

IFRS News

Emerging issues and practical guidance*

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New rules, more work – impairment testing under IFRS 3R

Many entities complete business combinations without acquiring 100% of the target. IFRS 3 Revised, 'Business combinations', introduces new requirements for the measurement of non-controlling interests and goodwill for these types of business combinations. It also introduces new requirements for the allocation of impairment losses when grossing up goodwill for impairment testing purposes. Julian Griffiths and Paul Shepherd of PwC's Global Accounting Consulting Services in Australia look at the detail.

The new IFRS 3R requirements can create additional record-keeping and computations, particularly for business combinations when less than 100% of the target is acquired. Management may want to consider the impact of the measurement method on their impairment test when choosing how to measure a non-controlling interest under IFRS 3R. The complexity of the requirements also means that entities have more work to do to keep track of each component of their goodwill balances.

'Full' and 'partial' goodwill

An entity that acquires less than 100% of a subsidiary can choose (on an acquisition-by-acquisition basis) how to measure the non-controlling interest (NCI). It can be measured at:

- The NCI's proportionate share of the acquisition date fair value of the acquiree's identifiable net assets (the 'proportionate share' method – this is essentially the same as under IFRS 3); or
- The fair value of the NCI at the acquisition date (the 'fair value' method).

IFRS 3R includes the NCI in the measurement of goodwill, so entities' choice of method will affect the amount of goodwill that will be recognised in the consolidated financial statements. Under the proportionate share method, only the controlling interest's (CI's) share of the goodwill is recognised; under the fair value method, goodwill includes both the parent entity's and the NCI's share of the goodwill in the subsidiary.

Impairment testing – 'gross-up' requirement

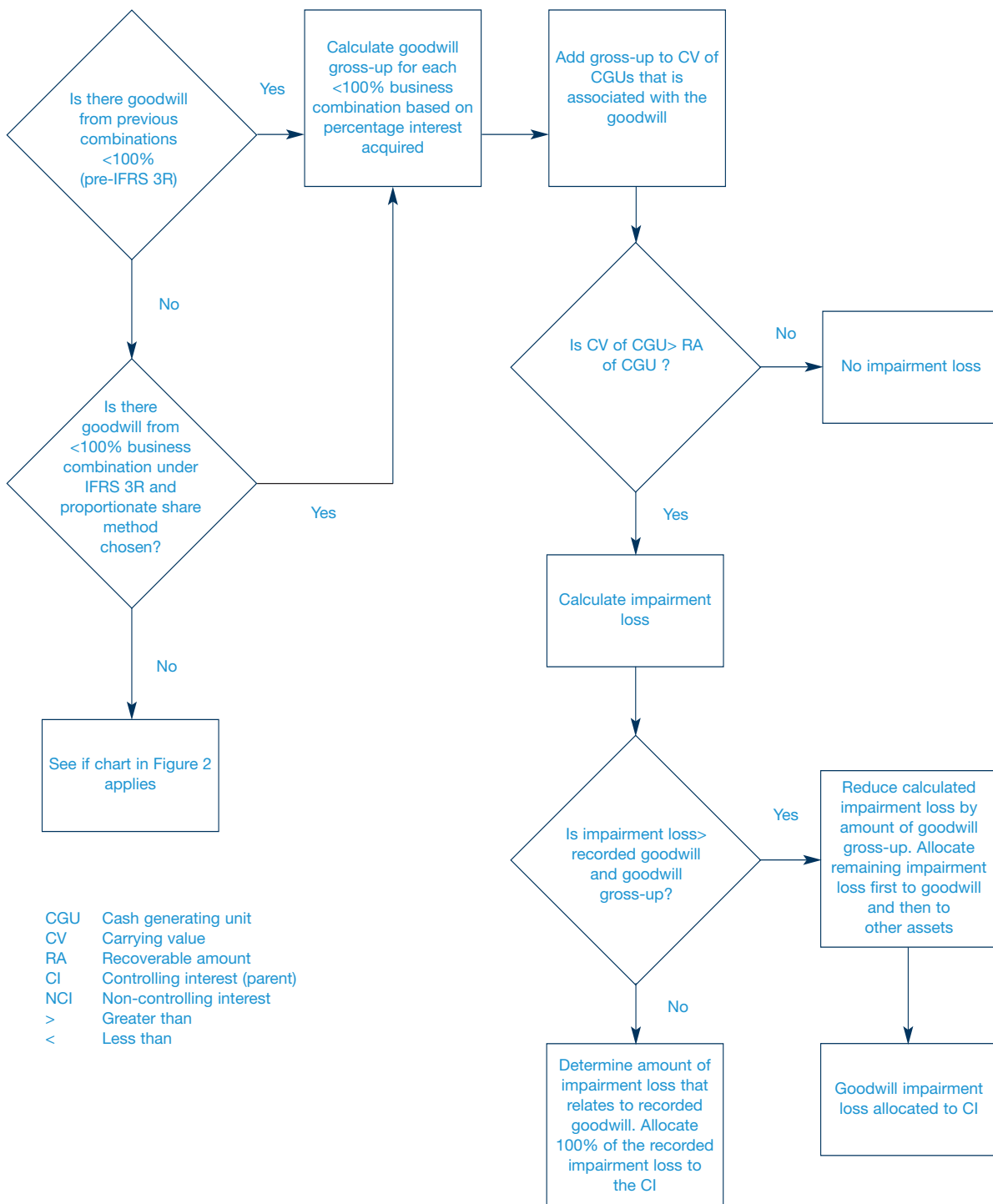
Any cash generating unit (CGU) containing goodwill is tested for impairment annually. How entities choose to measure the goodwill and NCI affects the impairment test and the amount of impairment loss recognised.

Under the proportionate share method, a notional gross-up of the entity’s goodwill balance is required to ensure the carrying value of the CGU includes the goodwill attributable to the NCI (see Figure 1 below). This grossed up amount is compared to the recoverable amount of the CGU, which includes the entire cash flows or fair value attributable to the CGU as well as the cash flows attributable to the controlling interest.

This is not a new requirement – entities should already be grossing up goodwill from partial business combinations in impairment tests. Application of the fair value method means that gross up is not required but does introduce some other complexities. Management should consider the impact on impairment tests when choosing the method to use. Example 1 on p2 illustrates the difference.

Figure 1. Impairment testing and the allocation of impairment losses

Goodwill from less than 100% business combinations prior to IFRS 3R, and less than 100% business combinations prior to IFRS 3R, and less than 100% business combinations under IFRS 3R if the proportionate share method is chosen



Example 1

Parent A acquires 80% of subsidiary B, which is a CGU. At the year-end, the carrying amount of B's identifiable net assets is C1,000; the recoverable amount of the CGU is C1,100. Goodwill would be C400 under the proportionate share method or C450 under the fair value method. The impairment tests under the two methods are as follows:

	Proportionate method	Fair value method
Identifiable net assets	1,000	1,000
Goodwill	400	450
Gross-up (400 x 100%/80%)	100	–
Total carrying amount of CGU	1,500	1,450
Less: Recoverable amount	(1,100)	(1,100)
Impairment	400	350
Impairment shown in income statement	320	350*

* Allocation of the impairment loss between CI and NCI is discussed below.

Under the proportionate share method, only the CI's share of the impairment loss is recognised in the income statement, because only the CI's share of goodwill is recognised. Under the fair value method, the impairment loss is recognised in full in the income statement. The headline impairment loss is therefore higher for an entity that elects to adopt the fair value method.

Allocation of impairment losses between the CI and the NCI

There are new requirements for allocating goodwill impairment losses between the CI and the NCI. The accounting is usually straightforward if the subsidiary with the NCI represents a CGU or group of CGUs for goodwill impairment-testing purposes: the allocation is done on the same basis as the allocation of profit.

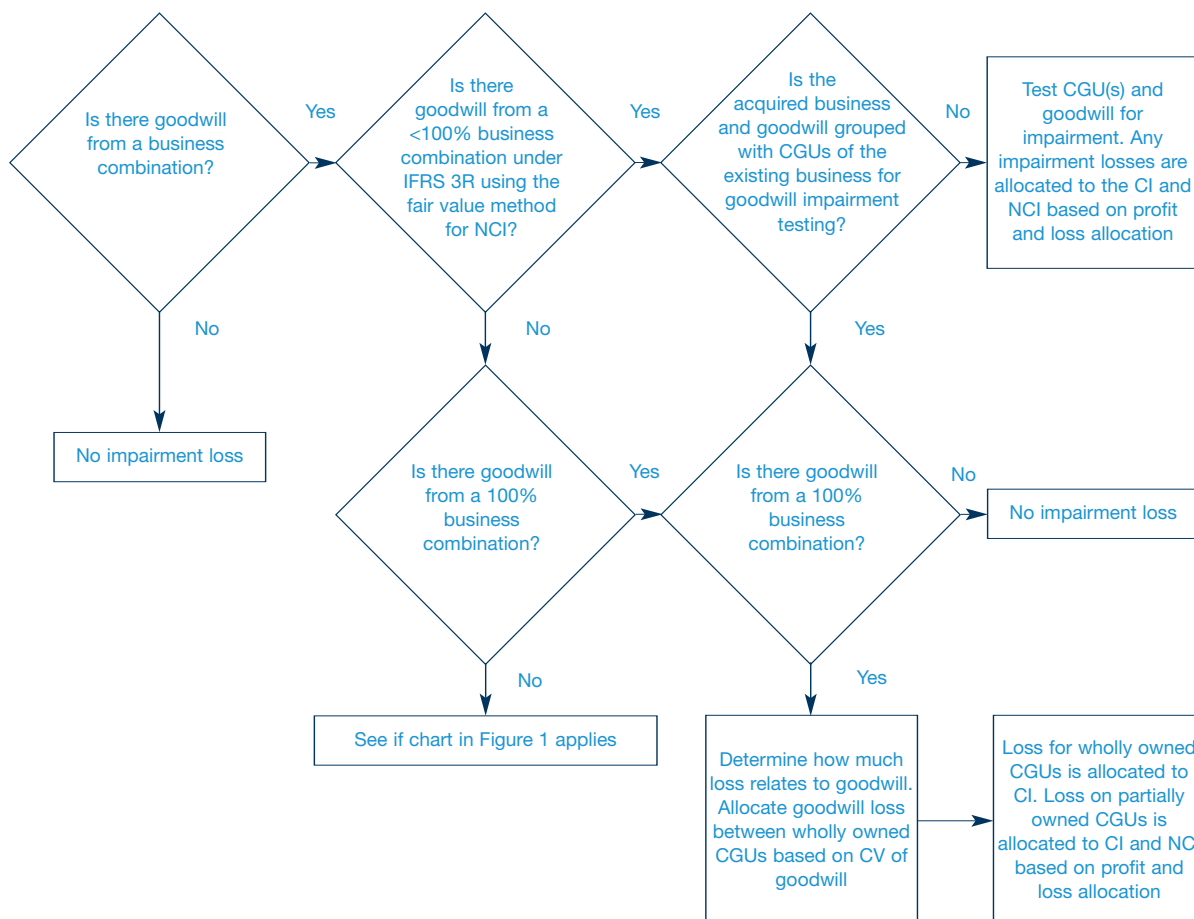
Based on Example 1, if profit is allocated on the basis of ownership interests, 20% of the impairment loss is allocated to the NCI. Therefore, under the proportionate share method, C80 of the C400 impairment loss is 'allocated' to the NCI; however, it is not recognised in the income statement because only the CI's share of goodwill is recognised. The full impairment loss of C350 is recognised in the income statement when goodwill has been recognised on the fair value method, but C70, or 20%, is allocated to the NCI.

The allocation of impairment losses between the CI and the NCI becomes more complex if the subsidiary is part of a larger CGU or group of CGUs for goodwill impairment-testing purposes.

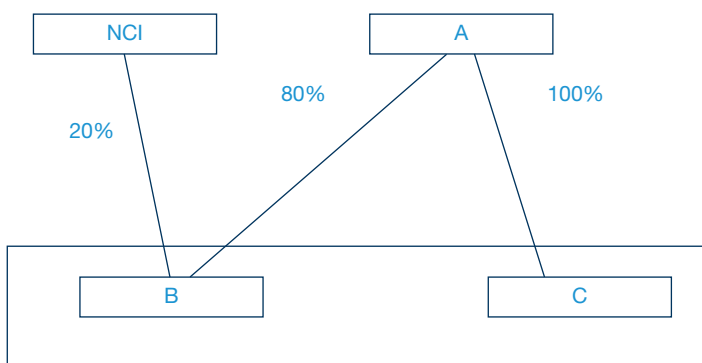
Figure 2 shows how impairment losses are allocated between different parts of a CGU and between the CI and the NCI. Example 2 illustrates this process.

Figure 2. Impairment testing and the allocation of impairment losses

Goodwill from 100% business combinations accounted for prior to IFRS 3R, and less than 100% business combinations under IFRS 3R if the fair value method is chosen



Example 2



Subsidiary B, acquired in Example 1, is part of a larger CGU that includes another subsidiary, C. C is 100% owned by parent A. C800 of goodwill arose on A's acquisition of C. The carrying amount of the identifiable net assets of the CGU is C2,250; the recoverable amount of the CGU is C3,300. The accounting outcome, assuming goodwill was calculated using the fair value method, is:

Carrying amount of identifiable net assets	2,250
Carrying amount of goodwill (800 + 450)	1,250
Total carrying amount of CGU	3,500
Less: Recoverable amount	(3,300)
Impairment loss	200

The allocation of the impairment loss is as follows:

Impairment losses are allocated first to goodwill and then to identifiable assets. All of the impairment loss therefore relates to goodwill and is allocated to the two components (subsidiaries) within the CGU based on their relative carrying amounts of goodwill. Therefore:

- 64% (being 800/1250) of C200 (C128) is allocated to subsidiary C to reduce the goodwill of \$800;
- 36% (being 450/1250) of C200 (C72) is allocated to subsidiary B to reduce the goodwill of C450;
- As entity C is 100% owned, the impairment loss of C128 is allocated to the CI; and

- As entity B is 80% owned, the impairment loss of C72 is shared between the CI and NCI on the same basis as the allocation of profits (20%, or C14, is allocated to the NCI).

This is a simple example; allocating impairment may well be a complex exercise in practice. It will be particularly difficult for entities that have a CGU, or group of CGUs, that have goodwill from several sources. For example:

- Subsidiaries acquired before IFRS 3R or after transition to IFRS 3R that applied the proportionate share method;
- Subsidiaries acquired after transition to IFRS 3R that applied the fair value method;
- Entities that have goodwill from 100% owned subsidiaries; and
- Entities that have goodwill allocated to a CGU from an acquisition in a different CGU.

Under IFRS 3R, impairment losses have to be allocated between each component of the goodwill in the CGU. Some entities will find the detailed tracking of each component of goodwill to be a crucial and time-consuming process.

What should entities do?

Management should be aware of the impacts of IFRS 3R on measuring goodwill, allocating it for impairment-testing purposes and recording impairment losses.

The method management uses to measure the NCI will have a significant impact on the impairment test, so it is important to choose it carefully. Entities that choose the proportionate share method have to grossing up the goodwill balance for impairment testing, but they will not have to recognise the NCI's share of any impairment loss. Entities that choose the fair value method may find that impairment losses have a larger impact on reported earnings because the full impairment loss (before allocation between the CI and NCI) is reported in the income statement.

Keeping track of each component of goodwill will now be essential, whichever method entities choose.