IFRS Accounting

Staff paper

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Date	**May 2023**
Project	**Business Combinations—Disclosures, Goodwill and Impairment**
Topic	**Effectiveness of impairment test—criteria and application**
Contacts	Tim Craig (tcraig@ifrs.org) Paolo Dragone (pdragone@ifrs.org)

Purpose and structure

1. The purpose of this paper is to provide the International Accounting Standards Board (IASB) with:
   (a) an explanation of the criteria we used to consider suggestions from respondents to the Discussion Paper *Business Combinations—Disclosures, Goodwill and Impairment* to improve the effectiveness of the impairment test of cash-generating units (CGUs) containing goodwill (impairment test);
   (b) feedback on the criteria; and
   (c) an explanation of how we applied the criteria to the various suggestions.

2. The paper is structured as follows:
   (a) Background (paragraphs 3–13);
   (b) Process (paragraphs 14–29), including:
      (i) Criteria for considering suggestions (paragraphs 14–15);
      (ii) Feedback on criteria (paragraphs 16–20);
      (iii) Application of criteria (paragraphs 21–25);
      (iv) Outreach (paragraph 26); and

(v) Other feedback (paragraphs 27–29); and

(c) Appendix—List of suggestions not pursued.

Background

Summary of the IASB's preliminary view

3. As explained in Agenda Paper 18 to this meeting, in the Discussion Paper the IASB identified two broad reasons for concerns about the possible delay in recognising impairment losses on goodwill:

(a) management over-optimism; and

(b) shielding.

4. The IASB considered the risk of over-optimism to be unavoidable, given the nature of the estimates required. IAS 36 *Impairment of Assets* 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 Accounting Standards.

5. To address shielding, the IASB considered whether it could design a different impairment test. As discussed in Agenda Paper 18B to this meeting, the IASB's preliminary view was that is not feasible to design a different impairment test that is significantly more effective than the impairment test in IAS 36 at recognising impairment losses on goodwill on a timely basis at a reasonable cost.

Summary of feedback

6. Agenda Paper 18B to IASB's May 2021 meeting contains detailed feedback on the IASB's preliminary views on how to improve the effectiveness of the impairment test. Paragraphs 7–12 summarise feedback on what could cause delays in recognising impairment losses on goodwill.

Reasons for the possible delay in recognising impairment losses on goodwill

7. Some respondents, many of which were preparers, were unconvinced there was a significant problem with the impairment test. In their view optimism is natural and IAS 36 has appropriate safeguards against over-optimism. Further, oversight from auditors and regulators ensures proper implementation of the impairment test. They said shielding is inevitable and is inappropriate only when goodwill is not properly allocated to CGUs.

8. However, overall, most respondents to the Discussion Paper commenting on this topic agreed that management over-optimism and shielding are the main reasons for concerns about the possible delay in recognising impairment losses on goodwill. Some respondents emphasised one reason over the other.

9. Respondents said management over-optimism occurs because:

   (a) of management bias;

   (b) of uncertainties in cash flow forecasts even when management are neutral;

   (c) financial plans and budgets that estimates are based upon are also used to incentivise management;

   (d) the impairment test is too subjective and difficult to audit and enforce, thus facilitating earnings management; and

   (e) of management's reluctance to accept that a decision to acquire a business was wrong.

10. A few national standard-setters and accounting firms said shielding is part of the design of the impairment test. In other words, because goodwill does not generate independent cash flows, the impairment test is a test of the carrying value of CGUs containing goodwill rather than a test of goodwill, and therefore shielding is unavoidable. A few respondents said there might be an 'expectation gap' whereby stakeholders expect the performance of the impairment test to be different.

11. Some respondents said shielding can be exacerbated by the level at which an entity tests CGUs containing goodwill. Some respondents said in practice many entities identify the testing level as a segment or a large group of CGUs. For example, one auditor group said, in its view, the major reason for the shielding effect is the way IAS 36 defines the level for impairment testing of goodwill, being the lowest level goodwill is monitored for internal management purposes but no larger than an operating segment. In many cases entities use the upper limit of an operating segment because, as an accounting residual, management does not monitor goodwill.

12. A few respondents highlighted possible other reasons why an entity might recognise impairment losses on goodwill later than the event that gave rise to the impairment, for example:

    (a) Goodwill is a residual—goodwill is initially recognised as a residual amount. Acquired goodwill cannot be measured directly nor can it be separated from internally generated goodwill, therefore it is not possible to identify impairments of goodwill on a timely basis.

    (b) Indicators of impairment—indicators of impairment in IAS 36 are very broad and focus too much on external factors which may contribute to impairments on goodwill not being recognised on a timely basis.

    (c) Tax shielding—the tax effects of the acquisition can shield goodwill from impairment.

    (d) Impairment test cannot react as quickly as the market—market, industry, and entity-specific factors disclosed or observed through other means is not a failing of the goodwill impairment model, but simply a practical reality that a periodic test cannot react as quickly as capital markets.

Suggestions to improve the test

13. Although most respondents commenting on the preliminary view agreed that it is not feasible to design a different impairment test to the one in IAS 36, many suggested ways to improve the application and effectiveness of the impairment test in IAS 36.

These suggestions are described in detail in Agenda Paper 18C to IASB's July 2021 meeting. In particular:

(a) paragraphs 8–35 and 48–56 of that paper discuss suggestions to reduce management over-optimism—by clarifying requirements, providing accountability and improving enforceability of the impairment test; and

(b) paragraphs 36–47 of that paper discuss suggestions to reduce shielding—targeted improvements to prevent the allocation of goodwill to CGUs at a higher level than necessary and aligning the level at which goodwill is tested with the level at which management monitors operations.

Process

Criteria for considering suggestions

14. This project was not established to conduct a full review of IAS 36—it is not a post-implementation review (PIR) of IAS 36. Instead, this project was established to respond to feedback to the PIR of IFRS 3 *Business Combinations*. Hence, considering whether the suggestions would respond to the feedback to the PIR of IFRS 3 about the impairment test was a key factor in identifying suggestions that could be explored further within the scope of this project.

15. To identify suggestions that could be explored further as part of this project we 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.

Feedback on criteria

16. As part of the outreach with the IASB's consultative groups and the IFRS Interpretations Committee to discuss respondents' suggestions of changes to the impairment test (see paragraph 26), we also asked these stakeholders whether they had any comments on the criteria discussed in paragraph 15.

17. One national standard-setter, although not explicitly agreeing with the criteria, said any changes to the impairment test should focus on improving the rigour of the test or reducing the cost of applying the test without reducing its rigour.

18. Although also not directly commenting on the criteria, many national standard-setters suggested focusing more on how to reduce shielding rather than on deterring management over-optimism. In their view, reducing shielding would result in a greater improvement in the timelier recognition of impairment losses on goodwill.

19. Other stakeholders said:

    (a) the IASB should prioritise only a limited number of improvements (one auditor); and

    (b) if the main response to feedback that the impairment test is not working is to increase requirements for disclosures about business combinations,[1] the IASB should consider reducing, or at least freezing, the disclosure requirements relating to the impairment test (one preparer).

20. Other stakeholders had no comments on the criteria.

[1] In September 2022 the IASB tentatively decided to propose requirements to disclose information about management's objectives and targets for business combinations and then in subsequent periods to disclose information about the extent to which those objectives are being met.

Application of criteria

21. Based on the criteria in paragraph 15, we think the following suggestions could be explored further as part of this project:

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

        (i) clarify the requirements in paragraph 80(a) 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;

    (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.

22. Agenda Paper 18D discusses these suggestions in more detail and explains why respondents to the Discussion Paper considered these suggestions could reduce shielding or management over-optimism.

23. On the other hand, we think the suggestions summarised in the Appendix do not fit in the scope of this project and should not be explored further.

24. Some of the suggestions would not mitigate the concerns expressed by stakeholders in the PIR of IFRS 3 that impairment losses on goodwill are not recognised on a timely basis and therefore do not meet the criteria in paragraph 15. For example, requiring an entity to disclose the amount of headroom in material CGUs containing goodwill at the acquisition date and for a few years afterwards would highlight, but not reduce, shielding. These suggestions were therefore not explored further.

25. The main reasons for not exploring other suggestions further were that, in assessing the extent to which those suggestions met the criteria in paragraph 15:

    (a) the suggestions would have only a marginal benefit and so were considered low priority. For example, requiring an entity to justify material changes in discount rates and growth rates used, because the effect of such changes is likely to already be clear from the sensitivity analysis required by paragraphs 134 and 135 of IAS 36.

    (b) the suggestions would be potentially costly and the benefits from the change are unclear. For example, requiring an entity to reconcile the recoverable amount of CGUs and the market capitalisation of an entity would be costly because it would require an entity to identify and analyse the reconciling items and it is uncertain how this would help reduce management over-optimism especially if the CGUs containing goodwill were only a small part of the overall entity.

    (c) the suggestions are more likely to result from application issues rather than something that should be addressed by standard-setting. For example, improving the requirements to disclose assumptions used in the periods leading up to the period the terminal value is extrapolated from, because if those assumptions are key assumptions (to which the recoverable amount is most sensitive) they should already be disclosed applying paragraphs 134 and 135 of IAS 36.

(d) the suggestions would require a broader change to IAS 36 which is considered outside the scope of this project. For example, providing additional guidance on what 'largely independent' cash inflows means could result in a fundamental change to one of the principles of IAS 36 and could have wider implications.

Outreach

26. In order to obtain additional feedback on the suggestions in paragraph 21 (suggestions we think could be explored further), we discussed those suggestions at the March 2023 meetings of the:

   (a) Global Preparer Forum (GPF);

   (b) Capital Markets Advisory Committee (CMAC);

   (c) IFRS Interpretations Committee (Committee); and

   (d) Accounting Standards Advisory Forum (ASAF).

Other feedback

27. The feedback on the suggestions in paragraph 21 is summarised in Agenda Paper 18D.

28. Although we did not ask stakeholders to comment on the suggestions we include in the Appendix to this paper, a few stakeholders suggested considering further some of those suggestions:

   (a) One auditor suggested considering providing additional guidance on the interaction between goodwill allocation for the purpose of impairment testing and goodwill allocation in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* for the purpose of measuring foreign currency gains and losses.

(b) One regulator suggested considering providing additional guidance on what each CGU that is 'expected to benefit from the synergies of the combination' means.[2]

(c) One regulator suggested providing additional guidance to clarify how to reflect less optimistic scenarios in forecasts and how to reflect different risks in the discount rate.

(d) One regulator suggested providing additional guidance on the internal consistency of assumptions used (with other assumptions used in the impairment test).

29. We included those suggestions in the Appendix because we think:

(a) the suggestions in paragraphs 28(a) and 28(b)would have only a marginal benefit and the suggestions in paragraph 21(a) are more likely to have a bigger effect;

(b) the suggestion in paragraph 28(c) would require a broader change to IAS 36 and it is unclear what application guidance would be needed in addition to that already in IAS 36; and

(c) the suggestion in paragraph 28(d) is more likely to result from an application issue.

[2] Paragraph 80 of IAS 36 includes requirements for how an entity allocates goodwill to CGUs for the purpose of the impairment test. It states: 'for the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.'

Appendix—List of suggestions not pursued

A1. Suggestions that we think should not be explored further for reasons explained in paragraphs 24–25 of this paper:

(a) improve the requirements to disclose assumptions used in the impairment test:

(i) clarify the requirements in paragraph 134 of IAS 36 to disclose key assumptions are linked to the metrics used by management to monitor the subsequent performance of business combinations;

(ii) improve the requirements to disclose assumptions used in the periods leading up to the period the terminal value is extrapolated from;

(iii) require an entity to disclose the effects of reasonably possible changes in key assumptions regardless of whether it could cause an impairment loss to be recognised; and

(iv) require an entity to justify material changes in discount and growth rate assumptions used compared to the prior period;

(b) require an entity to disclose information about why no impairment loss was recognised and how close an entity was to recognising an impairment loss in ‘close-call’ situations;

(c) provide additional guidance on the consistency of assumptions used with external evidence or other assumptions used in the impairment test;

(d) provide additional guidance how to factor in less optimistic scenarios in cash flow forecasts;

(e) provide additional guidance how to appropriately reflect risks in the discount rate;

(f) provide additional guidance how to estimate terminal value;

(g) require an entity to reconcile the recoverable amount of the CGUs and the market capitalisation of the entity;

(h) review how the requirements in IAS 21 to translate goodwill balances interact with the level goodwill is allocated for impairment testing purposes;

(i) develop criteria for when reorganising the reporting structure for the purpose of impairment testing is permitted, for example it could be permitted only if there is a change in the cash flow structure;

(j) provide additional guidance on what 'largely independent cash inflows' means;

(k) require an entity to disclose the amount of headroom in material CGUs containing goodwill at the acquisition date and for a few years afterwards;

(l) require an entity to disclose how CGUs have been identified and whether shielding in a group of CGUs is likely to be high;

(m) remove the prohibition on reversal of impairment losses on goodwill; and

(n) provide additional guidance on what each CGU 'that is expected to benefit from the synergies of the combination' means.