

GOODWILL IMPAIRMENT TESTING UNDER IFRS. PART 1: FRAMEWORK

Introduction

Testing goodwill for impairment is a controversial issue. The accounting rules are complex and companies have difficulty applying them. Critics call for changes to the rules. In this note, we focus on the rules themselves – the steps a company that applies IFRS must follow to determine the goodwill arising on a business acquisition, its allocation across cash-generating units (CGUs) in the company and the testing of goodwill-containing CGUs for impairment. We consider implementation issues in a subsequent note.

Goodwill: accounting on initial recognition

Goodwill is an intangible asset. It is the excess of the market value of a business over the book value of its net assets. In essence, this excess represents the capitalised value of the ‘abnormal’ returns – that is, the returns on capital in excess of its cost – that the market expects the business to generate over the foreseeable future.

However, goodwill is only recognised as an *accounting* asset when a business purchase has taken place. Internally generated goodwill is not recognised as an asset. Under IFRS, an acquirer must follow certain steps to establish the presence and amount of goodwill. Take the example of the acquisition of one company (B) by another (A).

- Company A first identifies all of the assets it has acquired and all of the liabilities it has assumed. Some of these assets and liabilities may not be on B’s current balance sheet. Examples are, in the case of assets, internally generated intangibles and, for liabilities, contingent liabilities that A considers probable.
- A then fair values all of B’s assets and liabilities it can identify, at the date of acquisition. The fair values are likely to differ from the carrying amounts in B’s books, in many cases.
- A then compares the fair values of the identifiable net assets acquired with the amount it has paid for them. If the purchase price exceeds the identifiable net assets’ fair value, the excess is deemed to be ‘goodwill on acquisition’. A recognises the asset as an intangible in its consolidated balance sheet. (If the purchase price is less than the identifiable net assets’ fair value, A is deemed to have made a ‘bargain purchase’. It recognises the shortfall as a gain in its consolidated income statement.)

In sum, the amount initially reported as ‘goodwill’ on the acquirer’s consolidated balance sheet is the difference between (a) the purchase price of the acquired business and (b) the fair value of the identifiable net assets acquired, where (a) is greater than (b).¹

Goodwill, on initial recognition	=	(a) Purchase price of acquired business	–	(b) Fair value of identifiable net assets acquired	where: (a) > (b)
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¹ International Accounting Standards Board, *IFRS 3: Business Combinations*, IFRS Foundation, London, para. 32. This calculation of initial goodwill is simplified. It assumes 100% control and the acquisition occurs at one time and is not spread out over several stages.

Allocation of goodwill to cash-generating units

On acquisition of a business, the acquirer allocates the initial goodwill among the various units within the company that are expected to benefit from being in a larger entity. These units are likely to be 'cash-generating units' (CGUs). IFRS define a CGU as "the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash flows from other assets or groups of assets."² However, the definition is broadened for purposes of goodwill allocation. A goodwill-containing CGU represents "the lowest level within the entity at which the goodwill is monitored for internal management purposes" (IAS 36, para. 80) – but it cannot be larger than an operating segment (as defined by IFRS 8). Thus, a goodwill-containing CGU may comprise a number of 'basic' CGUs.

An example illustrates the distinction between a goodwill-containing CGU and a basic CGU. Assume Company A is a large EU-based supermarket chain. It acquires Company B, a rival EU food retailer. Goodwill arises on the acquisition and must be allocated among the various units of the combined entity. Each of B's stores is a cash-generating unit. However, A does not allocate goodwill by store since its management reckon a store is too small a unit for goodwill monitoring purposes. Post-acquisition, B's stores are integrated into A's store network. Management form goodwill-containing CGUs by geographical area, consisting of stores from both A's and B's network, since this reflects how management run the business – and thus monitor goodwill.

Impairment testing of goodwill

Under IFRS, goodwill is not amortised since it is deemed to have an indefinite life. Instead, it is subject to regular impairment testing. Goodwill is not a separable asset. Thus, what is tested for impairment is the CGU to which goodwill has been allocated.

The procedure for testing a goodwill-containing CGU for impairment is the same as for other assets. Management estimate the CGU's 'recoverable amount'. Recoverable amount is the CGU's economic value to the company. The maximum amount the company can recover from a CGU is the higher of the CGU's sale value – measured by its current fair value less costs of disposal – and its value from continued use. 'Value in use' is the present value of the future cash flows the CGU is expected to generate as part of the company over the foreseeable future. Normally, a CGU's recoverable amount is greater than its carrying amount since many of the assets within the CGU are measured at cost or depreciated cost. If recoverable amount falls below carrying amount (where carrying amount includes allocated goodwill), the CGU is considered impaired and a loss is recognised. Note that, as with other assets, both the CGU's net fair value (i.e. fair value less costs of disposal) and its value in use must be less than the carrying amount in order for the CGU to be considered impaired.

Impairment loss	=	(a) Carrying amount of CGU's net assets, including goodwill	–	(b) Recoverable amount of CGU	where (a) > (b)
: 'Recoverable amount' is higher of CGU's net fair value and its value in use.					
: CGU is not impaired if either net fair value or value in use is greater than carrying amount.					

A CGU to which goodwill has been allocated must be tested annually or whenever there is an indication the unit may be impaired (IAS 36, para. 90). Management can undertake the annual impairment test at any time, provided it is done at the same time each year (IAS 36, para. 96).

² International Accounting Standards Board, *IAS 36: Impairment of Assets*, IFRS Foundation, London, para. 6.

If individual assets within the CGU are tested for impairment at the same time as the overall CGU, management must test the individual assets first and then the CGU (IAS 36, para. 97).

A goodwill impairment charge cannot be reversed. If the CGU's value recovers in a later period, the uplift in value is attributed to the other assets in the unit (but the uplift cannot exceed what the assets' carrying amounts would have been in the absence of impairment). As noted earlier, internally generated goodwill cannot be recognised as an asset. It is impossible to determine how much of the increase in the CGU's value is attributable to recovery in the value of purchased goodwill and how much to the generation of goodwill internally.

Allocation of impairment loss

How is the impairment loss allocated to the various assets in the CGU? IFRS require the loss to be allocated in the following order:

- 1) First, to reduce the carrying amount of allocated goodwill;
- 2) Then, to reduce the CGU's other assets *pro rata* on the basis of each asset's carrying amount (IAS 36, para. 104).

In allocating the loss, a company cannot reduce the carrying amount of an asset below the highest of:

- a) Its fair value, less costs of disposal (assuming fair value is measurable);
- b) Its value in use (again, assuming this value is determinable); and
- c) Zero.

The amount of the loss that cannot be allocated to an asset because of these restrictions must be allocated to the other assets of the CGU on a *pro rata* basis (IAS 36, para. 105). The effect of these restrictions on loss allocation is that assets measured at fair value – for example, cash and certain financial investments – are not written down and any impairment loss notionally allocated to them is re-allocated to other assets in the CGU.

Example

We illustrate the IFRS impairment loss allocation rules with an example. Diversified Company decides to enter the battery components sector in 20x2. It acquires Ode Company, a producer of cathodes for electric vehicle batteries, that year. Goodwill arising on the acquisition is €35 million. As Ode is considered an independent cash-generating unit for internal management purposes, all of the goodwill is allocated to Ode.

Diversified tests Ode's assets for impairment annually. There is no impairment in 20x3. However, management become aware in 20x4 that the global cathode market is oversupplied. This development is likely to have an adverse effect on the value of Ode's assets. As Diversified also tests trade receivables for impairment at year-end, both tests are carried out at end-December, the group's financial year-end. Management estimate the recoverable amount of Ode's trade receivables to be 50, resulting in an impairment loss specific to receivables (i.e. bad debt expense) of 10. (All amounts are in € millions.)

Management estimate the recoverable amount of Ode's remaining assets to be 350; the carrying amount of these assets at end-20x4 is 465. The impairment loss of 115 is allocated first to goodwill and the balance to Ode's remaining assets. Goodwill is written down from 35 to zero, leaving 80 to be allocated on a *pro rata* basis. As Ode's financial investments and cash are already carried at fair value, the remaining impairment loss is allocated to Ode's patents, tangible fixed assets and inventory.³ Table 1 shows the impact of the impairment loss allocation on Ode's balance sheet at the end of 20x4.

³ We assume, for simplicity, that after allocation of the impairment loss the carrying amounts of these assets exceed their fair values. Their values in use are not determinable.

Table 1 Diversified Co.: Testing of operating unit's assets for impairment, end-20x4**Facts**

- : Diversified tests assets of Ode, a cash-generating unit within company, for impairment.
- : End-20x4 carrying amounts of Ode's assets are shown below. All amounts are in €mn.
- : Individual assets are tested first. Recoverable amount of trade receivables is estimated to be 50.
- : Recoverable amount of Ode's assets, excluding receivables, is estimated to be 350.
- : Impairment loss of 115 is allocated first to goodwill & then *pro rata* to other assets.
- : Loss allocation excludes financial investments and cash since they are already fair-valued.

Ode's 20x4 impairment losses and their allocation

In €mn	Carrying amounts (pre-impairment), at end-20x4	Impairment losses relating to:		Carrying amounts (post-impairment), at end-20x4
		Individual assets	Other assets	
Non-current assets				
Goodwill	35		-35	0
Patents	48		-12	36
Property, plant & equipment	240		-60	180
Financial investments (at fair value)	100			100
Current assets				
Inventory	32		-8	24
Trade receivables	60	-10		50
Cash & cash equivalents	10			10
	525	-10	-115 *	400

*** Derivation of impairment loss and allocation**

Carrying amount of assets, excluding receivables, pre-impairment				465
Recoverable amount of assets, excluding receivables				<u>350</u>
Impairment loss, total				115
Allocated to goodwill				<u>-35</u>
Impairment loss, balance				80
Allocated to:	Patents	48	0.15	-12
	Property, plant & equipment	240	0.75	-60
	Inventory	<u>32</u>	0.10	<u>-8</u>
		320		<u>0</u>

Impairment testing in practice

Summarising the accounting rules on goodwill impairment testing is only half the story. We need to consider next how companies apply them. What are the warning signs that indicate potential impairment of a CGU? When an indicator flashes amber or red, how does a company estimate the CGU's recoverable amount and, in particular, its value in use? In a subsequent note, we explore how companies implement the IFRS rules on goodwill impairment testing. We also consider proposed changes to the rules that proponents claim will reduce the risk of goodwill overstatement and improve the quality of corporate accounting numbers.