EFRAG
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Business Combinations – Disclosures, Goodwill and Impairment (BCDGI)

Reducing cost and complexity and improving effectiveness of the impairment test
Issues Paper

Objective

1 To obtain EFRAG FR TEG views on the IASB discussions and tentative decisions about reducing cost and complexity and improving effectiveness of the goodwill impairment test.

Background

2 At its May 2023 meeting the IASB discussed whether to keep its preliminary view in the Discussion Paper *Business Combinations – Disclosures, Goodwill and Impairment* (DP) to remove the requirements to perform the annual quantitative impairment test and the ways to reduce costs and improve the effectiveness of the goodwill impairment test.

3 This discussion follows up a series of discussions with the IASB Global Preparers Forum, Capital Markets Advisory Committee, IFRS IC and ASAF in March 2023, on possible changes to the impairment test. In March 2023, the IASB staff asked the IASB to made tentative decisions on the IASB staff recommended changes and other changes that the IASB could consider at future meetings.

4 EFRAG has discussed the suggested changes with EFRAG FR TEG-CFSS on 15 March 2023 in preparation for the March 2023 ASAF meeting. The March ASAF meeting summary can be found here.

Structure of this paper

5 At the time of writing this paper, the IASB Update for the May 2023 meeting including the final wording of the IASB tentative decisions was not yet available.

6 This paper is based on the relevant IASB agenda papers and the IASB discussion at the May 2023 meeting and covers the following topics:

(a) Reducing cost and complexity - removing the annual quantitative impairment test (IASB AP18A)

(b) Effectiveness of impairment test - feasibility of designing a different impairment test (IASB AP18B)

(c) Effectiveness of impairment test - criteria and application (IASB AP18C)

(d) Effectiveness of impairment test - suggestions from respondents (IASB AP18D).

7 At its meeting in May 2023, the IASB made tentative decisions on the topics in paragraphs 6(a) and 6(b). The IASB discussed, but did not make tentative decisions, whether to pursue respondents' suggestions to improve the application of the impairment test (paragraphs 6(c) and 6(d). The IASB will discuss IASB staff recommendations on these suggestions at a future meeting.

Reducing cost and complexity - removing the annual quantitative impairment test

8 The IASB analysed the feedback received on its preliminary view in the DP to remove the requirement in IAS 36 *Impairment of Assets* to perform an annual quantitative impairment test of cash-generating units (CGUs) containing goodwill.

9 The EFRAG Secretariat notes that only a narrow majority (eight out of 14 IASB members) favoured removing the annual testing requirement when the DP was developed. Some IASB members would have supported the narrow majority view only if the IASB also reintroduced amortisation of goodwill. In their view, reintroducing amortisation would decrease reliance on the impairment test and justify removing the annual testing requirement.

10 The feedback to the DP showed that many respondents disagreed with the preliminary view, although many of those respondents considered that the annual testing requirement could be removed if the IASB decides to reintroduce amortisation of goodwill.

11 These respondents noted the following reasons:

(a) reduction in the effectiveness and robustness of the impairment test;

(b) difficulty in enforcing an indicator-only impairment test;

(c) limited reductions in cost savings; and

(d) loss of useful information (for example, information on key assumptions, the discount rates applied and sensitivity analysis, required by paragraph 134 of IAS 36 might not be disclosed when the impairment test is not performed).

12 The IASB staff analysed the respondent's feedback and some academic evidence from the United States that shows that entities performing a qualitative assessment (Step Zero) under US GAAP, exhibit no reduction in the timeliness of impairment loss recognition.

13 As a result, on balance, **the IASB staff recommended the IASB not to proceed with its preliminary view and to retain the annual impairment testing requirement** for the following reasons:

(a) removing the annual testing requirement risks reducing the robustness of the impairment test and might result in the loss of useful information for users; and

(b) proceeding with the preliminary view might not result in a significant reduction in the cost and complexity of the impairment test.

14 All 14 IASB members agreed with this recommendation.

15 The reasons mentioned were that in the light of the IASB's decision not to reintroduce goodwill amortisation, that an indicator-only approach was not robust enough and that the annual impairment test ensured necessary rigour. It was also noted that an indicator-only approach would provide very limited cost-savings (if any) because most costs arose from setting up the impairment test and not running it. Switching to an indicator-only approach would also create costs.

Alternatives to removing the annual goodwill impairment test

16 The IASB staff also considered the following alternatives to removing the annual goodwill impairment testing requirement:

(a) making paragraph 99[1] of IAS 36 easier to apply;

(b) requiring a quantitative impairment test to be performed periodically; and

(c) making the requirement for performing a quantitative impairment test annually an accounting policy choice.

17 As a result of its analysis the IASB **staff did not recommend the IASB pursuing any of the alternatives to an annual quantitative impairment** test suggested by respondents to the DP.

18 All 14 IASB members agreed with this recommendation.

19 The IASB staff will consider ways to increase the awareness of the relief provided by paragraph 99 of IAS 36 and discuss these with the IASB at a future meeting. Feedback indicated that many preparers, auditors and national standard-setters said paragraph 99 is rarely applied because some are not aware of this relief, some prefer to perform the impairment test annually for governance purpose, auditors apply the criteria for the relief very stringently; and it is difficult to demonstrate that the criteria for the relief have been met.

20 The detailed analysis of those alternatives as well as a feedback received from GPF, CMAC, IFRS IC and ASAF is provided in the IASB Agenda Paper 18A.

Effectiveness of impairment test - feasibility of designing a different impairment test

21 This section discusses the feasibility of designing a different impairment test that is significantly more effective than the impairment test of cash-generating units (CGUs) containing goodwill in IAS 36 at recognising impairment losses on goodwill on a timely basis at a reasonable cost.

22 The IASB identified two broad reasons for concerns about the possible delays in recognising impairment losses on goodwill:

(a) **Management over-optimism** - some stakeholders said management may sometimes be too optimistic in making assumptions for the cash flow forecasts needed to carry out the impairment test.

(b) **Shielding** - goodwill does not generate cash flows independently and therefore cannot be measured directly. The impairment test therefore focuses on testing a CGU, or a group of CGUs, containing goodwill. These typically contain headroom[2].

[1] Paragraph 99 of IAS 36 says that the most recent detailed calculation made in a preceding period of the recoverable amount of a CGU to which goodwill has been allocated may be used in the impairment test of that unit in the current period provided all of the following criteria are met: (a) the assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation; (b) the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and (c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote.

[2] The headroom of a CGU is the amount by which its recoverable amount exceeds the carrying amount of its recognised net assets—including goodwill. Headroom in a CGU comprises unrecognised assets and liabilities within a CGU, such as internally generated goodwill, and unrecognised differences between the carrying amount of recognised assets and liabilities and their recoverable amounts.

This headroom can shield acquired goodwill against the recognition of impairment losses.

23 The IASB considered the risk of over-optimism to be unavoidable, given the nature of the estimates required and that this is best addressed by auditors and regulators, not by changing IFRS Standards.

24 To address shielding, the IASB considered whether it could design a different impairment test, in particular one where at least a portion of any reduction in the recoverable amount of a CGU would be attributed to the acquired goodwill and not to unrecognised headroom (the headroom approach). However, the headroom approach did not receive much support from stakeholders.

25 The IASB's preliminary view was that it is not feasible to design a different impairment test that is significantly more effective than the impairment test in IAS 36 at a reasonable cost.

26 Most respondents commenting on this topic agreed with the preliminary view. Those, who disagreed suggested some ways to improve effectiveness of impairment test, such as:

(a) pursuing some form of headroom approach (e.g., pre-acquisition headroom and similar approaches);

(b) other forms of impairment test (e.g., implied goodwill approach, direct value approach and subsequent cash flow test);

(c) other methods to ensure CGUs are carried at no more than their recoverable amounts (e.g., reconsidering the accounting for goodwill and other unrecognised intangible assets and performing a fundamental review of IAS 36).

27 As a result of analysis of the above approaches, the IASB staff concluded that no compelling evidence to reconsider the preliminary view was provided.

28 Therefore, **the IASB staff recommended the IASB to maintain its preliminary view that it is not feasible to design a different impairment test that is significantly more effective than the impairment test in IAS 36 at a reasonable cost.**

29 The detailed description and analysis of these approaches can be consulted in the IASB Agenda Paper 18B.

30 All 14 IASB members agreed with this recommendation.

Effectiveness of impairment test - criteria and application

31 As explained above in paragraph 22, the IASB noted that management over-optimism and shielding were two main concerns about the possible delay in recognising impairment losses on goodwill.

32 To identify suggestions to improve the impairment test that could be explored further the IASB staff considered only those suggestions that:

(a) could mitigate either of the two main reasons that the IASB identified for impairment losses on goodwill not being recognised on a timely basis - management over-optimism and shielding; and

(b) can be implemented at a reasonable cost.

33 The suggested improvements are discussed in the paragraphs below.

Effectiveness of impairment test - suggestions from respondents

34 Based on the above criteria, the IASB staff considered that the following suggestions could be further explored as a part of this project:

Suggestions that could reduce shielding

(a) provide additional guidance on allocating goodwill to CGUs:

(i) clarify the requirements in paragraph 80(a)[3] of IAS 36 that refer to monitoring goodwill;

(ii) clarify the requirements in paragraph 80(b) of IAS 36 to explain that the operating segment ceiling is a safeguard; and

(iii) link the level goodwill is tested for impairment with the level the business combination is monitored for the purposes of providing the disclosures about subsequent performance;

(b) require an entity to perform an impairment test when it reorganises its reporting structure in a way that changes the composition of one or more CGUs to which goodwill has been allocated[4];

Suggestions that could reduce management over-optimism

(c) require an entity to disclose a comparison of cash flow forecasts used in past impairment tests with actual cash flows;

(d) clarify the requirement in paragraph 33 of IAS 36 to explain that cash flow projections based on the most recent financial budgets/forecasts need to be based on reasonable and supportable assumptions;

(e) improve the list of indicators of impairment set out in paragraph 12 of IAS 36; and

(f) require an entity to disclose the reportable segment in which CGUs containing goodwill are included.

35 More details about these suggestions and the IASB staff analysis can be found in the IASB Agenda Paper 18D.

36 The IASB staff decided not to pursue a number of other suggestions because they either had a marginal impact or have a broader implication on the IAS 36. The IASB staff reminded that the full review of IAS 36 goes beyond the objective of this project. The list of the suggestions not pursued could be consulted in the Appendix of the IASB Agenda Paper 18C.

37 During the discussion in May 2023, the IASB members were not convinced that the proposed changes would significantly improve how the impairment test is performed, that they will meet the requirements as a package and suggested to carefully balance any further work in this respect.

(a) Only some IASB members supported improvements to goodwill allocation and guidance on groupings of CGU's. Many of the IASB members suggested not to pursue any of the suggestions to reduce shielding (suggestions (a) and (b)) on the grounds that the proposed clarifications would only have a very marginal effect, and may take a lot of IASB resource to develop. Companies already knew how to do an impairment test and it was questionable whether extensive guidance and clarifications would bring added value to the impairment test.

(b) It was proposed to eventually add the reorganisation to the list of indicators discussed in suggestion (e).

[3] Paragraph 80 of IAS 36 says that each unit or group of units to which the goodwill is allocated shall: (a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and (b) not be larger than an operating segment as defined by paragraph 5 of IFRS 8 *Operating Segments* before aggregation.

[4] Paragraph 87 of IAS 36 says that if an entity reorganises its reporting structure in a way that changes the composition of one or more CGUs to which goodwill has been allocated, the goodwill shall be reallocated to the units affected.

(c) The proposal about comparison of past and actual cash flow forecasts (suggestion (c)) was not supported on the grounds that it would increase costs for preparers with unclear benefit for users. It was noted the new disclosure requirements will already increase costs for preparers and as a package it was not worth pursuing.

(d) The IASB members were unsure about any significant benefit of the suggestions (d) and (e). Some IASB members considered exploring further suggestion (f) and noted that allocating goodwill to the lowest level was an important point to pursue.

38 The IASB was not asked to make any decisions on the criteria and application of the goodwill impairment. The IASB staff will develop recommendations based on the IASB discussion to be discussed at a future IASB meeting.

Feedback of the EFRAG FR TEG-CFSS on the suggestions

39 EFRAG FR TEG-CFSS discussed the list of suggestions to improve impairment test at its meeting on 15 March 2023 and provided the following feedback:

Suggestion (a): additional guidance on allocating goodwill to CGUs

40 Members said that in practice many entities allocate goodwill to operating segments as a default, rather than considering it as a safeguard. Those members suggested clarifying what 'monitoring goodwill' means or replacing the phrase with another form of words.

41 Members suggested that application guidance on what monitoring means, what is monitored and at which level will be useful. Goodwill allocation to the lowest level is the core problem and should be addressed. Members suggested requiring an entity to allocate goodwill for impairment testing at a lower level than an operating segment, similar to what is required in US GAAP.

42 Members cautioned, however, about the danger of mixing the two things (option (iii)): goodwill recoverability test and success of business combination. In their view, the levels of monitoring should not necessarily be the same for both. Some members emphasised that goodwill should be tested at a level lower than operating segment.

Suggestion (b): Impairment test when entities reorganise

43 Members considered that more guidance on reallocation of goodwill could be helpful and suggested to consider the reorganisation not as an obligation to perform an impairment test, but rather as an indicator of impairment.

Suggestion (c): Comparison of past forecasts

44 Members did not express much support for this proposal, considered it to be more the audit and enforcement issue and thought that the objective to deter management over-optimism could be better achieved by other means.

45 Members noted that currently there was no requirements to disclose the cash flow projections used for the impairment test and questioned how the comparison to these cash flows can be provided in the future periods if the actuals were not disclosed.

46 Members noted that for this information to be useful, the explanations of variances of why actuals deviated from the target would be required and that this information could be commercially sensitive. It was also noted that auditors already perform this exercise.

47 Members explained that when computing value in use, the most of cash flows often lie in the terminal value and in the first three years they may even be zero, therefore the proposed disclosure would not address this issue. Members considered the accumulated growth rate for the projection period to be a key input.

48 Some members considered that the problem lies within the inherent imprecision of management estimates and projections and cannot be attributed to IAS 36 only but to other standards as well, for example IAS 1.

49 One member supported the disclosures from the perspective of a user, but noted the technical challenges noted by other members.

50 The observer with enforcer background stated that such information is useful for enforcers but acknowledged that it could be commercially sensitive in disaggregated form and the disclosure would not be easy to design. However, in his view, the proposal was worth further discussion.

51 Members considered that the proposed disclosure might result in a boiler plate information without any added value and suggested that requiring a sensitivity analysis to achieve a horizon of projections could better achieve the IASB objective.

Suggestion (d): Reasonable and supportable assumptions

52 Members considered it to be mostly an audit issue and that if the management forecasts are too stretched, they should be adjusted for impairment test purposes. The best-case scenario of the management forecast could be suitable for this purpose.

Suggestion (e): List of impairment indicators

53 Members considered that this suggestion would only have a very marginal impact.

54 The observer with enforcer background expressed the strong opposition to introduction of indicator-based approach to the impairment test.

Suggestion (f): Segments goodwill is allocated to

55 Members considered that although this proposal could be helpful, this information is already required by paragraph 134(a) of IAS 36, and they did not see how it will help to address management over-optimism. Members questioned how the disclosure at segment level will help with the impairment test performed at a too high level.

Paragraph 99 of IAS 36

56 Members confirmed that they rarely saw in practice the application of this paragraph. They suggested that one of the reasons might be that demonstrating that the entity meets these criteria may be more time-consuming and costly than performing the impairment test.

EFRAG Secretariat analysis

57 The EFRAG Secretariat agrees with the IASB's decision to retain the annual impairment testing requirement, especially in the light of not reintroducing amortisation of goodwill, as it would keep the robustness of the impairment requirements and contribute to good internal controls and governance. This decision is in line with the EFRAG position in its Comment Letter to the DP.

58 The EFRAG Secretariat also agrees with the IASB's decision not to pursue any of the alternatives to an annual quantitative impairment test.

59 The EFRAG Secretariat supports the IASB's decision to maintain its preliminary view that it is not feasible to design a different impairment test that is significantly more effective than the impairment test in IAS 36 at a reasonable cost. This is in line with the EFRAG position in its Comment Letter to the DP where it shared the IASB's reservations on the possibility to develop a different and more effective impairment approach.

60 The EFRAG Secretariat notes that the criteria and the list of suggestions to improve the impairment test is carried forward unchanged from the IASB March presentation to GPF,

CMAC, IFRS IC and ASAF which can be consulted here [BCDGI – Improvements and simplifications of the impairment test of goodwill (ifrs.org)](ifrs.org).

61 The EFRAG Secretariat shares the IASB members concerns about the time and efforts being spent on discussion of these additional detailed suggestions and clarifications which would only have a marginal effect on the overall effectiveness of the impairment test and take considerable time and effort to develop.

62 In line with EFRAG's Comment Letter on the DP, the EFRAG Secretariat considers that allocation of goodwill to the lowest CGU level remains an important point for improving the impairment test and potentially reduce the shielding effect.

Questions for EFRAG FR TEG

63 Does EFRAG FR TEG agree with the IASB decisions to retain the annual impairment testing requirement and not to pursue any of the alternatives to an annual quantitative impairment test?

64 Does EFRAG FR TEG agree with the IASB decision that it is not feasible to design a different impairment test that is significantly more effective than the impairment test in IAS 36 at a reasonable cost?

65 Does EFRAG FR TEG agree with the EFRAG Secretariat analysis? Which of the suggestions to improve the impairment test listed in paragraph 34 you would pursue?