Goodwill impairment – Key considerations

This article aims to

– Highlight important considerations for entities conducting goodwill impairment test under Ind AS.

Application of Ind AS would allow goodwill recognition only when there is a business combination. Such a goodwill would be an asset that represents the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

Under Accounting Standards (AS), goodwill would arise by application of erstwhile AS 10, *Accounting for Fixed Assets* consequent to an asset purchase, AS 14, *Accounting for Amalgamations* in respect of mergers and AS 21, *Consolidated Financial Statements* by virtue of equity interests of the reporting entity in other entities.

Goodwill does not generate cash flows independently of other assets or groups of assets and often contributes to the cash flows of multiple cash-generating units. Therefore, goodwill can never be a Cash Generating Unit (CGU) on its own.

An entity must ensure that its assets are carried at no more than their recoverable amount. According to Ind AS 36, *Impairment of Assets* when an asset is carried at more than its recoverable amount i.e. its carrying amount exceeds the amount to be recovered through use or sale of the asset, then in this case, the asset is described as impaired and an entity has to recognise an impairment loss.

Once an entity recognises goodwill arising from a business combination, Ind AS prescribes specific requirements about how goodwill is tested for impairment as part of the testing of CGUs.

Background to impairment testing

A CGU is the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups thereof.

In testing for impairment, the carrying amount of an asset or CGU is compared with its 'recoverable amount', which is the higher of:

- the asset's or CGU's fair value less costs of disposal; and
- value in use.

'Fair Value Less Costs of Disposal' (FVLCD) is the price that would be received to sell an asset or CGU in an orderly transaction between market participants at the measurement date, less the costs of disposal.

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Value in use' is the present value of the future cash flows expected to be derived from an asset or CGU. Value in use is a valuation concept that is specific to Ind AS 36 and not used in other Ind AS. It combines entity-specific estimates of future cash flows - from continuing use and eventual disposal of the asset or CGU - with a market participant-based discount rate. Ind AS 36 includes detailed rule-based requirements on determining value in use

Key considerations

In this article, we aim to elaborate on the important considerations that the entities following Ind AS should lay emphasis while conducting and presenting impairment test of goodwill.

Frequency of goodwill impairment

Under Ind AS, CGUs to which goodwill has been allocated are required to be tested for impairment annually. In addition, impairment tests could be performed by the entity as a result of a triggering event.

While under Accounting Standards, goodwill is tested for impairment only when there is a triggering event indicating impairment.

Under Ind AS goodwill is no longer amortised but tested for impairment.

Basis of allocation of goodwill to CGUs

As mentioned above, goodwill does not generate independent cash inflows; therefore, the asset needs to be allocated to a CGU or a group of CGUs. Therefore, goodwill arising in a business combination is allocated to the acquirer's CGUs that are expected to benefit from the synergies of the business combination in which goodwill arose. This is irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

Ind AS 36 does not prescribe any specific method of identifying synergies or of allocating goodwill and that valuation specialists could be used for this purpose. The pre-acquisition analysis of the acquirer may be useful in allocating the goodwill to CGUs. This analysis may indicate the drivers behind the synergies that are expected to arise from the acquisition and may help in finding an appropriate method for allocating the goodwill between CGUs. Examples of methods of allocation include the with or without method[1], allocation in proportion to the relative fair value of the identifiable net assets in each CGU and allocation in proportion to the relative fair values of the CGUs.

Measurement of impairment loss and interaction with Ind AS 108, Operating Segments

Goodwill sometimes cannot be allocated on a non-arbitrary basis to an individual CGU but only to groups of CGUs. Therefore, each unit or group of units to which goodwill is allocated:

- Should represent the lowest level within the entity for which information about goodwill is available and monitored for internal management purposes, and
- Should not be larger than an operating segment, determined in accordance with Ind AS 108 before applying the aggregation criteria of Ind AS 108.

Goodwill is allocated to the lowest level at which it is monitored for internal management purposes. This is to avoid the need to develop additional reporting systems to support goodwill impairment testing. However, this does not mean that entities can avoid testing goodwill at a level lower than an operating segment by simply not monitoring goodwill explicitly.

Under Accounting Standards, the reporting entities in India that have a matrix organisation could have used the management approach to define CGUs for the purpose of monitoring goodwill without taking the segments into consideration. Under Ind AS, reporting entities would need to consider the allocation of goodwill to CGUs while considering the interaction with Ind AS 108.

Method of impairment assessment

There are two scenarios in which goodwill is tested for impairment:

1. A CGU or a group of CGUs to which goodwill has been allocated is being tested for impairment when there is an indication of possible impairment, or
2. Goodwill is being tested for impairment in the annual mandatory impairment testing, without there being an indication of impairment in the underlying CGUs.

In the first scenario (indicator-based impairment test), the way in which impairment testing is carried out depends on whether goodwill has been allocated to individual CGUs or to a group of CGUs. If goodwill has been allocated to a group of CGUs, then impairment testing is performed in the following steps.

- The first impairment test is performed at the individual CGU level without goodwill (bottom-up test), and any impairment loss is recognised.
- The second impairment test is applied to the collection of CGUs to which the goodwill relates (top-down test).

However, if the goodwill has been allocated to an individual CGU, then there is no need for a two-step approach, and the entire CGU (including goodwill) is tested for impairment.

In the second scenario (annual impairment test), the collection of CGUs to which the goodwill relates is tested for impairment, and there is no requirement for two-stage (bottom-up and top-down) testing.

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1. Based on the difference between the fair value of a CGU before and after the acquisition.

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Cash flow projections

In measuring value in use, cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the range of future economic conditions. Ind AS lays greater weight to external evidence with which management determines its best estimate of cash flow projections. Management should also assess the reasonableness of the assumptions on which cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows and ensure consistency of the current cash flow projections with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years. Management may use cash flow projections based on financial budgets/forecasts over a period longer than five years if it is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

Ind AS 36 provides a detailed guidance on developing cash flow projections, including the treatment of future cost, capital expenditures, restructuring, etc.

Use of discount factor

As part of the impairment process, Ind AS 36 requires that future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency.

In determining value in use, projected future cash flows are discounted using a pre-tax discount rate that reflects:

- current market assessments of the time value of money; and
- the risks specific to the asset or CGU.

The discount rate is based on the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those of the asset or CGU. In other words, the discount rate is based on a market participant's view of the asset or CGU as at the current date. Therefore, although the cash flows in the value in use calculation are entity-specific, the discount rate is not.

In our experience, it is rare that a discount rate can be observed directly from the market. Therefore, an entity will generally need to build up a market participant discount rate that appropriately reflects the risks associated with the cash flows of the CGU being valued. In the absence of a discount rate that can be observed directly from the market, Ind AS 36 refers to other starting points in determining an appropriate discount rate:

- the entity's Weighted-Average Cost of Capital (WACC)
- the entity's incremental borrowing rate, and
- other market borrowing rates.

Key assumptions

While performing impairment analysis, there is a need to use assumptions that represent realistic future expectations. Ind AS 36 requires detailed disclosures on estimates used to measure the recoverable amount of CGU to which significant goodwill is allocated.

Value in use

When a CGU's recoverable amount is based on its value in use, considerable judgement has to be exercised by the management. Therefore, entities would need to provide sufficient CGU-specific qualitative and quantitative disclosures. The aim of Ind AS 36 is help users understand the approach followed by the management.

For value in use, Ind AS 36 requires management to explain its approach in determining the values assigned to each key assumption by allowing users to understand whether these values are consistent with external sources of information or how and why they differ from past experience or external sources of information.

Additionally, an entity would need to provide following disclosures:

- Each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the unit's (group of units) recoverable amount is most sensitive.
- The period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a cash-generating unit (group of units), an explanation of why that longer period is justified.
- The growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated.

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- The discount rate(s) applied to the cash flow projections.

Fair Value Less Costs of Disposal (FVLCD)

When a CGU's recoverable amount is based on its FVLCD, again considerable judgement has to be exercised by the management while applying valuation techniques. If FVLCD is not measured using a quoted price for an identical unit (group of units), an entity should disclose the following information:

- Each key assumption on which the management has based its determination of FVLCD. Key assumptions are those to which the unit's (group of units) recoverable amount is most sensitive.
- A description of management's approach to determining the value (or values) assigned to each key assumption, whether those values reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.
- The level of the fair value hierarchy (see Ind AS 113 within which the fair value measurement is categorised in its entirety (without giving regard to the observability of 'costs of disposal').
- If there has been a change in valuation technique, the change and the reason(s) for making it.

If FVLCD is measured using discounted cash flow projections, an entity should disclose the following information:

- the period over which management has projected cash flows
- the growth rate used to extrapolate cash flow projections
- the discount rate(s) applied to the cash flow projections.

Sensitivity analysis

Ind AS 36 calls for disclosures aimed at helping users in assessing the safety margin and evaluating how sensitive the assessment is to a change in one or several of key assumptions used when determining the recoverable amount. Therefore, entities would need to consider the current economic environment and make these disclosures relevant and include assumptions such the growth rates, the discount rate, the operating margin and their impact on revenues or volume of sales. Additionally, Ind AS 1, *Presentation of Financial Statements* requires similar disclosures on assumptions made about the future, and other major sources of estimation uncertainty, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets within the next financial year.

In our experience, the disclosures related to goodwill are the most challenging, requiring information about key assumptions made in estimating recoverable amount and a sensitivity analysis dealing with key assumptions that might reasonably change and thereby trigger an impairment loss. Additionally, the entities should check the consistency and reasonableness of the inputs used in various valuation techniques e.g. Ind AS 36, *Impairment of Assets,* Ind AS 37, *Provisions, Contingent Assets and Contingent Assets,* IAS 19, *Employee benefits,* etc. while presenting and disclosing financial statements.

Consider this

- Estimates of future cash flows in the value in use calculation are specific to the entity, and need not be the same as those of market participants. The discount rate used in the value in use calculation reflects the market's assessment of the risks specific to the asset or CGU, as well as the time value of money.
- An impairment loss for a CGU is allocated first to any goodwill and then pro rata to other assets in the CGU that are in the scope of Ind AS 36.
- An impairment loss is generally recognised in profit or loss.
- Reversals of impairment of goodwill are prohibited.

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