esma European Securities and Markets Authority

ESMA Report

European enforcers review of impairment of goodwill and other intangible assets in the IFRS financial statements

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List of abbreviations and acronyms used in this report

CAPM	Capital Asset Pricing Model
CGU	Cash-Generating Unit
DCF	Discounted Cash-Flows
IAAER	International Association for Accounting Education and Research
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
WACC	Weighted Average Cost of Capital

Executive Summary

This report, by the European Securities and Markets Authority (ESMA), provides an overview of accounting practices related to impairment testing of goodwill and other intangible assets. It evaluates the appropriateness of the related disclosures in the 2011 IFRS financial statements of a sample of 235 issuers with significant amounts of goodwill and includes recommendations to enhance the application of the provisions of IAS 36 - *Impairment of Assets*.

As a result of the financial and economic crisis, and the resulting poor economic outlook, assets in many industries may generate lower cash flows than expected when these assets were acquired. This has increased the likelihood that the carrying amount of the non-financial assets is greater than their recoverable amount and that impairment losses are required.

ESMA found that significant impairment losses of goodwill recognised in 2011 were limited to a handful of issuers, particularly in the financial services and telecommunication industry. Overall impairment losses on goodwill in 2011 amounted to €40 billion on the €790 billion of goodwill recognised in the 2010 IFRS financial statements. A fall in market capitalisation below the book value of equity is an indication that impairment may have occurred. As of 31 December 2011, 43% of the sample showed a market capitalisation below equity. Out of these issuers, 47% recognised impairment losses on goodwill in their 2011 IFRS financial statements. At the same time, the average equity/market capitalisation ratio of the sample rose from 100% at 2010 year-end to 145% at 2011 year-end. Although a decrease in market capitalisation may not lead directly to impairment (other relevant factors impacting market capitalisation might include e.g., investor uncertainty, risk aversion and low liquidity), the increased equity/market capitalisation ratio and relatively limited impairment losses can call into question whether the level of impairment in 2011 reflects the effects of the financial and economic crisis appropriately.

Although the major disclosures related to goodwill impairment testing were generally included, in many cases these were of a boilerplate nature and not entity-specific. This stems from a combination of a failure to comply with the requirements of the standard by issuers, as well as, arguably, a lack of specificity in the standard, especially in the area of sensitivity analysis. This also means that, in many cases, the user of the financial statements is not able to evaluate the reliability of the assumptions used from the disclosures given, which is the primary purpose of those disclosures.

As a result of this review five areas of concern emerged:

1. **Key assumptions of the management**: In the sample selected, only 60% of the issuers discussed the key assumptions used for cash flow forecasts other than discount rate and growth rate used in the impairment testing. Out of these issuers approximately 50% did not include details, required by the standard, that provide the users with the relevant entity-specific information. The result of the review indicates that approximately 70% of issuers focus insufficiently on disclosing the key assumptions in detail and in a way useful to investors.

   ESMA urges issuers to disclose all key assumptions and discuss the approach management has adopted in determining them for impairment testing.

2. **Sensitivity analysis**: ESMA has identified different practices with regard to disclosures on sensitivity analysis. Sometimes, these disclosures were formulated in a way that did make clear to investors how imminent the impairment loss could be. The lack of consistency of sensitivity analysis provided by issuers might suggest unclear requirements in the standard in this area, especially with respect to the requirement to provide sensitivity analyses only in certain circumstances.

   For issuers where the book value of their net assets exceeded their market capitalisation, only half presented a sensitivity analysis. In ESMA's view this figure appears low since this is an indication that impairment might have occurred. ESMA would expect those issuers to be more transparent and disclose the sensitivity of the impairment calculation to changes in key assumptions.

   ESMA urges issuers to make realistic estimates in determining possible changes in key estimates

that would cause the carrying amount of the cash generating unit to exceed its recoverable amount.

3. **Determination of recoverable amount**: Most issuers apply value in use for goodwill impairment testing purposes. As 60% of issuers who used fair value less costs to sell based the calculation on discounted cash flows, vast majority of issuers estimate the recoverable amount based on discounted cash flows. IAS 36 requires different criteria for cash flows when using value in use or fair value less costs to sell to determine the recoverable amount.

   ESMA would expect more weight to be given to external sources of information rather than entity-specific assumptions when determining fair value less costs to sell using discounted cash flows.

4. **Determination of growth rates**: More than 15% of issuers disclosed a terminal growth rate in excess of 3%. IAS 36 requires issuers to estimate terminal growth rate by extrapolating the projections based on the budgets and forecasts using a steady or declining growth rate for subsequent years that should not exceed long-term average growth rate for the products, industries or countries in which the issuer operates. In the current economic environment, using a long-term rate exceeding 3% appears ambitious and optimistic and may lead to an overstated long-term growth rate.

   ESMA urges issuers to provide realistic estimates of future growth rates that correspond to forecasts of economic development.

5. **Disclosure of an average discount rate:** Approximately 25% of issuers in the sample disclosed an average discount rate, rather than a specific discount rate on each material cash-generating unit.

   Because of the impact of the applied discount rate on determining value in use and fair value less costs to sell if a discounted cash-flows model has been used, ESMA urges issuers to use, and disclose, separate discount rates 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 when the risk profile of the identified cash-generating units differs. By disclosing single average discount rate, issuers potentially obscure information that may be relevant to financial statement users.

Focus of Enforcement Priorities

On the basis of this review's findings, and as already announced as part of the European common enforcement priorities[1], ESMA together with the national competent authorities will focus on:

- improving the rigour issuers apply in the impairment test of goodwill and other intangible assets;
- monitoring the application and compliance with IAS 36 requirements, in particular with regard to:
  - the reasonableness of cash flows forecasts;
  - key assumptions used in the impairment test;
  - the relevance and appropriateness of the sensitivity analysis provided (e.g. in circumstances when market capitalisation fall below the book value of net assets; and
- considering whether issuers have provided sufficient and relevant disclosures in this area.

ESMA expects issuers and their auditors to consider findings of this review when preparing and auditing the IFRS financial statements. ESMA expects national competent authorities will take or have already taken appropriate enforcement actions whenever material misstatements are identified and will actively monitor the progress of those actions. As indicated in the European common enforcement priorities, ESMA will collect data on how European listed entities have applied IFRS requirements in this area and will further report on its findings.

[1] European common enforcement priorities for 2012 financial statements , European Securities and Markets Authority, 12 November 2012

I. Introduction

1. Due to the financial and economic crisis and deteriorated outlook, assets in many industries might generate lower cash flows than expected when such assets were acquired. This increased the likelihood that the carrying amount of the non-financial assets is greater than their recoverable amount and that impairment losses are required.

2. As a result of the financial crisis, market participants have expressed concerns about the reliability of goodwill impairment tests. Reflecting on these concerns, Hans Hoogervorst, Chairman of the IASB, suggested at the IAAER conference in June 2012 that goodwill impairment often came too late during the financial crisis.

3. Against the backdrop of this economic environment, ESMA decided to include the impairment of non-financial assets in its working priorities for 2012 and to conduct a review of accounting practices related to the impairment of goodwill and intangible assets with indefinite useful lives (goodwill and other intangible assets).

4. European national enforcers identified various issues related to the rigour of impairment testing of goodwill in the IFRS financial statements and the level of transparency issuers provide to investors. In 2012, the Belgian enforcer and the Dutch enforcer published their respective findings in their jurisdictions. These reports found a lack of specificity of disclosures related to impairment of goodwill, determination of the recoverable amount and the related sensitivity analysis and that the decrease in market capitalizations does not seem to be fully reflected in the level of impairment of goodwill.

5. In September 2012, the study The European Goodwill Impairment Study 2012-2013 by Houlihan Lokey concluded "that companies' balance sheets appear to be more compromised in 2011 than in the past four years (following the start of the financial crisis)". The study noted that, despite higher goodwill impairments in 2011 compared to 2010 (when these fell below the average of the previous five years), issuers' market capitalisations to book value of equity (market-to-book) ratios have generally deteriorated. That study indicated that impairments of goodwill expected for some issuers had not yet been seen and that the amount of recorded impairment in recent years appeared not to fully reflect the decline in market capitalisation casting doubts about the rigour of the impairment test and the underlying assumptions.

6. These reports, as well as certain investor representatives, question the appropriateness of the assumptions used in goodwill impairment tests, and point out that there continues to be a certain level of optimism used in determining the parameters of the impairment test. This holds in particular with respect to the terminal growth rate, the period explicitly covered by the budgets (or extrapolation) and the reasonableness of the estimated cash flows.

II. Objectives and scope of the report

7. The main objective of this report is to provide an overview of the accounting practices related to the impairment of goodwill and other intangible assets, and evaluate the sufficiency of the related disclosures in the 2011 financial statements prepared in accordance with International Financial Reporting Standards (IFRS). Furthermore, the report aims to review how entities have taken the effects of the recent economic downturn in impairment testing into account.

8. The issues selected for review were grouped in the following categories:

    a. General information on goodwill impairment testing and related results;

    b. Specific information on methods of determining the recoverable amount and level of disclosures provided on value in use and fair value less costs to sell;

    c. Analysis of parameters used in calculating discounted cash flows (DCF), including discount rate, terminal growth rate and other key indicators; and

    d. Assessment of disclosures related to sensitivity analysis of the recoverable amount.

9. The review was performed on a sample of 235 European listed entities from 23 jurisdictions. The sample was selected through a two-step process to ensure representation of the largest European issuers with the most significant amount of goodwill, and a wide coverage of industries and balanced geographical representation across Europe.

10. When determining the significance of goodwill, both the absolute amount in the financial statements and the relative amount of goodwill in relation to the issuer's equity were considered. Geographical representation of the sample was ensured by including in the sample, issuers registered in 23 jurisdictions and by using a variety of indicators including the following:

    - a high proportion of goodwill to equity;
    - a high percentage of other intangible assets to total assets or total equity; and
    - significant impairment losses of goodwill or intangibles reported during the period or the existence of external indicators of impairment (e.g. significant decrease in the market capitalisation below book value).

11. The analysis was performed solely on the basis of the information included in publicly available IFRS financial statements. Due to the inherent limitations of a desk-based review, the review could not consider whether the criteria for disclosure have been met, but rather provides the findings based on issuers' disclosures.

12. The total amount of goodwill recognised in the selected issuers' financial statements amounted to €794,9 billion, while the total amount of other intangible assets totalled €136,9 billion. Almost all the issuers in the sample reported goodwill balances in their financial statements, whereas almost nearly half of the entities in the sample reported other intangible assets. The breakdown of the recognised goodwill per industry is indicated in the table below:

Table 1: Goodwill recognised per industry in 2011 (in Euro million)

Industry	Amount of goodwill recognised in million of Euro	Number of issuers
Food & Beverage	131,898	21
Telecommunications	129,969	25
Industrial Goods & Services	119,940	43
Media	74,485	19
Health Care	74,069	10
Financial Services	59,099	32
Construction & Materials	44,536	17
Utilities	42,193	9
Retail	39,775	10
Technology	21,152	15
Other	57,848	34
Total	**794,964**	**235**

III. Overview of IFRS requirements

13. IFRS requires recognition of goodwill in the consolidated financial statements of the investing entity when the entity pays a premium over the fair value of the identified assets and liabilities of the target in a business combination. After initial recognition, goodwill and intangible assets with indefinite useful lives are subject to annual impairment testing, but not to amortisation.

14. According to IAS 36, when the carrying amount of asset exceeds the recoverable amount, the asset is considered to be impaired and the entity should reduce the carrying amount, and recognise an impairment loss. Goodwill acquired in a business combination or intangible assets with indefinite useful lives has to be tested for impairment at least on an annual basis. Goodwill impairment loss cannot be reversed.

15. For the purposes of impairment testing, goodwill should be allocated to the cash-generating units (CGU) or groups of CGUs benefiting from goodwill. Such group of units should not be larger than an operating segment before aggregation.

16. Detailed disclosures, including the circumstances that have led to impairment are required in relation to each CGU with significant amounts of goodwill and other intangible assets. These shall include the key assumptions on which management has based cash flow projections, a description of management's approach to determining the values of each key assumption, terminal growth rates and discount rates as well as sensitivity analysis where a reasonable change in a key assumption would lead to impairment.

17. European enforcers have frequently encountered enforcement issues related to impairment testing of goodwill and the lack of robust disclosures about management judgments and parameters used in goodwill impairment testing by issuers.

    In the 12th extract of enforcement decisions published in October 2012[2], as well as in its annual activity reports on IFRS enforcement for 2010[3] and 2011[4], ESMA highlighted some common shortcomings related to the impairment test of goodwill. These included different practices, or different sources of information, used in the determination of the discount rate used in the value in use calculation, the reasonableness of management assumptions as well as the extent of disclosures on goodwill, intangible assets (e.g. brands) and impairment test assumptions.

[2] 12th Extract from the EECS Database of Enforcement, European Securities and Markets Authority, 10 October 2012.

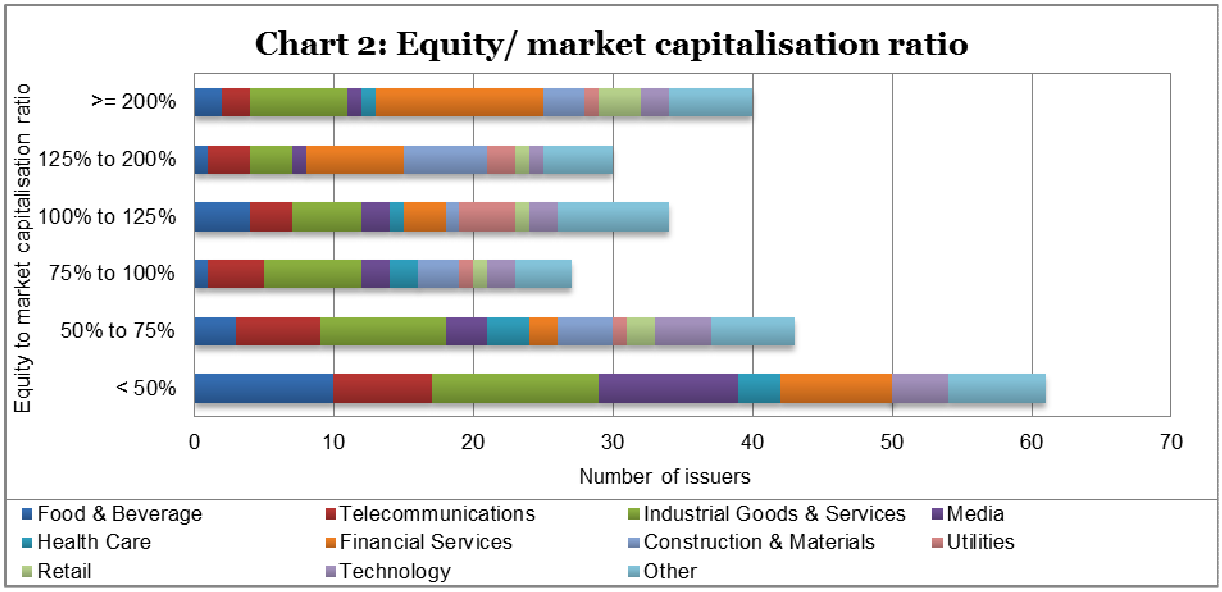
[3] Report - Activity Report on IFRS Enforcement in 2010, European Securities and Markets Authority, 21 October 2011

[4] Activity Report on IFRS Enforcement in the European Economic Area in 2011, European Securities and Markets Authority, 28 June 2012.

IV. Results of the review

18. This section sets out the detailed findings and conclusions for each of the areas identified as the main themes subject to review. The review first focuses on the general impairment information provided in the sampled financial statements. It then examines the extent of issuers applying either the value in use, or the fair value less cost to sell, and analyses the parameters applied in the DCF calculations.

19. An equity/market capitalisation ratio above 100% is one of the external sources of information indicating that assets may be impaired, and should be considered in assessing the realistic values of key assumptions used in impairment testing. The average equity/market capitalisation ratio of the sample rose from 100% at 2010 year-end to 145% at 2011 year-end. As of 31 December 2011, 43% of the sample showed a market capitalisation below equity compared to 30% in 2010. Furthermore, the number of entities with book values greater than or equal to twice the market capitalisation (equity/market capitalisation ≥200%) rose from 22 to 40 over the same period. The chart below shows the distribution of issuers based on the ratio of the book value of equity to the market capitalisation as of 31 December 2011:



20. The increase in the equity/market capitalisation ratio between 31 December 2010 and 31 December 2011 does not seem to be fully reflected in the level of goodwill impairment observed in 2011. Although paragraph 12(d) of IAS 36 states that assets may be impaired when the carrying amount of the net assets of an entity is more than its market capitalisation, only 47% of the issuers whose equity exceeded market capitalisation recognised impairment losses on goodwill and 12% recognised impairment losses on other intangible assets as at 31 December 2011. These entities operate mainly in three business sectors: financial services, telecommunications and media.

21. To account for the low level of impairment in light of a significant decrease of market capitalisations, it is worth noting that IAS 36 provides that issuers should use the higher of the fair value less costs to sell or value in use when testing for a potential impairment. Therefore, a decrease in market capitalisation may not systematically lead to impairment. The other relevant impacting factors on market capitalisation might also include e.g., investor uncertainty, risk aversion and low liquidity which would impact market prices.

A. General information on impairment test

22. This section of the report highlights findings and conclusions related to disclosures on impairment losses, on the composition of cash-generating units (CGUs) and level of aggregation, on goodwill allocation and on the basis for the determination of the recoverable amount.

Findings

Information on impairment losses

23. Paragraph 130(a) of IAS 36 requires disclosures of 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.

24. Almost 36% of the issuers in the sample recognised an impairment loss of goodwill in 2011 amounting to approximately 5% of goodwill recognised in the financial statements of the immediately preceding reporting period. However, significant goodwill impairment was limited to a handful of issuers, when 5% of issuers accounted for almost 75% of the goodwill impairment. Extent of impairment was widespread across industries as detailed in the table below:

Table 3: Goodwill impairment per industry in 2011 (in Euro million)

Industry	Goodwill impairment recognised in 2011	Amount of goodwill recognised at the end of 2010	2011 Impairment rate
Financial Services	19,183	76,076	25.2%
Retail	3,128	38,314	8.2%
Technology	1,594	19,810	8.0%
Telecommunications	9,712	138,477	7.0%
Utilities	1,202	43,182	2.8%
Media	1,724	74,592	2.3%
Construction & Materials	714	45,890	1.6%
Industrial Goods & Services	1,545	112,546	1.4%
Food & Beverage	363	127,784	0.3%
Health Care	21	65,386	0.0%
Other	1,225	47,578	2.6%
Total	**40,410**	**789,635**	**5.1%**

25. The impairment rate by industry ranged from insignificant impairment in some industries (food & beverages and health care) to significant impairment amounting to about 25% of previously reported goodwill recorded in the financial services industry. More than 75% of the impairment of goodwill reported in the financial services industry was reported by two financial institutions from a single jurisdiction. A similar concentration of impairment was reported in the telecommunications industry, where a single issuer accounted for more than three quarters of the goodwill impairment recognised.

26. Amongst entities reporting other intangible assets, 25% recognised impairment losses on other intangible assets. In total €4,2 billion of impairment losses were recognised in 2011 compared to a total carrying amount of other intangible assets of €98,7 billion as of the preceding period end. Nonetheless, impairment losses recognised on other intangible assets were limited in amount and in scope.

27. One third of issuers that recognised impairment charge on goodwill or other intangible assets did not comply with the requirements of paragraph 130(a) of IAS 36. Most of the issuers which disclosed the events and circumstances leading to recognition of impairment loss provided vague and rather generic explanations like: “worsening economic outlook, slowdown of the demand, competitive environment…”. Only some issuers provided specific information such as “significant deterioration of the economic conditions in country X” or “impacts on the forecast cash flows due to political situation in country X”.

Composition of CGUs, level of aggregation and goodwill allocation

28. Paragraph 80 of IAS 36 provides guidance on allocation of goodwill to CGU for impairment testing purposes. Paragraph 130 (d) of IAS 36 requires a description of the CGU for each material impairment loss recognised, disclosure of the amount of the impairment loss by reportable segment as well as a description of any changes to the aggregation of assets for identification of the CGU.

29. Information on the composition of CGUs and the level of aggregation is usually provided together with information on how goodwill is allocated in cases where impairment loss was recognised.

30. The results of the study show that 86% of the issuers provide information on the level at which CGUs are being defined. In almost 75% of the sample, a link between the level of CGUs used for impairment testing and the operating segments was apparent. Half of the issuers which do not provide information on the level at which they define CGUs also did not disclose the basis on which goodwill is allocated. Of the issuers that do not provide information as to how they allocate goodwill to the CGUs for impairment testing purposes, only one issuer recognised goodwill impairment losses in the period.

31. The survey shows that 13% of the issuers in the sample indicated that they changed the way the CGUs were defined in 2011. All those issuers provide a qualitative explanation of the change in accordance with paragraph 130(d)(iii) of IAS 36. However, 70% of those that report a change in level of CGUs state that the change was due to internal changes without expanding on the reason.

Conclusions

32. ESMA found that 36% of the issuers of the sample recognised impairment losses on goodwill. Impairment losses recognised on other intangible assets were more limited in amount and scope. Although only one indicator that goodwill may be impaired, the increased equity/market capitalisation ratio compared to 2010, together with relatively low ratio of impairment losses/prior year carrying amount for both goodwill and other intangible assets, can call into question whether the level of impairment in 2011 appropriately reflects the effects of the financial and economic crisis.

33. ESMA believes that the quality of narrative information could be improved when describing the events and circumstances which led to the recognition of impairment.

34. With respect to disclosures on goodwill allocation and the level of CGUs, ESMA found that most issuers do provide appropriate information. At the same time, enhanced qualitative descriptions of the reasons for the changes in aggregating assets and identifying CGUs compared with previous period, could be provided where material impairment losses for those CGUs were recognised.

B. Determination of the recoverable amount

35. IAS 36 requires an asset or a CGU to be tested for impairment by comparing its recoverable amount with its carrying amount. Paragraph 134(c) of IAS 36 requires the disclosure of the basis on which the recoverable amount has been determined, i.e. whether it is a fair value less costs to sell or a value in use.

36. Paragraphs 20 and 25 to 29 of IAS 36 further describe how to determine fair value less costs to sell. These paragraphs constitute a fair value hierarchy under which the 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, or, when neither is available, the best information available to reflect the amount that the entity could obtain from the sale of the asset. The last category also comprises discounted cash flow computations. Disclosures of the methodology used are required by paragraph 134 (e) of IAS 36.

37. Paragraph 30 of IAS 36 sets the principles to be applied when calculating a value in use. The calculation of the value in use is always a discounted cash flow computation with IAS 36 setting the

requirements for estimating the future cash flows, dealing with foreign currency cash flows and the discount rate. According to paragraph 33 of IAS 36 cash flow projections in value in use should be based on reasonable and supportable assumptions by the management and greater weight should be given to external evidence. Cash flow projections should exclude cash inflows from future restructurings or from improving the asset's performance. Paragraph 134(d) of IAS 36 sets the disclosures required for value in use-calculations.

Findings

38. It appears from the review that the disclosures provided on the basis on which the recoverable amount has been determined, comply with the requirements in IAS 36 for 92% of the issuers in the sample. More than three quarters of the issuers stated that the recoverable amount is determined based on value in use, whereas 6% of the issuers use fair value less cost to sell. Another 14% of issuers declare that both the value in use and the fair value less costs to sell are used to determine the recoverable amount, depending on the CGU.

39. Of the issuers that described the basis of the fair value less costs to sell calculation, very few stated that this was estimated based on a binding sales agreement, and 19% of the issuers stated that comparable transactions were used. The issuers referring to comparable transactions are engaged in various industries and come from various countries, i.e. there are no observable industry or country trends. The majority of the issuers stated that they determined the fair value less costs to sell based on discounted cash flow computations, whereas another 8% of the issuers stated that they used other methodologies.

40. Based on the definition of fair value less costs to sell in paragraph 6 of IAS 36, estimates of fair value should always reflect market assumptions of the value of the asset. Among the sampled issuers that used fair value less cost to sell, half of them stated that the fair value less costs to sell reflected market assumptions.

Conclusions

41. Based on these findings ESMA concludes that the quality of disclosures referring to the management's approach with respect to setting assumptions in estimating fair value less costs to sell can be improved. The issuers using discounted cash flow methodology should not forget that IAS 36 requires different criteria for cash flows when used to determine value in use or fair value. Cash flows in fair value less costs to sell calculations are based on market's assumptions, whereas the cash flows in value in use calculation are based on management's best estimate and exclude future cash flows that arise from a future restructuring to which issuer is not yet committed or cash flows that arise from improving the assets. When estimating fair value less costs to sell using the DCF method, ESMA believes that more weight needs to be given to external sources of information rather than entity-specific assumptions.

42. For those issuers which use both value in use and fair value less costs to sell to determine the recoverable amount, ESMA believes that the disclosure could be enhanced by indicating which method was used for each CGU as required by IAS 36. ESMA urges issuers to be more specific when disclosing the basis for determination of recoverable amounts to ensure that users of financial statements have a proper understanding of the way the recoverable amount of each significant CGU is determined.

C. Analysis of parameters used in DCF calculations

43. This section of the report highlights the analysis of parameters used in the DCF calculations, whether the DCF method was used to determine value in use or fair value less costs to sell.

Discount rate

44. In accordance with paragraphs 134 (d)(v) and 134 (e)(v) of IAS 36 entities shall disclose the discount rate applied to the cash flow projections for each CGU with significant goodwill.

45. Paragraph 55 of IAS 36 states that, for "value in use" calculations, the discount rate must be a pre-tax discount rate that 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. Paragraph A16 of IAS 36 requires issuers to estimate the discount rate, when an asset-specific rate is not directly available from the market. In practice, the weighted average cost of capital (WACC) is commonly used. Paragraph A19 of IAS 36 requires determining the discount rate independently of the capital structure of the issuer.

46. The cost of equity is often determined by using the capital asset pricing model (CAPM). In this model, assumptions regarding risk-free rate, market risk premium and beta must be made. When determining the risk-free rate, attention must be paid to its correlation with the inflation assumptions and the time horizon of expected cash flows.

Findings

47. Two thirds of the issuers in the sample disclosed the discount rate specific for each disclosed CGU, whereas 25% of the sample disclosed an average (non-CGU-specific) discount rate. Only 8% of the issuers in the sample have not disclosed any information regarding discount rates used for impairment testing. Of the issuers disclosing an overall discount rate, 66% disclosed one single discount rate while the rest disclosed a range.

48. Almost half of the issuers disclosed a pre-tax discount rate, whereas 22% of the issuers provided a post-tax discount rate, 8% of the issuers specified both pre- and post-tax discount rates and 22% of the issuers have not indicated what kind of discount rate was used.

49. Of those issuers which reported a pre-tax discount rate, the majority of the issuers used discount rates between 8% and 11% (post-tax rate 7% to 10%). Financial services, technology and telecommunications are industries that seem to use higher discount rates while health care applies discount rates in the lower part of the range.

50. When issuers presented a range of discount rates, 40% of the issuers have used a 0-2.5 percentage points range, 35% have used a 2.5–5 percentage points range, and 12% have used a 5-7 percentage points range. Only a small proportion used a wider range.

51. Only 13% of the issuers disclosed further aspects of the discount rate, such as risk-free rate, country risk premium, market risk premium or other premia. These disclosures are not required, but might be helpful to assist users in their assessment of the impairment tests.

52. Two-thirds of issuers also presented the discount rate for the comparative period. Based on the results of the survey, there were no significant changes in disclosed discount rates between 2010 and 2011.

Conclusions

53. Given the significant impact of the applied discount rate on determining value in use, ESMA urges issuers to use separate discount rates when the risk profile of the identified CGUs differs. By disclosing one average discount rate, issuers potentially obscure information that may be relevant to financial statements users.

54. Given the omission by one third of the issuers of comparative discount rate information, ESMA points out the requirement of paragraph 38 of IAS 1 to disclose comparative information for all amounts reported in the current period's financial statements.

<u>Terminal growth rate</u>

55. Paragraphs 134 (d)(iv) and 134(e)(iv) of IAS 36 require disclosure of the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent forecasts (terminal

growth rate) and justification of using a 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. This may be the case if the applied growth rate exceeds expected inflation. The requirement to justify using a higher than average growth rate is related to the concept that higher than average growth can only be sustained over the short-term, since such conditions will attract new entrants and give rise to competition; the long-term growth rate will thus be the same as the overall economic long-term growth rate.

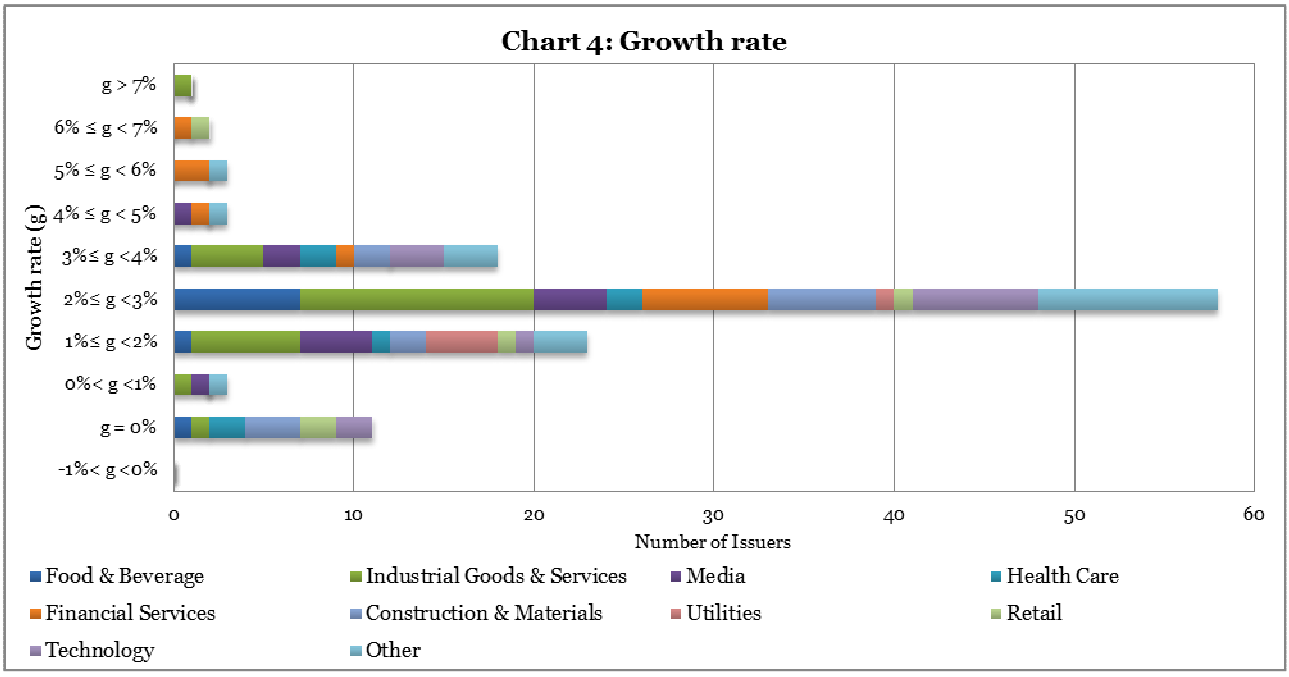
56. These paragraphs require providing the growth rate for each cash-generating unit for which the carrying amount of goodwill or other intangible assets allocated to that unit is significant.

57. The terminal value constitutes a very important component of the total amount of the recoverable amount when a DCF method is used. Therefore, the assumptions regarding the normalised perpetual cash flows and the estimated terminal growth rate significantly impact this calculation. The cash flow projections as well as terminal growth rate should be based on reasonable and supportable assumptions. Paragraph 33 of IAS 36 requires issuers to give greater weight to external evidence estimating future cash flows.

Findings

58. 83% of the issuers disclosed the terminal growth rate, with a majority presenting a specific growth rate by CGU, whereas a quarter of the issuers presented a range of growth rates. The remaining issuers disclosed an average growth rate for all CGUs. The comparative information on the terminal growth rate used in the comparative period is provided in less than half of the issuers' financial statements.

59. The sample shows that approximately two thirds of the issuers, providing specific growth rate per CGU or average growth rate, apply a growth rate of between 0-2%. Approximately 20% of the issuers have applied a growth rate equal or exceeding 3%. Only 10% of the issuers apply zero or negative terminal growth rates. The chart below shows distribution of the disclosed growth rate:



60. Of the issuers that disclosed a range of growth rates, almost half of the issuers applied a maximum limit of the growth rate equal or greater than 3%. At the same time, more than a third of the issuers disclosing a range of growth rates applied a minimum limit of growth rate of zero or below.

61. Based on the results of the review, there are no significant differences in the growth rate applied between the issuers whose market capitalisation was below the book value of equity and those whose market capitalisation exceeded the book value.

Conclusions

62. Based on the results of the survey, in some cases, the terminal growth rates applied might appear to be too optimistic, especially compared with the long-term expectations of the investors reflected in the market capitalisation. Issuers should carefully consider how the cash flows of the most recent projection period are normalised when used as a reference in determining terminal value.

63. When considering issuers disclosing the growth rate, approximately 15% of the issuers disclosed growth rates exceeding 3%. When disclosing average growth rates or ranges of growth rates, in the current recession, using a long-term growth rate exceeding 3% in mature markets might appear ambitious and may lead to an overstated long-term growth. Paragraph 33(c) of IAS 36 requires issuers to base the projections on a steady or declining growth rates for subsequent years unless an increasing rate can be justified. ESMA urges the issuers to provide realistic estimates of future growth rates that correspond to current predictions of the nominal economic growth.

64. In light of the omission by the majority of the issuers of comparative growth rate information, ESMA reminds issuers of the requirement in paragraph 38 of IAS 1 to disclose comparative information for all amounts reported in the current period's financial statements.

Period covered by cash flow projections

65. Paragraph 134(d)(iii) of IAS 36 requires disclosure of the period over which management has projected cash flows based on financial budgets/forecasts approved by management. This refers to the period where detailed projections have been used before application of the long-term or terminal growth rate (the forecast period).

Findings

66. The sample showed a high degree of compliance with this requirement with 88% of the relevant issuers in the sample providing information about the period covered by detailed cash flow projections.

67. Where the forecast period is greater than five years, the standard also requires disclosure of an explanation justifying the longer period. This is because detailed long-term forecasts generally become less reliable the further into the future they are made and thus, cash flows are assumed to grow only by the long-term growth rate. More than 80% of those issuers which disclosed the forecast period had used periods of five years or less, the great majority specifically using five years. Of the remainder 14% issuers used forecast periods of six to ten years while three issuers used periods exceeding ten years. Of the issuers using forecast periods of over five years, 61% disclosed the basis for the chosen period while 39% did not. Explanations given for the chosen forecast period ranged widely in length and content.

Conclusions

68. The overall aim of disclosures on impairment testing is to assist users in evaluating the reliability of the estimates used by management to support the carrying amounts of goodwill. Disclosures that do not add to the user's understanding or which only repeat that the issuer has exercised judgement in this area, do not address this aim. Explanations that are explicitly linked to the circumstances of the issuer, the CGU or the industry enable users to form a view as to whether the longer forecast period is reasonable.

69. While the number of issuers forecasting detailed cash flows for a period greater than five years is relatively small, ESMA reminds issuers that if they use cash flow projections exceeding five years, the

projections should be reliable and management should be able to demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

Key assumptions

70. Paragraphs 134(d) (i) and (ii) of IAS 36 require potentially extensive disclosures concerning 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. IAS 36 paragraph 134(d)(i) requires 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 recoverable amount is most sensitive.

71. Paragraph 134(d)(ii) of IAS 36 requires issuers to provide a description of management's approach to determining the values assigned to each key assumption. This disclosure should 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.

72. Similar disclosures concerning key assumptions used in fair value less costs to sell calculations are required.

73. It is clear from the standard that the required key assumptions are in addition to determining the long-term growth rate and the discount rate, all of which are the subject of separate sub-paragraphs 134(d)(iv)-(v) of IAS 36.

74. The standard requires issuers to disclose 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. The assumptions required are such as those which drive the results of the forecast period itself as exemplified in Illustrative Example 9 of IAS 36. From this example, it appears that the IASB envisaged assumptions to be at a deeper level than, for example, a simple reference to profit growth. The information disclosed should assist users in evaluating the reliability of the impairment tests.

Findings

75. Almost 56% of the sample disclosed that the cash flow projections concerned were consistent with past experience. Similarly, with respect to consistency of the forecasts with external sources of information, 55% of the sample stated that this was the case.

76. Of the approximately 60% of issuers disclosing assumptions, a little less than half could be said to have given compliant descriptions of the type, and in the level of detail, suggested in Illustrative Example 9, which include different assumptions such as gross margin, specific products price inflation, market share and development of the exchange rate.

77. The quality of explanations varied. Some referred to measures, which could be seen as the result of more basic assumptions, for example, *EBITA* and *EBITDA*, *profitability*, *operating cash flows*. Other assumptions appeared not to apply to the forecast period but rather to other factors such as the discount rate (risk-free interest rate, premium to reflect inherent risk). Some issuers gave a long list of factors (sometimes 10 or more), raising the question of whether all such assumptions were actually key assumptions. On the positive side, many issuers provided assumptions of the type indicated in the Illustrated Example 9 of IAS 36.

78. Some issuers disclosed on the management approach only a generic sentence that the cash flow forecasts are based on budgets approved by management. In such cases it was not possible to evaluate the extent to which the budgets are based on past experience or external sources of information.

Conclusions

79. ESMA's conclusion is that issuers should improve disclosure of the key assumptions as required by IAS 36, and that those assumptions given should be appropriate both in number and in type. The assumptions need to be provided in addition to those relating to discount rate and the terminal growth rate. The shortfall in this area is particularly concerning given the role that disclosure of key assumptions is meant to play in assisting users in evaluating the reliability of an issuer's impairment tests. Therefore, ESMA urges issuers to disclose all key assumptions and discuss what kind of approach the management has adopted.

D. Sensitivity analysis

80. According to paragraph 134(f) of IAS 36, an entity shall disclose the sensitivity analysis, if a reasonably possible change in a key assumption on which management has based its determination of the CGU recoverable amount would cause the carrying amount of the CGU to exceed its recoverable amount.

81. It is important to underline that both the value assigned to the key assumption, as well as 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 need to be disclosed. The objective of the sensitivity analysis is to provide investors with information on what change in the values of key assumptions used in impairment testing would lead to the recoverable amount of the tested unit becoming equal to the carrying value; that is, how imminent is a possible impairment loss.

82. Typical assumptions for which the values are needed to be determined when performing impairment test include sales volumes and margins (e.g. gross margin or EBIT-%) for the forecast period, their growth compared to past performance, growth rate for the terminal period and discount rate. Issuers may also use other assumptions when determining the estimated cash flows, e.g. market share, development of new technologies etc.

83. IAS 36 requirements regarding the disclosures on sensitivity analysis rely on management judgement. If management considers that a reasonably possible change in any key assumption would cause an impairment loss, the standard requires the disclosure of a sensitivity analysis; otherwise no information is required.

Findings

84. A quarter of the issuers disclosed the values of all required variables regarding sensitivities: the amount of headroom, values of key assumptions and the amount by which the values of assumptions must change in order to the headroom disappear. Nonetheless, the majority of those issuers disclosing how much the values of key assumptions must change in order for the headroom to disappear, limited the analysis to terminal growth rate and discount rate. Many of those issuers mentioned having used other key assumptions as well yet did not disclose these values. Only one third of those issuers disclosed the sensitivity of other assumptions, such as gross margin or EBIT. Where the issuer stated that gross margin or EBIT was a key assumption, more than half of those issuers disclosed also the values of those margins.

85. Around 40% of the issuers disclosed only one or two of the required disclosures. Nearly 50%of them additionally disclosed the statement indicating that no reasonable possible change in key assumptions could cause impairment loss. Among the 40% issuers, it was most common to disclose the values of key assumptions and the amount of headroom without giving any information on the necessary changes in key assumptions. Less than half of the 40% of issuers disclosed the needed change in key assumptions which combined with other information would be the most important information in the sensitivity analysis. Without having information on all the required line items, it is difficult to picture the full impact of the sensitivities.

86. Approximately 50% of the issuers, who disclosed the sensitivity analysis, had provided the analysis on an aggregate basis and not separately for each significant CGU. When the sensitivity analysis is required to be disclosed, it should be disclosed separately for all CGUs or groups of CGUs whose amount of goodwill is significant to the total amount of goodwill of the issuer.

87. Approximately 25% of the issuers did not comment on the sensitivities of key assumptions: they provided neither a negative confirmation of impairment nor any numerical information on sensitivities.

88. Instead of omitting a sensitivity test, 10% of issuers have disclosed only a statement indicating that no reasonably possible change in key assumptions could cause impairment loss; that is, providing a negative confirmation of impairment.

89. In total, approximately 40% of issuers claimed that no reasonable change in any key assumption would cause an impairment loss, although their share price was already affected by the expectations on possible impairment losses (measured by the change in equity/market capitalisation). For those issuers with their equity book value exceeding market capitalisation, only half presented a sensitivity analysis.

Conclusions

90. Disclosure on the sensitivity of key assumptions is an area where different practices were observed. ESMA notes that a considerable number of issuers provide very vague sensitivity analysis disclosures. Including a negative confirmation of impairment is wide-spread among issuers. Disclosing such a confirmation might be helpful for the readers of the financial statements, but it can also cause some confusion, as an investor cannot determine either the amount of headroom or what management considers to be "not a reasonably possible change". As a result of these different practices, users of financial information do not always know why the sensitivity analysis was not provided.

91. ESMA would thus expect issuers to be more transparent and disclose the sensitivity of the impairment calculation to changes in key assumptions.

92. In ESMA's view, it is surprising that only 50% of issuers with their equity book value exceeding market capitalisation presented a sensitivity analysis since the lower market capitalization suggests that the market perceives a potential for impairment.

93. ESMA would expect these issuers to disclose clearer information on the sensitivity of the impairment calculations to changes in key assumptions. When disclosing the sensitivity analysis, ESMA also urges issuers to make realistic estimates in determining possible changes in key estimates that would cause the carrying amount of the CGU to exceed its recoverable amount.

94. Some issuers tend to disclose sensitivity analysis that fulfils only a part of the requirements of IAS 36 or is otherwise difficult to understand for the investors. Sensitivity analyses that are vague and not understandable for the reader are not useful.

95. Issuers should also disclose sensitivity analysis for other key assumptions in addition to discount rate and terminal growth rate.