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Business Combinations – Disclosure, Goodwill and Impairment

Improvements to the goodwill impairment test Issues paper

Objective

- 1 This paper discusses the IASB's tentative decisions taken in July 2023 on improvements to the goodwill impairment test, as part of the IASB's redeliberations of its proposals in the Discussion paper [Business Combinations – Disclosures, Goodwill and Impairment](#) ('the DP').
- 2 The purpose of this paper is to follow on from the IASB's discussions at its May 2023 meeting on suggestions to improve the application and effectiveness of the goodwill impairment test. In May 2023, the IASB discussed, but did not make tentative decisions, whether to pursue respondents' suggestions to improve the application of the goodwill impairment test under IAS 36 *Impairment of Assets*. These decisions were made in July 2023.

Structure of this paper

- 3 This paper is structured as follows:
 - (a) Previous EFRAG discussions
 - (b) IASB tentative decisions
 - (c) IASB's preliminary view and existing requirements
 - (d) Feedback on the proposals
 - (e) IASB staff analysis/recommendations and IASB discussion
 - (f) EFRAG Secretariat analysis
 - (g) Questions to EFRAG FR TEG

Previous EFRAG discussions

- 4 EFRAG FR TEG discussed suggested improvements to the impairment test at its meeting in June 2023. These same suggestions were also discussed at the EFRAG FR TEG-CFSS meeting in March 2023 in preparation for the March ASAF meeting. At this meeting, ASAF members, including EFRAG, were asked for views on:
 - (a) the criteria used to select suggestions to be explored further;
 - (b) suggested changes to improve the application of the impairment test by reducing management over-optimism;
 - (c) suggested changes to improve the application of the impairment test by reducing shielding; and

- (d) suggested ways to reduce the cost and complexity of the impairment test.
- 5 The link to the summary of the March 2023 ASAF meeting is [here](#).
- 6 The complete list of suggestions discussed with EFRAG FR TEG and EFRAG CFSS in March 2023 are included in appendix 1 to this paper.

IASB tentative decisions

- 7 In July 2023, the IASB discussed how to improve the goodwill impairment test ([IASB agenda paper 18B](#)), as well as the IASB staff analysis of suggestions from respondents and recommendations ([IASB agenda paper 18A](#)).
- 8 The improvements focused on mitigating the two broad issues regarding why the goodwill impairment test may not work as intended:
 - (a) Shielding effect on goodwill; and
 - (b) Management over-optimism.
- 9 Based on feedback received, including feedback from the ASAF March 2023 meeting, the IASB decided to pursue suggestions that would mitigate the concerns noted above and could be implemented at a reasonable cost.
- 10 Some of the suggestions discussed at the March ASAF meeting were not supported by ASAF members, including EFRAG, mainly because of cost-benefit reasons.
- 11 **In July 2023, the IASB tentatively decided:**
 - (a) to replace 'goodwill is monitored for internal management purposes' in paragraph 80(a) of IAS 36 with 'business associated with the goodwill is monitored for internal management purposes';
 - (b) to clarify the meaning of the proposed new wording for paragraph 80(a) by providing limited clarifications of what is meant by 'monitoring' a business associated with goodwill;
 - (c) to clarify that 'operating segment' in paragraph 80(b) of IAS 36 is intended to show the highest level that can be used by an entity in the impairment test when applying paragraph 80(a);
 - (d) to clarify why IAS 36 requires an entity to allocate goodwill to a CGU or group of CGUs; and
 - (e) to take no further action on any of the other suggestions from respondents to the DP to improve the effectiveness of the impairment test.
- 12 All 14 IASB members agreed with these decisions.
- 13 The IASB tentatively decided to require an entity to disclose the reportable segments in which cash-generating units containing goodwill are included. Thirteen of 14 IASB members agreed with this decision.
- 14 The IASB also tentatively decided to explain the difference between management monitoring 'strategically important' business combinations for the purpose of subsequent performance disclosure and management monitoring a business associated with the goodwill for the purpose of impairment testing. Eleven of 14 IASB members agreed with this decision.

IASB's preliminary view and existing requirements

- 15 In the DP, the IASB identified two broad reasons for concerns about possible delays in recognising impairment losses on goodwill:
 - (a) **Shielding** – goodwill does not generate cash flows independently and therefore cannot be measured directly. The impairment test therefore focuses

on testing a Cash-generating Unit (CGU), or a group of CGUs, containing goodwill. These typically contain headroom¹. This headroom can shield acquired goodwill against the recognition of impairment losses.

- (b) **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.

16 When developing the DP, the IASB considered whether it could design a different impairment test. However, consistent with its preliminary view, in May 2023 the IASB tentatively decided 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. It would therefore focus on developing additional guidance on how goodwill is allocated to a CGU/group of CGUs.

Additional guidance on how goodwill is allocated to CGUs

17 Paragraph 80 of the **existing requirements** in IAS 36 contains the requirements for allocating goodwill to CGUs or group of CGUs. In particular, it requires each CGU or group of CGUs to which goodwill is allocated to:

- (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.

18 Paragraph BC140 of the Basis for Conclusions on IAS 36 confirms the IASB's intention that there should be a link between the level at which goodwill is tested for impairment and the level of internal reporting that reflects the way an entity manages its operations. Paragraph BC146 explains that when a business combination enhances the value of all of the acquirer's pre-existing CGUs, it would be wrong to conclude that goodwill can be tested only at the entity level.

19 When the IASB developed its preliminary views in the DP it concluded that it would be difficult to provide additional guidance on identifying CGUs and on allocating goodwill to CGUs that could apply to all entities. This is because the allocation of goodwill should reflect an entity's internal structure which can differ between entities.

Reducing management over-optimism

20 The DP considered the risk of over-optimism to be unavoidable, given the nature of the estimates required. IAS 36 contains requirements that reduce the risk that cash flow forecasts could be too optimistic. If estimates of cash flows are sometimes too optimistic, the IASB considered that this is best addressed by auditors and regulators, not by changing IFRS. Respondents to the DP provided some suggestions about how to tackle management over-optimism which the IASB considered when redeliberating this issue.

Feedback on the proposals

21 Most respondents agreed with the IASB's preliminary view that it is not feasible to design a different impairment test at a reasonable cost.

¹ 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.

- 22 Many respondents, including EFRAG, provided ideas for additional disclosure requirements to combat management over-optimism and suggested the IASB develop additional guidance to improve the level at which goodwill is allocated to CGUs to reduce the ‘shielding’ effect described in the DP.
- 23 Respondents also agreed with the IASB’s preliminary view not to provide additional guidance on identifying CGUs. However, many disagreed and suggested providing guidance on how to allocate (and reallocate) goodwill to CGUs and reconsidering the level at which the impairment test is performed.
- 24 In its Final Comment Letter, EFRAG had a similar view suggesting that the guidance on goodwill allocation to CGUs is discussed and possibly amended to improve how the impairment test is applied in practice. EFRAG highlighted the need to enhance the guidance on the allocation of goodwill to CGUs, which would reduce shielding to a certain extent, judgement and opportunistic behaviour.
- 25 In addition, EFRAG considered that goodwill should be allocated to the lowest level possible. For example, to reduce the possibilities of opportunistic behaviour, a rebuttable presumption could be considered that the allocation level is below operating segment level. Any allocation to segment level should be reasonably explained in the notes by management with a focus on explanation of cash inflow structure and cash inflows that can be monitored and would trigger impairment.
- 26 The suggestions from respondents² that were further explored by the IASB staff are listed below and can be found in [IASB Agenda Paper 18A](#). A summary of the complete list of suggestions discussed with EFRAG FR TEG and EFRAG CFSS in March 2023 are included in appendix 1 to this paper.

IASB staff analysis /recommendations and IASB discussion

- 27 Following the feedback at the ASAF meeting in March 2023, the IASB staff made the following recommendations:
- (a) replace ‘goodwill is monitored for internal management purposes’ in paragraph 80(a) of IAS 36 with ‘business associated with the goodwill is monitored for internal management purposes’;
 - (b) provide limited guidance on what is meant by monitoring the business associated with goodwill when an entity applies paragraph 80(a) of IAS 36;
 - (c) clarify that the reference to operating segment in paragraph 80(b) of IAS 36 is intended as a ceiling to the level that an entity determines applying paragraph 80(a);
 - (d) clarify why IAS 36 permits allocating goodwill to groups of CGUs;
 - (e) include an illustrative example explaining the difference between management monitoring ‘strategically important’ business combinations for the purpose of subsequent performance disclosure and management monitoring a business associated with the goodwill for the purposes of impairment testing;
 - (f) require an entity to disclose in which reportable segments CGUs containing goodwill are included; and
 - (g) not pursue further any of the other suggestions analysed in this paper or included in the appendix to this paper.

² This paper only includes suggestions that were explored further and analysed by the IASB staff. The summary of all suggestions from respondents to improve the effectiveness of impairment test can be found in [IASB AP18B July 2023](#).

IASB discussion in July 2023

- 28 IASB members generally supported the IASB staff's recommendations but expressed concerns particularly on 27(e) to include an example.
- 29 One IASB member disagreed with the recommendation in paragraph 27(e)27(f)27(f).

Suggestions that could reduce shielding

- 30 The IASB members agreed with the IASB staff's recommendation to amend the requirements in paragraph 80 of IAS 36 which in their view would be the most cost-effective solution to improve the application of that paragraph.
- 31 In addition, the IASB members agreed that there is a need to clarify the way goodwill is allocated to CGUs, and more specifically to clarify the difference between the level of management at which goodwill is tested for impairment and the level at which subsequent performance is monitored. However, there were disagreements on how the clarification would be dealt with. Overall, it was agreed the guidance should not be too detailed.
- 32 Some IASB members did not agree with the recommendation of including an illustrative example to clarify the difference between the level of management at which goodwill is tested for impairment with the level at which the subsequent performance is monitored. Having an example may end up being very prescriptive and does not reflect the diversity in the organisational structure of entities. Therefore, the IASB decided to clarify the topic using a principles-based approach with guidance included in the actual requirements.

Suggestions that could reduce over-optimism

- 33 Even though the suggestion from respondents to the DP to disclose the reportable segment in which CGUs containing goodwill are included was considered beneficial for users (as in 27(f)), some concerns were raised by IASB members on its usefulness for improving the effectiveness of the impairment test. The proposal was considered to result in additional costs associated with the additional disclosure and the allocation of goodwill to lower level of CGUs. Furthermore, an IASB member flagged that the proposal itself, made a distinction between listed (entities with reportable segments CGUs complying with IFRS 8) and non-listed entities.

Feedback on the suggestions from EFRAG FR TEG and EFRAG -CFSS

- 34 In March 2023, EFRAG FR TEG and EFRAG-CFSS members discussed how the effectiveness of the impairment test could be improved and provided the following suggestions:

Suggestions that could reduce shielding

- (a) To enforce the goodwill allocation to a level lower than the operating segment;
- (b) To provide application guidance on how to make this allocation and identify the lowest level;
- (c) To provide more guidance on how to deal with right of use assets, especially in the case when assets are removed from a CGU to be impaired separately and whether to include or exclude lease payments in the impairment test;

Suggestions that could reduce management over-optimism

- (d) To add restructuring as an impairment indicator;
- (e) To link cash flow projections to budgets and forecasts approved by management;
- (f) To require more sensitivity analysis;

- (g) To provide guidance on what is meant by “largely independent cash inflows”;
 - (h) To consider extending the limit of 5 years in paragraph 33(b) of IAS 36 for climate-related risks.
- 35 In particular, EFRAG FR TEG and EFRAG CFSS emphasised the suggestion outlined in paragraphs 27(a) - 27(c) (on improved guidance to paragraph 80 of IAS 36) since the lack of clarity on the goodwill allocation was considered to be the main issue (the level of allocation was considered high).

EFRAG Secretariat analysis

- 36 The EFRAG Secretariat agrees with the IASB’s decisions are generally in line with EFRAG’s position in its Final Comment Letter (paragraphs 95-114) and views (some views) provided by EFRAG FR TEG and CFSS in recent meetings.
- 37 Furthermore, in its Final Comment Letter EFRAG did not completely agree with IASB’s preliminary view that management overoptimism is best addressed by auditors and regulators. EFRAG noted that auditors and regulators may not have better knowledge about the business development than management and therefore, they might not replace the management’s estimations with their own. To address the risk that estimates used by management could be too optimistic, EFRAG suggested that the IASB considers developing possible disclosure solutions for a better transparency of the estimates made or their achievement and improving the guidance for identification of impairment testing trigger events. EFRAG provided some examples how this could be done.
- 38 The EFRAG Secretariat is of the view that some of the more detailed clarifications agreed at the July 2023 IASB meeting, including additional guidance to paragraph 80 of IAS 36, are aligned with EFRAG’s position on how to improve how entities allocate goodwill to a CGU/CGUs.
- 39 We also consider that the limited guidance on what is meant by monitoring the business associated with goodwill will help entities better apply the requirements in IAS 36 and allocate goodwill to a level that is consistent with how those entities report internally and how those entities manage their operations.

Questions for EFRAG FR TEG members

- 40 Does EFRAG FR TEG agree with the IASB decisions in paragraph 1111? If not, please explain why.
- 41 Does EFRAG FR TEG agree with the IASB tentative decisions in paragraph 13 on reportable segments? If not, please explain why.
- 42 Does EFRAG FR TEG agree with the IASB tentative decisions in paragraph 1414? If not, please explain why.
- 43 Does EFRAG FR TEG have any other comments / additional suggestions on the IASB tentative decisions taken in July 2023?

Appendix

Suggestions by respondents to improve the effectiveness of the goodwill impairment test

- 1 This appendix provides a summary of the suggestions provided by respondents to the DP to improve the effectiveness of the goodwill impairment test and feedback from EFRAG TEG-CFSS on these discussions. The suggestions included four suggestions to reduce management over-optimism, two to address the shielding effect and two to reduce cost and complexity of the impairment test.

Suggestions to reduce management over-optimism

- 2 **Suggestion 1:** To disclose a comparison of cash flow forecasts used in impairment tests in prior years with actual cash flows.
- 3 **Suggestion 2:** To provide additional guidance or illustrative examples on the application of paragraph 33 of IAS 36 about reasonable and supportable assumptions and the most recent financial budgets or forecasts approved by management used in cash flow forecasts.
- 4 **Suggestion 3:** To disclose in which reportable segments the CGU(s) containing goodwill are included in the year of acquisition and/or in the subsequent periods.
- 5 **Suggestion 4:** To review the list of indicators of impairment in paragraph 12 of IAS 36³.

Suggestions to reduce shielding

- 6 **Suggestion 5:** Allocating goodwill to CGUs for impairment testing
 - (a) To clarify the reference to 'operating segment' in paragraph 80(b) of IAS 36⁴ is not a default but a safeguard to prevent goodwill being tested at too high a level (e.g., at an entity level);
 - (b) To clarify the requirement in paragraph 80(a) of IAS 36 to allocate goodwill to the lowest level within the entity at which goodwill is monitored for internal management purposes;
 - (c) When clarifying how to allocate goodwill and what 'monitoring' means in point (b) above, to link the level management monitors the business combination, applying the IASB preliminary views⁵, to the requirements in paragraph 80 of IAS 36.

³ Paragraph 12 of IAS 36 includes a list of internal and external sources of information an entity should consider in assessing whether there is an indication that an asset may be impaired.

⁴ 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.

⁵ In September 2022, the IASB tentatively decided to propose adding to IFRS 3 a requirement for an entity to disclose, for 'strategically important' business combinations, information about (i) management's objectives for the business combination; (ii) the metrics and targets management will use to monitor whether those objectives are being met; and (iii) in subsequent periods, the extent to which management's objectives are being met, using those metrics, for as long as management monitors the business combination against its objectives.

Suggestion 6: To perform an impairment test based on its previous reporting structure before reallocating goodwill to different CGU(s)⁶.

Suggested changes that could reduce cost and complexity of the impairment test

- 7 **Suggestion 7:** Clarify or amend paragraph 99 of IAS 36⁷ in order to make it easier to apply.

Feedback from EFRAG TEG-CFSS

- 8 EFRAG FR TEG and EFRAG CFSS discussed all the suggestions below at the March 2023 EFRAG FR TEG-CFSS meeting. The link to the paper is here [agenda paper 09-01](#).
- 9 EFRAG TEG-CFSS generally supported suggestion 3 and suggestion 5. The other suggestions received limited support.

⁶ 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.

⁷ 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.