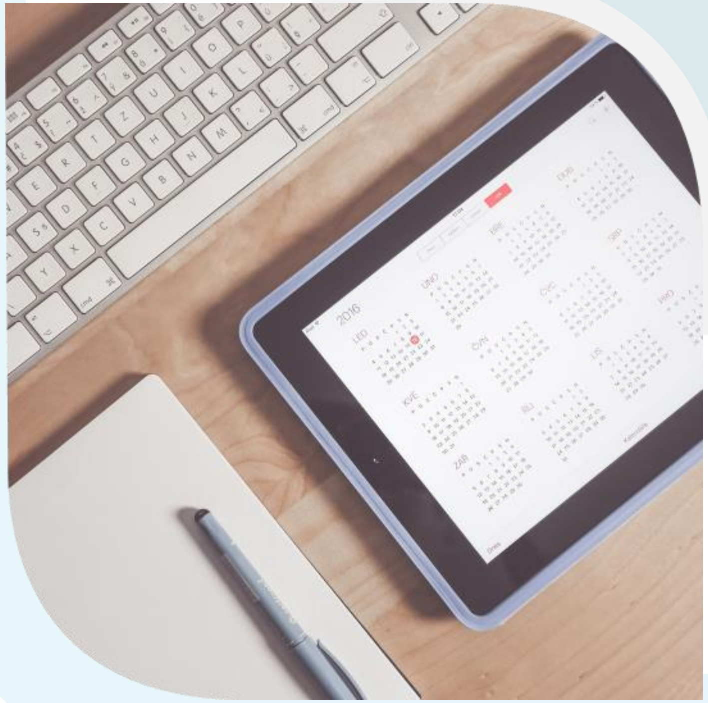
Business Combinations—Disclosures, Goodwill and Impairment

Project Update on recent IASB tentative decisions



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This paper is the same as Agenda Paper 09-02 of the EFRAG FR TEG meeting of 20 December 2023. The session in December 2023 was cancelled.

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OVERVIEW

- IASB tentative decisions in March 2023
- IASB tentative decisions in May 2023
- IASB tentative decisions in July 2023

(The IASB discussed ways to reduce costs and complexity and improve the effectiveness of the goodwill impairment test at the above meetings)

- IASB tentative decisions in September 2023 (transition and due process)
- Next steps
- Questions to EFRAG FRB members

IASB tentative decisions – March 2023

Reducing costs and complexity of the impairment test

IASB tentative decisions – March 2023

- In March, the IASB discussed ways to reduce the cost and complexity of the impairment test of cash-generating units containing goodwill under IAS 36 *Impairment of Assets* and the removal of some disclosure requirements from IFRS 3 *Business Combinations.*
- The IASB tentatively decided to made changes to the following:
  - Estimating value in use under IAS 36
  - Other suggestions to reduce cost and complexity in applying the impairment test
  - Deleting disclosure requirements under IFRS 3

1. Value in use

Future restructuring, improvements and enhancements

The IASB tentatively decided to propose:

- to remove a constraint on cash flows used to estimate value in use. An **entity would no longer be prohibited from including cash flows**:
  - arising from future restructuring to which the entity is not yet committed; or
  - from improving or enhancing an asset's performance
- to retain the requirement to assess assets or cash-generating units in their **current condition**
- no additional constraints/guidance on the inclusion of those cash flows beyond those already in IAS 36.

Post-tax cash flows and discount rate to estimate value in use

The IASB tentatively decided to propose:

- to **remove from IAS 36 the requirement to use pre-tax cash flows and pre-tax discount rates** in estimating value in use – an entity should use internally consistent assumptions for cash flows and discount rates and be required to disclose the discount rates used (as per current requirement)
- to remove the requirement that the discount rate disclosed be a pre-tax rate; and
- to require an entity to disclose whether a pre-tax or a post-tax discount rate was used.

Value in use (continued)

- In reaching its tentative decisions on future restructurings, the IASB considered whether that IAS 36 contained sufficient safeguards/ guidance on cash flows when estimating value in use
- Specifically, IAS 36 incorporates the following safeguards:
  - paragraph 33(b) of IAS 36 requires an entity to base cash flows projections on the most recent financial budgets/forecasts approved by management;
  - paragraph 44 of IAS 36 requires an entity to estimate future cash flows for the asset or cash-generating unit (CGU) in its current condition; and
  - paragraphs 134(d) and 134(f) of IAS 36 require entities to disclose information about the assumptions on which management based its estimates of the recoverable amount

Value in use - IASB preliminary views

Future restructuring, improvements and enhancements

- The IASB's preliminary view was that it should develop a proposal to remove from IAS 36 the restriction on including cash flows arising from a future restructuring to which a company is not yet committed or from improving or enhancing an asset's performance
- This proposal would apply not only to cash-generating units containing goodwill but to all assets and cash-generating units within the scope of IAS 36

Post-tax cash flows and discount rate to estimate value in use

The IASB's preliminary view was that it should develop a proposal to:

- remove the explicit requirement to use pre-tax cash flows and pre-tax discount rate in estimating VIU;
- require use of internally consistent assumptions for cash flows and discount rates, regardless of whether VIU is estimated on a pre-tax or post-tax basis; and
- retain the requirements to disclose the discount rates used but remove the requirement that the discount rate disclosed should be a pre-tax rate

Value in use – Feedback from respondents

Future restructuring, improvements and enhancements

- Many stakeholders, including EFRAG, agreed with the preliminary view and considered that further guidance is unnecessary because IAS 36 already requires an entity to use reasonable and supportable assumptions
- Many respondents noted that it could be difficult and judgmental assessing whether cash flows form future restructurings or asset enhancements are reasonable and supportable and suggested additional guidance on when to include cash flows arising from a restructuring or enhancing the asset’s performance
- EFRAG also noted that additional clarification would be needed what cash flows to include in value in use estimations regarding asset enhancements

Value in use – Feedback from respondents (continued)

Post-tax cash flows and discount rate to estimate value in use

- Almost all respondents to the ED, including EFRAG, agreed with the IASB's preliminary view
- The feedback highlighted that entities already use post-tax cash flows and discount rate to estimate VIU
- In EFRAG Final Comment Letter, EFRAG noted that the IASB should provide guidance on possible issues, such as how deferred taxes should be reflected in the future cash flows or if the carrying amount of the CGU should be adjusted
- In response to additional guidance, the IASB noted that the objective was to simply deleted 'pre-tax' and did not add any further guidance – the view of the IASB staff was that in principle the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of future tax cash flows

Value in use – EFRAG FR TEG feedback (June 2023)

Future restructuring, improvements and enhancements

- Welcomed the IASB's tentative decision to remove the prohibition on including cash flows arising from future uncommitted restructuring or improvement or enhancement of an asset's performance in the estimate of the value in use
- However, **members noted that the IASB should provide further application guidance** on what type of cash flows could be included in the calculation
- The proposals to assess assets or CGUs in their current condition could lead to confusion and application questions, considering that the prohibition of including restructurings, improvements or enhancements was a direct consequence of this requirement and that routine and ordinary maintenance is already allowed (IAS 36, paragraph 49)

Value in use – EFRAG FR TEG feedback (continued)

Post-tax cash flows and discount rate to estimate value in use

- Agreed with the IASB's tentative decision to remove from IAS 36 the requirement to use pre-tax cash flows and pre-tax discount rates in estimating value in use
- **Noted the importance of having additional guidance on how to reflect deferred taxes in future cash flows** and in the carrying amount of the asset/CGU when making a post-tax calculation, considering that deferred tax assets are currently outside of the scope of IAS 36 and that paragraph 50 of IAS 36 explicitly excludes "income tax receipts or payments" in estimating future cash flows
  - In practice there are several ways to do this (e.g., (i) adjusting the future cash flows and the carry amount of the asset/CGU with the related remaining tax depreciation; (ii) using a market participant perspective; or (iii) using a normative tax rate
  - The IASB should provide application guidance and illustrative examples to ensure a consistent application of post-tax calculation to both carrying amount and value in use and avoid "double counting" of future tax consequences of temporary differences in estimating future cash flows
  - the IASB should not prescribe a specific method but specify which methods of calculating post-tax cash flows are permitted

2. Deleting disclosure requirements

- The IASB tentatively decided to **remove from IFRS 3** requirements to disclose:
  - information about acquired receivables (paragraph B64(h));
  - in the reconciliation between opening and closing goodwill balances, adjustments resulting from the subsequent recognition of deferred tax assets (paragraph B67(d)(iii)); and
  - the amount and an explanation of any material gain or loss recognised in the current reporting period that relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period (paragraph B67(e))
- The IASB considered that the information in paragraph B64(h) would be disclosed applying paragraphs 35A-35M of IFRS 7 *Financial Instruments: Disclosures*
- The IASB noted that paragraph 67 of IFRS 3 would never result in changes to the carrying value of goodwill during the reporting period. Paragraph B67(d)(iii) of IFRS 3 became redundant when the IASB amended IFRS 3 in 2008

Deleting disclosure requirements (continued)

- The IASB tentatively decided to **make no changes** to the requirements to disclose:
  - the amount of goodwill expected to be deductible for tax purposes (paragraph B64(k) of IFRS 3);
  - information about acquisition-related costs (paragraph B64(m) of IFRS 3);
  - information about business combinations completed after the end of the reporting period (paragraph B66 of IFRS 3); and
  - in interim financial statements, information about business combinations (paragraph 16A(i) of IAS 34 Interim Financial Reporting)
- **EFRAG FR TEG members generally agreed** with the above IASB tentative decisions (discussed in June 2023)

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3. Other suggestions

- The IASB tentatively decided:
  - not to add more guidance to IAS 36 about the difference between:
    - value in use; and
    - fair value less costs of disposal; and
  - not to mandate a single method for measuring recoverable amount
  - not to provide additional guidance on performing the impairment test for entities in the financial services sector; and
  - not to provide additional guidance to clarify the interaction between IAS 36 and either IFRS 13 Fair Value Measurement or IAS 21 *The Effects of Changes in Foreign Exchange Rates*
- **EFRAG FR TEG members generally agreed** with the above IASB tentative decisions

EFRAG Secretariat analysis – IASB March 2023 tentative decisions

- Most of the IASB's tentative decisions are in line with the EFRAG's suggestions included in its Comment Letter to the DP.
- In addition, the IASB's tentative decisions aim to reduce the cost and complexity of applying the impairment test, as well as responding to requests from stakeholders for an alignment between the practice and the requirements of IAS 36 (e.g., post-tax cash flows and discount rates).
- However, there may be a need to request **further application guidance** in the following areas:
  - on what type of cash flows could be included in the calculation when considering future restructurings and enhancements (slide 10)
  - how to reflect deferred taxes in future cash flows and in the carrying amount of the asset/CGU when making a post-tax calculation (slide 11)

IASB tentative decisions – May 2023

Effectiveness of the impairment test

IASB tentative decisions – May 2023

At its May 2023 meeting, the IASB discussed suggestions provided by respondents to the DP.

The IASB tentatively decided:

- to retain the requirement to perform a quantitative impairment test annually
- that it is not feasible to design a different impairment test that would, at a reasonable cost, be significantly more effective than the impairment test currently required by IAS 36

IASB preliminary views

- The DP proposed to remove the requirement in IAS 36 to perform an annual quantitative impairment test of cash-generating units (CGUs) containing goodwill
- 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

EFRAG FR TEG feedback (June 2023)

- Agreed with the IASB tentative decisions to retain the annual impairment testing requirement
- Agreed not to pursue any of the alternatives to an annual quantitative impairment test
- Agreed 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
- Highlighted the importance of pursuing the suggestions to address shielding, such as allocating goodwill to the lowest level of CGU
- EFRAG FR TEG members views are in line with other feedback received by the IASB on the DP

EFRAG Secretariat analysis – IASB May 2023 tentative decisions

- The IASB's decisions are generally in line with EFRAG's views in its Comment Letter and also supported by EFRAG FR TEG members in recent discussions
- The IASB decided 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 is in line with EFRAG's position in its Comment Letter.

IASB tentative decisions in July 2023

Improving effectiveness of the impairment test

IASB tentative decisions - July 2023

In July, the IASB discussed ways to improve the way goodwill is allocated to a cash-generating unit(s). The IASB tentatively decided to provide additional guidance on how to apply paragraph 80 of IAS 36 on allocating goodwill to a cash-generating unit(s) (CGU) as follows:

- 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';
- 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;
- 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);
- to clarify why IAS 36 requires an entity to allocate goodwill to a cash-generating unit or a group of cash-generating units; and
- to take no further action on any of the other suggestions from respondents

Allocating goodwill to cash-generating units under IAS 36

Paragraph 80 of IAS 36 requires each CGU or group of CGUs to which goodwill is allocated to:

- represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and
- not be larger than an operating segment as defined by IFRS 8 *Operating Segments* before aggregation.

The BC of IAS 36 explains 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. Therefore, 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

IASB preliminary views

- The IASB identified two broad reasons for concerns about possible delays in recognising impairment losses on goodwill:
  - **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 headroom. This headroom can shield acquired goodwill against the recognition of impairment losses
  - **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
- The IASB considered 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
- 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.

Feedback from respondents

- Most respondents **agreed with the IASB's preliminary view that it is not feasible to design a different impairment test** at a reasonable cost.
- Some respondents noted that an entity's management often does not monitor goodwill but instead monitors the overall business and in these situations entities default to testing goodwill for impairment at the operating segment level
- Many respondents, including EFRAG, **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. EFRAG considered that goodwill should be allocated to the lowest level possible

EFRAG FR TEG discussions on tentative decisions (October 2023)

- One FR TEG member questioned whether the proposed changes to paragraph 80 of IAS 36 on how goodwill is allocated to a cash-generating unit(s) went far enough to make a difference in practice.
- The IASB representative explained that the objective of this proposal was to clarify that when allocating goodwill to a cash-generating unit(s), paragraph 80(a) should be applied before applying paragraph 80(b). Many respondents to the DP noted a lack of clarity in this regard.
- Paragraph 80 of IAS 36 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

EFRAG Secretariat analysis – IASB July 2023 tentative decisions

- The EFRAG Secretariat considers that some of the more detailed clarifications, 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 cash-generating unit (s)
- The aim of the IASB tentative decisions was to highlight that paragraph 80(a) should be applied before applying paragraph 80(b) when allocating goodwill to a cash-generating unit(s)

IASB tentative decisions in September 2023

IASB tentative decisions – September 2023

In September 2023, the IASB concluded its redeliberations on this project.

Transition and first-time adopters and due process

The IASB tentatively decided:

- to require an entity to apply the proposed amendments to the **disclosure requirements in IFRS 3** to business combinations for which the **acquisition date is on or after the effective date of the amendments**, with earlier application permitted;
- to require an entity to **apply the proposed amendments to IAS 36 to impairment tests on or after the effective date of the proposed amendments**, with earlier application permitted; and
- not to provide first-time adopters with a specific exemption from applying the proposed amendments to IFRS 3 and IAS 36
- The IASB decided to set a comment period of **120 days for the Exposure Draft**

During its discussion in October 2023, EFRAG generally agreed with the IASB tentative decisions

Next steps

Next steps

- The IASB expects to publish its **exposure draft on the project in H1 2024** with a comment period of 120 days.
- The EFRAG project team **has conducted targeted outreach via a survey to preparers** on the IASB tentative decisions on the subset of business combinations considered to be ''strategically important'' and the application of the exemption for disclosure requirements. The results of the survey will be presented at the EFRAG FR TEG meeting in early 2024.
- In Q1 2024, the EFRAG project team will discuss with EFRAG FR TEG the key messages in preparation for the development of the EFRAG draft comment letter. At this stage, we have not planned for further outreach.

Questions to EFRAG FRB members

- Do EFRAG FRB members agree with the IASB decisions taken in March, May and July 2023? If not, please explain why
- Do EFRAG FRB members agree with the IASB tentative decisions on transition and first-time adopters? If not, please explain why
- Do EFRAG FRB members agree with the 120-day consultation period for the forthcoming exposure draft?
- At this stage, do EFRAG FRB members have any other comments or suggestions on improvements to the goodwill impairment test or next steps?

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