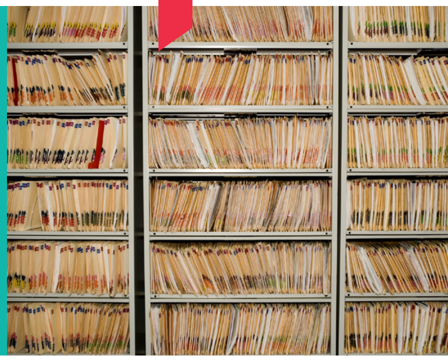
ESMA's REVIEW OF IMPAIRMENT OF GOODWILL AND OTHER INTANGIBLE ASSETS IN THE IFRS FINANCIAL STATEMENTS

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/07



STATUS
Final

EFFECTIVE DATE
Immediate

ACCOUNTING IMPACT
Focus areas for European enforcers; also relevant for other jurisdictions due to global coordination among national enforcers.

Background

The European Securities and Markets Authority (ESMA) has released a report outlining the findings of its 2011 financial statement review of impairment testing of goodwill and other intangible assets. The report evaluates the appropriateness of disclosures from a sample of 235 European issuers from 23 countries with a combined total of approximately €800bn of goodwill. This total was similar to the total of €790 billion recognised in 2010 IFRS financial statements.

ESMA's review found that impairment losses of €40bn (5%) had been recognised in 2011, with significant losses having been recognised by only a few issuers. Goodwill impairment was limited predominately to the financial services sector (€19.2bn) and telecommunication industry (€9.7bn) – with 75% of the impairment in the financial services sector being made up of only two entities from the same jurisdiction. Interestingly, this level of impairment was similar to that of other intangible assets, with impairment losses of €4.2bn being recognised in comparison with the €98.7bn carrying amount of these assets.

Given that significant impairment losses of goodwill and other intangible assets were limited to only a handful of issuers, ESMA has questioned whether the amount of impairment disclosed in the 2011 financial reports appropriately reflected the difficult economic operating environment. ESMA has also noted that the disclosures made by most entities were boilerplate in nature and were not entity specific. Key areas of concern include:

– Key assumptions of management
– Sensitivity analysis
– Determination of recoverable amount
– Determination of growth rates
– Disclosure of an average discount rate.

As a result, ESMA has signalled that it expects issuers (and their auditors) to consider the findings of the report when preparing (and auditing) their current IFRS financial statements. ESMA then plan to collect data on how European listed entities have applied the requirements of IAS 36 *Impairment of Assets* in this area in their 2012 financial reports, with the intention of reporting its findings to the market.

Further, the findings and recommendations of the report will be incorporated into reviews carried out by each national authority, which will take corrective action (which may include a requirement for public restatement of financial statements) in the event that a material error is identified.

While ESMA is a European regulator, listed companies in other jurisdictions that apply IFRS (and their auditors) should be aware of, and take into account, the enforcement priorities raised in the statement, as they relate to financial reporting issues that are not isolated to the European financial reporting environment. It is also relevant that enforcers worldwide are increasingly sharing information that they collect in the process of their activities.

Introduction

Executive summary

Impairment of goodwill and other intangible assets will be an focus area of ESMA's 31 December 2012 year-end financial statement reviews. It should be assumed that ESMA is expecting issuers to incorporate the points raised in the report in the preparation of their 2012 financial statements.

An overview of the key disclosures issues raised by ESMA is highlighted below:

- **Key assumptions:** The required disclosure of key assumptions made by management in the calculation of recoverable amount, whether by fair value less cost to sell or value in use, need to be clear, complete, and transparent. Although the disclosures need to cover only the key assumptions, these need to be in addition to disclosures already required for the discount rate and terminal growth rate.
- **Sensitivity analysis:** Disclosure of a sensitivity analysis is required where a reasonably possible change in a key assumption would lead to impairment. The existence of a reasonably possible change in a key assumption is likely to be evidenced where the market capitalisation of an issuer is lower than the book value of its equity. The sensitivity analysis needs to be for each cash generating unit (CGU), not simply an aggregate of some or all of an issuers CGUs.
- **Determination of recoverable amount:** IFRS requires that cash flows are based on market assumptions when the recoverable amount under fair value less cost to sell is based on discounted cash flows. More weight is required to be given to external sources of information rather than entity specific assumptions. It is important to also note that the approach differs when the recoverable amount is determined through value in use, based on discounted cash flows.
- **Determination of terminal growth rates:** The terminal growth rate needs to reflect a realistic estimate of future growth rates that correspond to forecasts of economic development, and should not exceed long-term average growth rate for the products, industries or countries in which the issuer operates. With reference to the current European economic environment, ESMA has specifically stated that in most cases the use of a terminal growth rate exceeding 3% would be overly optimistic.
- **Disclosure of an average discount rate:** ESMA has noted that the disclosure of a single average discount rate (rather than a discount rate that is specific to each material CGU) potentially obscures information that may be relevant to users of financial statements. When the risk profile of the CGU differs, ESMA expects to see specific discount rates disclosed.
- **Forecast period:** IFRS requires that the forecast period for amounts used for the purposes of impairment tests must not exceed five years unless an extended period can be justified. ESMA cautions issuers that do use a forecast period that exceeds five years to first ensure that they have an accurate track record in being able to project cash flows out beyond five years (i.e. the comparison between actual results and budgets).
- **Comparative information:** IFRS requires that prior period information must be presented for all amounts presented in the current period's financial statements. Therefore amounts disclosed in the current period in respect of the discount rate, terminal growth rate, and any other key assumptions must be accompanied by prior period comparative information.

1. General information on impairment tests – summary of ESMA findings

a) Information on impairment losses

Requirements of IFRSs

IAS 36.130(a) requires an entity to disclosure the events and circumstances that led to the recognition of the impairment loss for each material impairment loss recognised during the period for an individual assets, including goodwill, or a CGU.

ESMA findings

As mentioned in the background, very few entities recognised significant charge for impairment against the carrying amount of goodwill and other assets. Of those that did report impairment losses, the disclosures in relation to the events and circumstances that led to the recognition of the impairment loss often appeared vague and included generic explanations, such as being due to a 'worsening economic outlook', 'slowdown of the demand', and 'competitive environment'.

Very few issuers provided specific information that went towards complying with IAS 36.130(a), such as presenting their explanations in the following format: 'significant deterioration of the economic conditions in country X' or 'impacts on forecast cash flows due to political situation in country X'.

b) Information on the composition of CGUs, level of aggregation and goodwill allocation

Requirements of IFRSs

IAS 36.80 provides guidance on allocation of goodwill to a CGU for the purposes of impairment tests.

IAS 36.130(d)(i)-(iii) require an entity to disclose:

- A description of the CGU for each material impairment loss recognised
- Disclosure of the amount of the impairment loss by reportable segment
- A description of any changes to the aggregation of assets for identification of the CGU.

In practice, these disclosure requirements would be expected to be presented together.

ESMA findings

Information on the level at which CGUs are being defined by issuers, and a link between the level of CGUs used for impairment testing and the operating segments, was apparent in a majority of cases.

However, criticisms from ESMA included:

- Issuers that did not provide information on the level at which they define CGUs, and also did not disclose the basis on which goodwill is allocated
- Issuers that indicated that they had changed the way the CGUs were defined, with a large majority simply stating that this was due to 'internal changes', with no further explanation.

Conclusions and Expectations noted by ESMA

ESMA noted that the quality of narrative information could be improved when describing the events and circumstances which led to the recognition of impairment. It should be expected that they will focus on this area in their 2012 financial statement reviews.

Also, ESMA questioned whether the level of impairment in 2011 appropriately reflected the effects of the financial and economic crisis, given that for some issuers there were instances of:

- Increased equity/market capitalisation ratio compared to 2010
- Relatively low ratios of impairment losses to prior year carrying amounts for both goodwill and other intangible assets.

Given that there has been very little (if any) positive improvement in European markets during 2012, it is possible that there will be an increase in both the quantum and number of issuers reporting impairments against goodwill (and other intangible assets) in their 2012 financial statements.

2. Determination of the recoverable amount – summary of ESMA findings

Requirements of IFRSs

IAS 36 requires that an asset or a CGU is tested for impairment by comparing its recoverable amount with its carrying amount, with recoverable amount being the higher of either fair value less costs to sell of value in use.

IAS 36.134(c) of requires an entity to disclose which of the two above bases has been used to determine a recoverable amount.

The determination of *fair value less cost to sell* is detailed in IAS 36.20 and 25-29, which provide a hierarchy upon which fair value less costs to sell can be determined, by reference to:

– A binding sales agreement
– An active market in which the asset is traded (including recent transactions for similar assets)
– The best information available to reflect the amount that the entity could obtain from the sale of the asset (requires the use of discounted cash flow computations based on market assumptions).

The determination of value in use is detailed in IAS 36.30, which in all instances requires the use of discounted cash flow computations with specific requirements in relation to:

– Estimating the future cash flows
– Dealing with foreign currency cash flows
– Computation of the discount rate.

IAS 36.33 further expands on the requirements for estimating future cash flows for the purposes of value in use, requiring that:

– They should be based on reasonable and supportable assumptions by the management (with greater weight given to external evidence)
– They **exclude** cash inflows from future restructurings or from future expenditure to improve the asset's performance.

IAS 36.134(e) prescribes the required disclosures in relation to the methodology used in determining fair value less cost to sell. IAS 36 paragraph 134(d) prescribes the required disclosures in relation to the methodology used in determining value in use.

ESMA findings

Disclosure of the basis on which the recoverable amount had been determined was provided in almost all cases.

The majority of issuers determined recoverable on a value in use basis, with only a few using a fair value less cost to sell (the remainder using a mixture of the two).

For those issuers using fair value less cost to sell, with reference back to the hierarchy set out above:

– Very few referred to a binding sales agreement
– Reference to comparable transactions was used by some issuers
– Discounted cash flow computations were used by the majority of issuers
– The remaining minority of issuers used other methodologies.

Half of issuers using fair value less cost to sell did not state that the fair value less costs to sell reflected market assumptions.

(Refer to section 3. for details about value in use)

Conclusions and Expectations noted by ESMA

ESMA noted that there is room for improvement in the quality of disclosures for issuers using fair value less cost to sell to determine recoverable amount, particularly in regard to management's approach in setting assumptions and estimates.

ESMA also highlighted that issuers need to:

– Remember that the requirements are different for discounted cash flows when used to determine value in use or fair value less cost to sell (i.e. fair value less costs to sell calculations are based on market's assumptions)
– Give more weight to external sources of information rather than entity specific assumptions
– Provide more specific disclosures around the basis of determining recoverable amounts so that this is clear to users.

3. Determination Analysis of parameters used in DCF calculations – summary of ESMA findings

a) Discount rate

Requirements of IFRSs

IAS 36.134(d)(v) and 134(e)(v) requires an entity to disclose the discount rate applied to the cash flow projections for each CGU with significant goodwill.

IAS 36.55, A16 and A19 prescribe the following requirements for determining the discount rate in value in use:

- The discount rate must be a pre-tax rate which reflects the current market assessments of the time value of money and of the specific risks for which the future cash flow estimates have not been adjusted and is independent from the entity's capital structure
- If an asset-specific discount rate is not directly available from the market, the discount rate must be estimated
- Determining the discount rate is performed independently of the capital structure of the issuer (i.e. based on the market capital structure).

Note: the capital asset pricing model (CAPM) is commonly used to determine the cost of equity, and requires assumptions to be made in relation to the risk-free rate, market risk premium and beta. Attention needs to be paid to the correlation of inflation assumptions and the time horizon of expected cash flows when determining the risk free rate.

ESMA findings

Highlights of ESMAs findings in relation to discount rate disclosures were:

- Very few issuers failed to disclose the discount rate used. Of those issuers that did disclose, a majority disclosed a specific rate and approximately a quarter disclosed an average non-CGU specific rate
- Just over one fifth of issuers made no disclosure of whether the discount rate was pre-tax or post-tax. Of the remaining issuers, the majority disclosed a pre-tax rate, approximately a fifth disclosed the use of a post-tax rate, and a small minority disclosed a both a pre-tax and post-tax rate
- The pre-tax discount rate used by the majority of issuers fell between 8% and 11%. The financial services sector and the technology and telecommunications industries however used rates higher than this, with the health care industry applying a discount rate at the lower end
- Of those issuers that presented a range of discount rates, three quarters presented a 0-5% range, with very few going above 7%
- The disclosure of further aspects of the discount rate, such as the risk-free rate, country risk premium, and market risk premium (while not specifically required by IAS 36) was only made by a small minority of issuers
- Two thirds of issuers presented comparative information for discount rates.

Conclusions and Expectations noted by ESMA

ESMA noted that disclosing only a single average discount rate potentially obscures relevant information and therefore urges issuers to use separate discount rates when the risk profile of the identified CGUs differs.

ESMA has also highlighted that:

- Prior period information relating to discount rates should also be presented by issuers – a general requirement of IAS 1 *Presentation of Financial Statements* paragraph 38
- While parameters such as the risk-free rate, country risk premium, and market risk premium are not specifically required by IAS 36, they may be helpful to assist users in their assessment of the impairment tests.

b) Terminal growth rate

Requirements of IFRSs

IAS 36.134(d)(vi) and 134(e)(vi) require an entity to disclose the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent forecasts (i.e. the 'terminal growth rate'), for each cash-generating unit for which the carrying amount of goodwill or other intangible assets allocated to that unit is significant.

Additional disclosure and justification is required if the issuer uses a terminal growth rate that exceeds the long-term average growth rate for the products, industries or countries in which the entity operates or for the market to which the unit is dedicated (i.e. if the terminal growth rate exceeds, for example, inflation).

The justification is required because, conceptually, a higher than average terminal growth can only be sustained over the short-term, as such conditions will attract new entrants and give rise to competition.

IAS 36.33(c) requires that terminal growth rate projections are made on a steady or declining growth rates for subsequent years unless an increasing rate can be justified.

As above, IAS 36.33 requires greater weight to be given to external evidence estimating future cash flows.

ESMA findings

Highlights of ESMAs findings in relation to discount rate disclosures were:

– Almost one fifth of issuers failed to disclose the terminal growth rate used. Of those issuers that did disclose, the majority disclosed a specific rate, with a quarter disclosing a range of growth rates. The remaining issuers disclosed an average growth rate for all CGUs
– Fewer than half of issuers presented comparative information in relation to discount rates
– The majority of issuers used a terminal growth rate between 2-3%, with 15% of issuers using higher rates of terminal growth
– Just over 10% of issuers used a growth rate of 0%, with almost no issuers using negative growth rates.

ESMA also noted that there were no significant differences in the growth rate applied between:

– Issuers whose market capitalisation was below the book value of equity
– Issuers whose market capitalisation exceeded the book value of equity.

Conclusions and Expectations noted by ESMA

ESMA noted that in some cases, the terminal growth rates applied might appear to be too optimistic, especially in cases where the market capitalisation was below the book value of the entity.

Given the current recession, terminal growth rates that exceed 3% in mature markets might appear ambitious (i.e. may lead to an overstated terminal growth rate and recoverable amount). Therefore issuers need to provide realistic estimates of future growth rates that correspond to current predictions of the nominal economic growth.

As above ESMA has also highlighted that prior period information relating to the terminal growth rate should also be presented by issuers (IAS 1.38).

c) Period covered by cash flow projections

Requirements of IFRSs

IAS 36.134(d)(iii) requires an entity to disclose the period over which management has projected cash flows based on financial budgets/forecasts approved by management (i.e. the 'forecast period' prior to the above 'terminal period'), for each cash-generating unit for which the carrying amount of goodwill or other intangible assets allocated to that unit is significant.

IAS 36.33(b) requires that the forecast period covers a maximum period of five years, unless a longer period can be justified – this is because long-term forecasts generally become less reliable as they move further into the future.

ESMA findings

Highlights of ESMA's findings in relation to discount rate disclosures were:

- Just over 10% of issuers failed to disclose information regarding the period covered by the forecast period
- Of those that did disclose information regarding the period covered by the forecast period, the vast majority (80%) of issuers used a forecast period of five years or less, 14% used a period of 6-10 years, and an extremely small number used a period greater than 10 years
- Almost 40% of those issuers that used forecast periods in greater than 5 years, failed to disclose the reasons for doing so. For those that did, explanations varied in length and content.

Conclusions and Expectations noted by ESMA

ESMA highlighted that issuers that use forecast periods greater than 5 years should:

- First be able to demonstrate their ability to forecast cash flows accurately over that longer period (i.e. based on past experience)
- Disclosure explanations that are explicitly linked to the circumstances of the issuer, the CGU or the industry as to why a longer forecast period has been use.

d) Period key assumptions

Requirements of IFRSs

Depending on the specifics of an entity, IAS 36.134(d)(i)-(ii) require an entity to make (potentially extensive) disclosures regarding key assumptions used in value in use calculations for each cash-generating unit for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit is significant.

These require an entity to disclose:

- A description of each key assumption (i.e. those to which the unit's recoverable amount is most sensitive on which management has based its cash flow projections)
- A description of management's approach to determining the values assigned to each of the above key assumptions, and stating state whether the values used reflect past experience or, if appropriate, are consistent with external sources of information and why they differ from past experience or external sources of information, if applicable.

These are similar to the disclosures required for the key assumptions used in fair value less costs to sell calculations.

IAS 36 illustrative example 9: *Disclosures about cash-generating units with goodwill or intangible assets with indefinite useful lives*, while not a prescribed requirement in itself, provides insight into the level of detail anticipated for disclosures around management assumptions (i.e. gross margin, specific products price, inflation, market share and development of the exchange rate).

ESMA findings

Highlights of ESMAs findings in relation to key assumptions were:

- Approximately 40% of issuers failed to disclose information regarding key assumptions
- Of those that did disclose information regarding key assumptions, almost half were not compliant in comparison with the level of detail in illustrative example 9
- Some issuers provided a long list of assumptions (10 or more), while others provided very few
- Some issuers simply disclosed a generic disclosure that 'cash flow forecasts are based on budgets approved by management'.

Conclusions and Expectations noted by ESMA

ESMA noted that the disclosure of the key assumptions as required by IAS 36 is an area requires improvement, specifically:

- Both the number and type of assumptions disclosed needs to increase (however these should only be the key assumptions, not a list of all assumptions)
- These assumptions are **in addition** to the required disclosures relating to discount rate and the terminal growth rate.

4. Sensitivity analysis – summary of ESMA findings

Requirements of IFRSs

IAS 36.134(f) requires the disclosure of a sensitivity analysis, if a reasonably possible change in a key assumption on which management has based its determination of the CGU recoverable amount would result in impairment.

In assessing a reasonably possible change in a key assumption, consequential effects of changes to other variables need to be factored in and disclosed.

ESMA findings

Highlights of ESMAs findings in relation to discount rate disclosures were:

- Approximately 40% of issuers claimed that no reasonable change in any key assumption would cause an impairment loss, despite the fact that their share price was already affected by the expectations on possible impairment losses by the market (measured by the change in equity/market capitalisation)
- Only half of issuers who had a negative market capitalisation disclosed a sensitivity analysis
- Half of those issuers that provided a sensitivity analysis did so on an aggregated basis, rather than separately for each CGU.

Conclusions and Expectations noted by ESMA

ESMA noted a number of issues in its assessment of compliance with the sensitivity analysis requirements:

- A variety of different disclosure practices were observed
- Negative confirmations, i.e. 'that no reasonably possible change in key assumptions could cause impairment loss', is potentially confusing to investors and fails to provide adequate information around headroom and managements judgements
- Sensitivities analysis needs to be considered for key assumptions other than the discount rate and the terminal growth rate.

ESMA also stated that it was surprised to see the lack of sensitivity analysis disclosures from issuers whose equity book value exceeded their market capitalisation, given that the market capitalisation of a company provides a useful indicator of whether the market perceives the existence of any impairment to carrying value of the issuer's assets.

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