestions to improve this area of the goodwill impairment test?

Duff & Phelps Comments

Please see discussion under Q1.1 above.

In addition, EFRAG raises the following point: "regardless of the basis of allocation, in principle the method should not result in a decrease of the headroom. The entity would therefore need to apply an 'allocation ceiling' to each CGU in all cases, with any excess goodwill over the aggregated allocation ceiling being written off" (2.13). Adding that "the objective is to ensure that goodwill is allocated only to the CGU expected to benefit from the acquisition and in an amount that does not exceed the expected synergies" (2.14).

The IASB is actively working on ways to improve the goodwill impairment test and is also exploring various approaches (such as the pre-acquisition headroom approach and the updated headroom approach), and it would be premature to set out a principle of how to address these situations prior to assessing IASB's proposals.

In the interim, we observe that if the goodwill at the target has economic support (through the fair value of the acquired business), or to the extent a synergy allocable to a pre-existing CGU of the acquirer has economic support (it is expected to increase the value of the CGU), this should not result in a decrease in headroom in a goodwill allocation. A decrease in the headroom could occur if the synergy is misallocated to a CGU or group of CGUs (where the benefit is not expected to be realized), or when a portion of the acquired goodwill arises from "overpayment" (i.e. purchase price that is not economically supported by cash flows at either the target or the acquirer). Given that overpayments are infrequent, this underscores the need to properly allocate goodwill.

CGU Reorganizations and Goodwill Re-allocation

EFRAG notes that constituents have also expressed concern about the impact of reorganizations on group and CGU structure, as it relates to the reallocation of goodwill. Some constituents had also noted that "re-allocation can be used to hide potential impairment losses".

We think that existing guidance in IAS 36 should address the latter concern. IAS 36.12 makes direct reference to plans to discontinue or restructure an operation in which an asset resides as a potential impairment indicator. Since goodwill is an asset[3], this arguably this could apply to goodwill as well:

> IAS 36.12: "In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:
>
> …. (f) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, *plans to discontinue or restructure the operation to which an asset belongs*, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite… "[emphasis added]

We are aware of interpretations in practice that this guidance requires an evaluation of whether an impairment may exist prior to the reallocation of goodwill. Perhaps some clarifying language could be used in conjunction with IAS 36.12 in this regard, and also consider stating that there may also be a need to evaluate if a reorganization may result in a goodwill impairment.

[3] IAS 36.81 states "Goodwill recognised in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised."

QUESTION 2 WHEN AN ENTITY SHOULD DETERMINE THE RECOVERABLE AMOUNT

In paragraphs 2.23 to 2.37 of Chapter 2, EFRAG discusses the introduction of a 'Step Zero' to the impairment test.

Q2.1 Do you agree with the introduction of an initial qualitative assessment?

EFRAG proposed to introduce a Step Zero, similarly to US GAAP requirements, which "would allow an entity to perform a qualitative assessment of the likelihood of an impairment loss. A separate qualitative assessment would be required at least annually for each CGU to which goodwill has been allocated. An entity would not be required to determine the recoverable amount when, and only when, the likelihood of an impairment is assessed to be remote. That is, when it is highly probable that the recoverable amount exceeds the carrying amount" (2.27).

It further mentions that "the introduction of a Step Zero would require more specific and adapted indicators for goodwill, which would build on those in IAS 36" (2.28).

It is added that "it could also be possible to add a quantitative component to the Step Zero in the form of an 'acid test'. For example, a market capitalization lower than the carrying amount of the net assets (for listed entities) or a decline in the revenues of the CGU of more than a defined threshold could be treated as a determinative indicator that automatically requires an entity to determine the recoverable amount" (2.30).

"To increase transparency, an entity would have to disclose how it reached a conclusion on its qualitative assessment for each CGU to which a significant amount of goodwill has been allocated. The disclosure could include a description of the significant factors evaluated" (2.31).

Duff & Phelps Comments

We think that the introduction of an optional Step 0 test can be a good simplification and have the following observations:

- While it seems that the IAS 36.99 can be leveraged to introduce a Step 0, the reality is that the threshold inherent is in IAS 36.99 could be a challenge. Should the threshold for passing Step 0 be that the likelihood of an impairment loss is "remote"? This is a very high threshold that may be difficult to get comfortable with qualitatively.

  It should also be noted that currently this "remote" threshold is associated with the ability to carryforward a quantitative calculation for a recoverable amount from one impairment test to the next, to be used (to stand in) the current quantitative test, hence the high threshold. However, it may be more operational to lower the threshold used for the purpose of a Step 0.

  In this regard, relevant experience under U.S. GAAP may be considered, where an optional Step 0 has been available since 2011. U.S. GAAP uses a "more-likely-than-not" threshold, which is a likelihood of more than 50%.

FASB dealt with very similar issues (an existing carryforward option at the time with a high threshold) when it amended the impairment test guidance for the effect of Step 0. See the Basis for Conclusions of ASU 2011-08., par. BC 14:

> "The Board also considered modifying the previous guidance to allow for increased use of the option to carry forward a prior-year fair value calculation but concluded that this approach would not result in meaningful cost reductions. In making this decision, the Board acknowledged that, for various reasons, many public and nonpublic entities have not used the carryforward option previously provided in paragraph 350-20-35-29. One of the criteria required to utilize the carryforward option was that the likelihood of a reporting unit's current-year fair value calculation being less than its carrying amount must be remote. Several preparers stated that they have been unable to satisfy the carryforward criteria primarily because of the remote probability threshold, and many added that, in practice, there is a bias toward not placing reliance on a prior-year fair value calculation.
>
> The Board concluded that if the amendments required an entity to perform a fair value calculation to periodically support its qualitative assertions, then the benefits of the proposal would be reduced because some entities would still be required to calculate fair value under the first step of the test, regardless of their conclusions reached in performing the qualitative assessment. The Board concluded that an entity would no longer be permitted to carry forward a reporting unit's fair value calculation from a prior year as previously permitted by paragraph 350-20-35-29. The Board reached that conclusion because if an entity determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then the entity must calculate the current fair value of the reporting unit rather than place reliance on a prior-year fair value calculation. However, the Board concluded that if an entity has a recent fair value calculation for a reporting unit, it should include as a factor in its consideration the difference between the fair value and the carrying amount in determining whether to perform the first step of the impairment test."

- Impairment indicators already exist in IAS 36, which can be leveraged to perform a Step 0. However, IAS 36 includes assets in its scope other than goodwill. As such, more specific and goodwill-oriented indicators could be useful, and they can be used both as factors to be considered in a qualitative assessment (Step 0) as well as impairment indicators for goodwill. Additionally, we think that any enhanced list of factors should indicate that it is not all inclusive.

  We do not think that an "acid test", such as market capitalization below the carrying amount of net assets, is necessary to trigger an automatic quantitative test. (For example, it is possible that market cap dips temporarily below carrying value.) Rather, this would be just one of the factors evaluated that may receive a significant weight, depending on the circumstances (see next bullet).

We also think that incorporating discrete quantitative decline thresholds for revenue or other financial metrics as an impairment indicator may result in prescriptive guidance, which is incongruent with a Step 0 qualitative assessment.

- As to the way qualitative factors would need to be assessed (in response to par. 2.33 and 2.35 of the DP), we think they would need to be evaluated in the aggregate[4].

- Par. 2.27 makes reference to performing Step 0 for "each CGU". It is unclear if this is intentional or not, as goodwill may be allocated to a group of CGUs. In that case, Step 0 may need to be performed on the group level.

- Also, as to disclosures about Step 0, at a minimum, there should be a disclosure that Step 0 has been applied and passed.

- The introduction of a Step 0 should be considered in conjunction with any revised impairment testing model. (For example, how might Step 0 be applied if a goodwill accretion model or another model were in place?) However, it might be possible to define a slightly different measurement objective for the qualitative test (i.e. a different comparison from that required for the quantitative test.)

Q2.2 Do you have any other suggestions to improve this area of the goodwill impairment test?

Duff and Phelps Comments

We think that the quality of qualitative disclosures around goodwill impairment is key and we agree with the conclusions of the ESMA Report, *European Enforcers Review of Impairment of Goodwill and Other Intangible Assets in the IFRS Financial Statements* (ESMA/2013/2) in that respect. Particularly, clear disclosure of the sensitivity of key assumptions could be helpful.

[4] For example, see FASB's ASC 350, *Intangibles – Goodwill and Other,* par. ASC 350-20-35-3D through 3G.

QUESTION 3 HOW AN ENTITY SHOULD DETERMINE THE RECOVERABLE AMOUNT

In paragraphs 2.38 to 2.78 of Chapter 2, EFRAG discusses how an entity determines the recoverable amount.

Q3.1 Do you agree with having a single method for determining the recoverable amount?

EFRAG considers that "from a practical standpoint, requiring or allowing only one method could simplify the impairment test as both preparers and users will not have to consider whether there is a difference in terms of assumptions and inputs used in the DCF model when calculating the VIU and FVLCD. This could be achieved by retaining only one of the two methods (either VIU or FVLCD) as the measurement of recoverable amount" (2.41).

Duff & Phelps Comments

In general, highlighting and explaining the methodology differences between the two approaches could address any confusion about their application. Each difference could be addressed and discussed in a manner similar to the EFRAG's approach to Restructuring and Pre-tax Rates. It should also be emphasized that VIU calculations still need to leverage certain market inputs and evidence.

We think that the concept of a recoverable amount, specifically the VIU component, introduces some complexity into the testing process. Certain assumptions used in the derivation of VIU are prescriptive (for example, the 5-year projection period) and not necessarily reflective of the economics of the assets or businesses being tested. The deviation from the market participant view tends to infuse more subjectivity into this measurement.

Notwithstanding any clarification that may be undertaken, we believe that using fair value (or FVLCD) as a measurement attribute against which impairment is evaluated (i) provides the most relevant information about the performance of a CGU (group of CGUs); (ii) may be easier to apply; and (iii) is consistent with the basis on which goodwill and other intangibles were initially recorded in the business combination.

We also would like to point out that the fair value concept and measurement framework defined in IFRS 13 did not exist when IAS 36 was issued. IFRS 13 clarified a number of fair value concepts, which should largely dispel any negative connotation of an exit transaction (and exit price) on value, even when management plans to continue holding and operating the asset(s) or business.[5]

[5] Par. 2.44 of the DP references a "hypothetical immediate sale which management does not intend to make" when discussing FVLCD.

Q3.2 Do you agree with the inclusion of future restructurings in the calculation of the value in use?

EFRAG considers that "the requirements for the VIU measurement should be changed to allow the effect of planned future restructurings (inflows and outflows) to be incorporated in the cash flow projection, even when the threshold to recognize a provision for restructuring costs has not yet been met" (2.50).

Duff & Phelps Comments

We agree with the inclusion of restructuring in VIU. We also think that the limitation on capital enhancements complicates the VIU calculation.

However, even with these modification, we would recommend a single measurement of the recoverable amount, which is FVLCD.

Also, See our discussion in Q3.1 above.

Q3.3 Do you agree with allowing the use of a post-tax discount rate?

EFRAG considers that the requirements should be changed to allow entities an election between a pre-tax or post-tax calculation. Entities would need to disclose the basis chosen.

Duff & Phelps Comments

The requirement to conduct the test on a pre-tax basis and the related requirement to exclude the effect of DTAs and DTLs in the determination of the carrying value of the cash generating unit introduces unnecessary complexity and may produce unintended results.

Most practitioners are already using a post-tax basis, (as noted in paragraphs Z81 to Z84 of the Basis for Conclusions of IAS 36).

We therefore agree with allowing a post-tax measurement.

Q3.4 Do you agree that the impairment test should target internally generated goodwill? Is the goodwill accretion an acceptable way to do so?

Par. 2.65 of the DP states: "one of these ['buffers' that can potentially offset an impairment loss] is due to the fact that after the business combination, the acquirer may generate additional goodwill through its efforts and investments. Conceptually, this is not part of purchased (and paid for) goodwill."

EFRAG considers that "IAS 36 should require entities to make an adjustment, when testing purchased goodwill, in order to eliminate the effect of the internally generated goodwill. The adjustment would be made by means of a 'goodwill accretion' and would be determined only for the purpose of the impairment test with no recognition in the financial statements (2.68).

It further adds that "each year, the entity would determine an accretion amount by applying a rate to the opening balance of goodwill. This amount would be added to the carrying amount of the CGU. If no impairment loss is recognized, the balance of accretion would be carried forward. When the inclusion of the accretion results in the recognition of an impairment loss, the balance of the

accretion would be correspondingly reduced. The entity would continue to determine the accretion until the goodwill is fully written off (2.69).

Duff & Phelps Comments

Economically, goodwill captures the residual cash flows not assigned to identifiable assets of the purchased business. IFRS 3 defines goodwill as an "asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized"[6].

We understand that while there may be continued agreement on the above, the IASB is exploring various approaches to improve the effectiveness of the goodwill impairment test, and will be issuing a document for comment in the coming months. We think it is important to evaluate the IASB's proposal before exploring other approaches.

Q3.5 Do you have any other suggestions to improve this area of the goodwill impairment test?

Duff & Phelps Comments

Other than the specific comments offered in this letter, we believe that the impairment test provides relevant information, and together with the associated disclosures, has confirmatory value.

[6] IFRS 3, Defined Terms