



FINANCIAL REPORTING COUNCIL

REVIEW OF GOODWILL IMPAIRMENT DISCLOSURES

OCTOBER 2008

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1 Introduction

Economic conditions have deteriorated significantly since the start of the credit crisis in August 2007. Financial markets continue to be stressed and many commodities have been subject to high price volatility. These conditions are having a significant effect on a wide range of businesses with many reporting reduced sales volumes and reduced margins.

These reductions mean that for many businesses the assumptions used to estimate the value of goodwill will need to be revised. The purpose of this review is to highlight areas of reporting of goodwill that will need to be enhanced as companies cope with the current environment.

In corporate reporting terms, the consequence of these changes in economic conditions may be an immediate need to write down the value of goodwill. For others there may be a need for additional disclosures to explain that the value of goodwill has decreased closing the gap on its book value, and that the likelihood of impairment losses in future has increased.

The accounting literature has been revised in recent years to require more disclosures about risk and uncertainty. In particular:

- IAS 36 '*Impairment of assets*' requires companies with material amounts of goodwill to disclose the key assumptions and the approach adopted in the making of those assumptions when using valuation models to check that goodwill does not need to be written down.
- IAS 36 also requires more detailed quantified and narrative disclosures when a "reasonably possible change" in a key assumption would have caused a material impairment loss to arise at the year end.
- IAS 1 '*Presentation of financial statements*' requires companies to provide additional information about key assumptions and other key sources of estimation uncertainty that have a "significant risk" of causing a material goodwill impairment loss within the next financial year.

The FRC review team looked at the December 2007 annual reports of 32 UK entities within the top 350 UK listed companies. Companies were selected if they had reported significant amounts of goodwill in their annual financial statements.

2 Summary of results and conclusions

All companies in the sample gave disclosures about their approach to impairment testing of goodwill. However, the level of supporting detail varied greatly:

- For many companies, the disclosures were more generic than specific in nature. Only a minority of companies provided information that was directly relevant to their business.
- Narrative information about the way in which key assumptions are identified and quantified tended to be vague. In many cases there was a generalised statement to the effect that past experience was modified based on management's expectations for the future.
- Only a minority of the companies surveyed provided information by cash generating unit ('CGU'), even where significant amounts of goodwill were allocated to more than one CGU.

Generic and inappropriately aggregated information hinders the ability of investors and lenders to understand the factors affecting the valuation of goodwill and hinders the evaluation of management's estimates. There is a need to avoid excessive disclosure about immaterial items that results in unnecessary clutter within annual reports. However, all of the companies were selected on the basis that goodwill was a material item for which full disclosure would be warranted.

Four of the companies surveyed reported that reasonably possible changes to their assumptions would lead to a goodwill write down and thus trigger the extended disclosures required by IAS 36. However, some of these disclosures would have benefitted from being more specific about the company's exposure to changing economic conditions. The proportion of companies with large goodwill balances that will trigger these additional disclosures is likely rise very substantially in 2008/9 when compared with last year.

Eight companies gave informative sensitivity information about the level of changes in assumptions that would be required for the carrying value of goodwill to reduce to its recoverable amount. These entities may have concluded that there was a "significant risk" of a material goodwill charge in their next reporting period, a conclusion which triggers disclosures required by IAS 1. These disclosures typically gave less detail than those required for reasonably possible changes in assumptions that would have resulted in an impairment loss.

Overall the review team assessed the quality of goodwill impairment disclosures reported by the companies in the sample as follows:

Quality assessment	Number of companies
Boiler plate – rather uninformative	17
Some company specific - useful	9
Company specific – very useful	6

These results demonstrate that there is an opportunity for companies to refine their goodwill disclosures. In addition, the effect of the deteriorating economy will result in goodwill issues becoming more material and trigger additional disclosures in 2008/9.

3 Review of compliance by area

3.1 Information about an impairment charge in the year

IAS 36.130 requires extensive disclosures about impairment losses reported in a period including the events or circumstances that led to the loss, the business affected and the method used to assess the residual value.

Only four companies in the survey incurred an impairment charge in the year under review. None of the reported impairment losses were material, and it may be for this reason that the disclosures were highly summarised and not comprehensive.

There has been a significant increase in impairment charges reported in recent half-yearly reports and so these disclosures are likely to become more extensive in the forthcoming annual reporting season.

3.2 Disclosures by cash generating unit

IAS 36.134 requires detailed disclosure where goodwill is allocated across different business units, together with the aggregate amounts so allocated to different businesses (CGUs) or groups of businesses.

The review team found that these narrative disclosures tended to be made at an aggregate rather than CGU level. In some but not all instances, discount rates and long term growth rates were given by CGU, but in others there were only unquantified references to adjustments for risks specific to the relevant market. In only a few cases was there a separate discussion by CGU. In view of the increased risk that impairments of goodwill will arise in one rather than every GCU, it is likely that these disclosures will arise more often in 2008/9.

3.3 Disclosures where recoverable amount is based on value in use

IAS 36.134 requires disclosure of the key assumptions used to value CGUs, management's approach to determining these assumptions, the period of projected cash flows and the long-term growth rates adopted.

IAS 36.134 also requires disclosure of the basis on which cash flows have been assumed to develop beyond the period covered by budgets and forecasts and the justification for growth rates that exceed long-term average growth rates for that product, industry or country.

An example illustrating some of these disclosures is as follows:

“The main assumptions on which the forecast cash flows were based include the television share of advertising market, share of commercial impacts, programme costs and the level of PSB savings. The key assumptions in assessing the recoverable amount of this goodwill are the growth in the total television market and ITV's share within that market. These assumptions have been determined by using a combination of long term trends, industry forecasts and in-house estimates. It is also assumed that ITV is able to renew its broadcasting licences in 2014. Broadcasting goodwill exceeds its carrying amount by approximately £200 million. In assessing the recoverable amount, ITV's TV advertising revenues are assumed to have a net present value of £14.8 billion. Goodwill would be equal to its carrying amount if there were a 12% fall in the growth rate assumed in assessing ITV's TV advertising revenues.

The vast majority of companies in the survey reported that they estimated the recoverable amount of goodwill based on value in use and so fall within these requirements. The reduced expectations of growth in the economy of most nations combined with higher market prices for risk and thus higher discount rates will place much more pressure on impairment calculations and disclosures in 2008/9.

The review findings in relation to these disclosures were as follows.

3.3.1 Description of key assumptions

There was evidence of standardised wordings in the description of key assumptions with seven companies in the survey using almost identical text.

Discount and long-term growth rates were generally considered to be the most important assumptions. Other references were to selling prices and direct costs. In twelve cases more specific factors were quoted, including commodity prices, competition, market share or industry-specific issues. However, even where these were mentioned, little information was given in most cases about the effect of these assumptions.

In a number of instances, differences between cash generating units were not disclosed even though it was clear from commentary elsewhere in the report that the various businesses had significantly different growth, risk, profitability and geographic profiles.

Short-term growth rates were rarely given, whilst one company referred to “modest” growth rates. In many cases indications of future growth expectations were disclosed within the business review rather than in the financial statements and not cross referenced, so it was not clear that they formed the basis of the calculation.

3.3.2 Management’s approach to determining assumptions

Many companies used text that followed the words in the standard, stating that *past experience was adjusted for expected changes in future conditions*.

All of the companies in the survey would have benefitted from enhancing their narrative disclosures. Seven companies made no reference to the use of past experience, and six made no reference to any changes to reflect expected future conditions.

Ten companies mentioned the use of external sources of information. However, in most cases this was limited to either unspecified industry growth rates or, where applicable, to market prices of commodities.

3.3.3 External sources of information

Companies are asked to state the extent to which assumptions are consistent with external sources of information. However, little disclosure was given on this by the companies in the sample which may add to uncertainty about how reliable these valuations are in practice.

Impairment assessments may have been carried out wholly on the basis of internal estimates and assumptions, perhaps because the headroom between

book and current values was found to be significant. However, greater use of external data may prove to be necessary in the future to support key assumptions where the impairment calculations show that a loss should be reported or is narrowly avoided.

3.3.4 Cash flow projections and long-term growth rates

The disclosure of long-term growth rates and similar metrics was very varied. Two companies reported that they used cash flow estimates for less than five years in their impairment testing. Six companies did not disclose the long-term growth rate they had used.

Growth rates, where disclosed, varied from 0% to 5%. In most, but not all cases, this was accompanied by a statement that the rate used did not exceed the relevant long-term growth rate. However, long-term growth rates were often aggregated even where a company operated over a number of sectors or geographies, with the result that the information was not very useful.

3.3.5 Reporting discount rates

There is widespread evidence of the use of standardised text to explain how the discount rate is set, with many repeating some of the words in the standard (IAS 36.A16). The result is not very informative.

The discount rate used was not disclosed by three companies in the sample.

3.4 Disclosures where recoverable amount is based on fair value less costs to sell

IAS 36.134 requires detailed disclosures to be made where the valuation of goodwill is based on what the business could be sold for in a market transaction.

Few companies in the sample based recoverable amount on fair value less costs to sell. However, where they did, disclosures about the calculation method tended to be short and rather uninformative. These valuations were generally reported to be based on current market prices for transactions.

Equity markets have fallen significantly over the last year and share price volatility has been very high. The reduction in market values may give rise to impairment losses in 2008/9.

3.5 Effect of reasonably possible changes in assumptions on impairment

IAS 34.134 requires enhanced disclosures where a reasonably possible change in a key assumption would have caused an impairment write down to be recorded at the year end. These disclosures include the specific value given to the assumption, the amount of the headroom and the amount of change in the assumption that would see the headroom disappear.

IAS 1.116 (now 1.125) requires enhanced disclosures where there are key sources of estimation uncertainty arising from the use of assumptions, and other reasons, that have a significant risk of causing a material adjustment to the carrying amount of goodwill or other intangibles within the next financial year.

An example illustrating some of these disclosures is as follows:

“The unprecedented level of increases in wheat prices and decreased volume as a result of a general decline in consumption of bread in the UK has adversely impacted the profitability of the Bread Bakeries CGU. The Group has considered this impact on the assumptions used and has conducted sensitivity analysis on the impairment test of the CGU’s carrying value. This has not resulted in any impairment of the carrying value at 31 December 2007 as the CGU’s recoverable amount exceeds its carrying value by £257m. However, if the unprecedented cost pressures were to continue and only a 1% annual growth rate in the forecast cash flows achieved, then this would result in the CGU’s recoverable amount reducing to a level comparable with its carrying value.”

Four companies in the sample disclosed that reasonably possible changes in assumptions could result in impairment. A further eight companies, whilst not reporting that a reasonably possible changes could result in impairment, provided additional information about the types of changes that would have to occur for impairment to exist.

The companies that included these additional disclosures enabled investors and lenders to obtain a much better understanding of their goodwill valuations. As a result of these disclosures investors and lenders would be better able to anticipate the effect on asset values of further changes in economic conditions.

4 Appendix – excerpts from IFRS – “bold paragraphs”

IAS 1.116

An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:

- (a) their nature; and
- (b) their carrying amount as at the balance sheet date.

IAS 36.134

An entity shall disclose the information required by (a)-(f) for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives:

- (a) the carrying amount of goodwill allocated to the unit (group of units).
- (b) the carrying amount of intangible assets with indefinite useful lives allocated to the unit (group of units).
- (c) the basis on which the unit's (group of units') recoverable amount has been determined (ie value in use or fair value less costs to sell).
- (d) if the unit's (group of units') recoverable amount is based on value in use:
 - (i) a description of 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.
 - (ii) a description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) 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.

- (iii) 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.
 - (iv) 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.
 - (v) the discount rate(s) applied to the cash flow projections.
- (e) if the unit's (group of units') recoverable amount is based on fair value less costs to sell, the methodology used to determine fair value less costs to sell. If fair value less costs to sell is not determined using an observable market price for the unit (group of units), the following information shall also be disclosed:
- (i) a description of each key assumption on which management has based its determination of fair value less costs to sell. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.
 - (ii) a description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) 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.
- (f) if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount:
- (i) the amount by which the unit's (group of units') recoverable amount exceeds its carrying amount.
 - (ii) the value assigned to the key assumption.
 - (iii) the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount.

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