Grant Thornton

Accounting

Advisory

Global

Insights into IAS 36

Other impairment issues

IAS 36 ‘Impairment of Assets’ is a Standard that has been on issue for many years. However, some areas of the Standard are complex and therefore can be challenging to apply in practice, and therefore many entities struggle when determining whether or not their assets should be impaired.

The articles in our ‘Insights into IAS 36’ series have been written to assist preparers of financial statements and those charged with the governance of reporting entities understand the requirements set out in IAS 36, and revisit some areas where confusion has been seen in practice.

This article considers some regularly encountered application issues when applying IAS 36, which are:

- the ‘deferred tax and goodwill problem’
- non-controlling interests
- equity accounting, and
- the interaction between IAS 36 and other IFRS.

Deferred tax and goodwill problem

This refers to a well-known application issue that sometimes arises in testing goodwill for impairment. In some business combinations, goodwill arises mainly or solely as a consequence of deferred tax liabilities (DTLs). DTLs are recognised (and increase goodwill) when the acquisition date fair value of identifiable assets exceeds their tax base. The effect of deferred tax on goodwill is relevant to most business combinations but can be particularly significant for acquisitions involving:

- properties acquired in a corporate shell for which the tax base is driven by the historical amount paid by the shell entity, and
- intangible assets that are recorded at fair value by the acquirer but were not recognised by the acquired entity (and therefore have a tax base of zero).

Example 1 illustrates how this interaction can affect the impairment review.

Example 1 – Deferred tax and goodwill problem

Entity A is a real estate investor and developer. The acquisition of an investment property is usually accomplished through buying a shell company which holds the property. The shell is used to minimise taxes payable when the property is sold on. The shell company allows the owner to postpone corporation tax on any increase in the value of the property.

During the reporting period, Entity A acquires an investment property (a retail outlet) through buying Entity B, a shell or single asset entity company that holds the property. Entity A concludes the acquisition is a business combination because the retail outlet is a business as defined in IFRS 3 'Business Combinations'.

The price paid by Entity A for 100% of Entity B is CU5,000, which is equal to fair value of Entity B and the fair value of the retail outlet is also CU5,000. The tax base of the retail outlet is CU3,000. The applicable tax rate is 35%. There are no other assets or liabilities in the shell company.

Entity A records the retail outlet at fair value in accordance with IFRS 3. The difference between the fair value of the investment property and its tax base (which in this case is the cost of the property in Entity B's individual financial statements) results in a DTL. This is measured on an undiscounted basis in accordance with IAS 12 'Income Taxes'. Entity A's acquisition accounting is then summarised:

	CU
Fair value of the retail outlet	5,000
Deferred tax liability 35% * (5,000-3,000)	(700)
Net assets acquired in accordance with IFRS 3	4,300
Goodwill (balancing figure)	700
Consideration transferred	5,000

For this purpose, the retail outlet is considered a separate cash-generating until (CGU).

Analysis

As required by IAS 36, Entity A tests its goodwill for impairment at least annually. The carrying value of the CGU determined excluding the DTL is CU5,700. However, if fair values remain the same as the acquisition date then the fair value less costs of disposal (FVLCOD) is CU5,000 less costs of disposal. Also, it is very likely that VIU would be similar to fair value in this fact pattern (unless Entity A can benefit from significant synergies or other entity-specific advantages not available to other market participants). If the VIU calculation also results in CU5,000, this suggests an apparent immediate impairment loss of CU700.

In our view, this deferred tax-related goodwill is an accounting phenomenon that does not represent real benefits that the acquirer has paid for and that may increase future cash flows. When this goodwill is tested for impairment (having been allocated to CGUs) using the normal IAS 36 approach, as illustrated in the example above, it may be immediately impaired (also referred to as a 'day 1' impairment).

IAS 36 requires the carrying value of a CGU to be calculated in a manner consistent with the determination of VIU. Hence, tax balances should generally be excluded from CGUs for impairment testing. However, recognising a day 1 impairment loss is also counter-intuitive and is viewed by some as an unintended consequence of the various requirements in IFRS 3, IAS 12 and IAS 36.

For this reason, many commenters believe that it is appropriate to use a practical expedient to avoid a day 1 impairment when it is due solely to DTLs increasing goodwill in a business combination. However, views differ on how to achieve this.

Practical insight – The deferred tax and goodwill problem
In example 1, recoverable amount based on FVLCOD, assuming that the acquisition price was fair value (and that nothing else has changed and costs of disposal are immaterial), would be CU5,000. In our view, when comparing this to carrying value, it is appropriate to include the DTL. This is because FVLCOD takes account of the tax features of the asset and the DTL would transfer to a buyer of the CGU (assuming they buy the shell company). Accordingly, no impairment loss arises. However, this approach is not a complete solution. While it may justify the CGU's carrying value based on FVLCOD, in other circumstances recoverable amount is wholly or partly based on VIU (eg if FVLCOD cannot be reliably measured going forward – which is more likely the case for some intangible assets recognised in a business combination).

In our view, however, IAS 36 can also be interpreted to allow some flexibility when considering which assets and liabilities can be included in the carrying value of a CGU for the purpose of comparison to VIU. It can be argued that, in order to undertake a meaningful impairment calculation, it is necessary to include the DTL in the net assets of the CGU to which this goodwill relates. However, it would only be appropriate to include this specific DTL in the carrying amount of the CGU. It is also important to note that over time, it may be difficult to track the specific DTLs that have led to the goodwill gross-up, especially as the related asset's carrying value and tax base change over time.

Non-controlling interests

Non-controlling interests (NCI) are equity instruments of the acquiree not held directly or indirectly by the acquirer and arise when a parent holds less than 100% of the equity of a subsidiary. IFRS 3 includes an accounting policy option to initially measure NCI at either:

- fair value, or
- the proportionate interest in the acquiree's recognised identifiable net assets,

When the fair value model is used, 100% of the goodwill in the acquiree is effectively recognised (both the acquirer's and the NCI's share) in the statement of financial position. This is sometimes described as the 'full goodwill' method. In this case, when the entity performs its impairment review, there is no 'mismatch'. This is because VIU and FVLCOD are estimated based on 100% of the asset or CGU under review and its related cash flows. Said differently, the entity will be comparing 'like with like'.

In practice however, an acquirer more often measures NCI at the proportionate interest in the acquiree's recognised identifiable net assets. In this case, only the acquirer's interest in the goodwill is recognised ('partial goodwill' method). Therefore, without an adjustment, the carrying value of the CGU is understated because recoverable amount is based on 100% of the cash flows but the carrying value does not include all the goodwill that contributes to those cash flows). Put another way, the entity will not be comparing 'like with like'.

In this situation, an adjustment is required to address the mismatch. The carrying amount of goodwill allocated to the unit must be grossed-up to include the goodwill attributable to the NCI. This involves:

- adding goodwill attributable to the NCI to the CGU, and
- comparing the adjusted carrying amount of the CGU to its recoverable amount.

If an impairment loss then arises, this must be allocated between the amount relating to the parent's recognised goodwill and the NCI share. Only the impairment loss relating to the goodwill that is allocated to the parent is recognised as a goodwill impairment loss.

Example 2 demonstrates how to adjust the impairment test when the proportionate interest method option (ie the partial goodwill method) is used to recognise and measure NCI in a business combination.

Example 2 – Adjusting the impairment test when the partial goodwill method has been applied

Assume Entity A acquired an 80% interest in Entity B during the reporting period for consideration of CU1,750. At that time, Entity A calculated the fair value of the identifiable net assets to be CU1,350 resulting in goodwill of CU400. Assume for simplicity that Entity B is a separate CGU (CGU B), that all the goodwill is allocated to CGU B and that Entity B only includes assets which belong to this CGU.

At the end of the reporting period, Entity A tests this goodwill for impairment. Management calculates CGU B's recoverable amount to be CU1,700. The carrying value of CGU B's identifiable assets remains CU1,350.

Analysis

Entity A performs the following calculations:

Carrying amounts of CGU B's assets		**1,350**
Allocated goodwill	80%	400
Notional NCI share of goodwill	20%	100
Notionally adjusted carrying amount of CGU B		**1,850**
Recoverable amount		1,700
Notional impairment loss		**150**

	CGU B (Entity A's interest)	NCI allocation	Total allocation
Allocated goodwill	400	–	400
NCI	–	100	100
Notional impairment loss allocated as follows	**(120)**	**(30)***	**(150)**
	280	70	350
Remaining CGU B's assets	1,350	–	1,350
Revised carrying amount	**1,630**	**70**	**1,700**

* Entity A recognises CU120 impairment loss only (its share of the impairment), not the CU30 as that is the portion attributable to the NCI

Practical insight – Tracking NCI share of goodwill

Example 2 demonstrates the mechanics of considering NCI in the goodwill impairment test. If Entity A were to ignore this requirement, it would have calculated an impairment of CU50 (CU1,750 – CU1,700), rather than the CU120 recognised in accordance with IAS 36.

An entity must ensure that it tracks the NCI's share of goodwill on an acquisition-by-acquisition basis in order to apply this guidance. It is important to note that the 'gross-up' illustrated above is based on the NCI percentage when the acquisition occurred. If the NCI percentage later changes (due for example to partial disposals or NCI purchases with no change of control), this does not alter the amount of goodwill or the gross-up percentage. The tracking process also becomes more complex in various other circumstances, such as when:

- goodwill is allocated to more than one CGU
- goodwill from multiple acquisitions with different NCI percentages is allocated to the same CGU
- CGUs are reorganised, and
- components of a CGU with allocated goodwill are disposed of.

IAS 36 and equity accounting

The requirements of IAS 36 apply to subsidiaries, associates and joint ventures accounted for under the cost method in the parent's separate financial statements and to investments accounted for using the equity method in accordance with IAS 28 'Investments in Associates and Joint Ventures'. The impairment review for an investment in an associate or a joint venture involves two steps:

Step 1	Applying the equity method to recognise the investor's share of any impairment losses from the associate's or joint venture's identifiable assets
Step 2	Reviewing the investment in the associate or joint venture as a whole for impairment and recognising any impairment loss

Step 1: Applying the equity method

IAS 28 requires use of the equity method for investments in associates and joint ventures (with some very limited exceptions). In summary, the equity method involves:

- recording the investment at cost on acquisition, and
- subsequently adjusting the carrying value for the investor's share of profits or losses, less any distributions received.

In determining its share of share of profits or losses, the investor uses financial statements of the investee that comply with IFRS and are prepared using uniform accounting policies. This includes the application of IAS 36 to account for impairment of the investee's identifiable assets. It should be noted the investor should adjust the carrying amount of the investee's assets and liabilities to fair value at the date significant influence or joint control is obtained (in a similar manner to business combination accounting). This may in turn require subsequent adjustments to the investee's results – including its depreciation and impairment charges (see example 3).

Step 2: Reviewing the investment in the associate or joint venture as a whole for impairment

After applying the equity method, the investor should also consider whether there is objective evidence of impairment of its overall net investment. Any goodwill identified at acquisition is included in the overall net investment for this purpose. In evaluating the need for any additional impairment charge, the investor:

- applies the requirements of IFRS 9 'FInancial Instruments' to determine whether or not there is objective evidence of impairment
- if necessary, applies the requirements of IAS 36 to quantify any impairment loss

Example 3 – Step 1: Applying the equity method

On 1 January 20X3, Investor A acquires a 40% interest in Entity B, for CU300. Investor A determines that Entity B meets the IAS 28 definition of an associate. Entity B reports in accordance with IFRS and applies accounting policies consistent with Investor A's. At 1 January 20X3, Entity B's net assets total CU540. Investor A applies the requirements of IFRS 3 to recognise and measure Entity B's identifiable assets, liabilities and contingent liabilities (mainly at their fair value). The book values and adjustments are summarised in the following table:

	Book value at 1 January 20X3	Fair value and other adjustments	Notes	Total
Property, plant & equipment (PP&E)	300	100	a)	400
Goodwill	40	(40)	b)	–
Other intangible assets	–	150	c)	150
Other assets & liabilities	200	–		200
Contingent liability – litigation	–	(150)	d)	(150)
Total	**540**	**60**		**600**
Investor A's 40% interest				**240**
Cost of 40% interest				**300**

- Adjustment to revalue PP&E to fair value of CU400. The remaining useful life is assessed as 10 years, with zero residual value
- Goodwill recognised by Entity B is not an identifiable asset so is excluded from the fair value statement of financial position
- Adjustment to recognise two brands owned by Entity B: Brand X is valued at CU130. Brand Y is valued at CU20. The estimated useful life of both brands is 10 years
- Adjustment to record at fair value a contingent liability in relation to a lawsuit filed against Entity B.

The accounting entry recorded on 1 January 20X3 is as follows:

1 January 20X3	Debit	Credit
Allocated goodwill	–	300
Notional NCI share of goodwill	300	–

Example 3 – Step 1: Applying the equity method (cont.)

During 20X3, Entity B records a net profit of CU200. This figure includes:

- an impairment charge of CU40 in relation to the goodwill recorded in Entity B's statement of financial position
- depreciation of CU30 in relation to PP&E, and
- a charge of CU200 reflecting a payment to settle the lawsuit referred to in (d) above.

Also, during 20X3 Entity B's management decides to discontinue Brand Y and focus on Brand X. Investor A determines that Brand Y is fully impaired. Entity B does not make any distributions in the year.

Based on these facts, Investor A makes the following adjustments to Entity B's net profit to determine the share of profit for equity accounting purposes:

	Notes	CU
Net profit as reported by Entity B		200
Adjustments:		
• additional depreciation	a)	(10)
• reversal of B's goodwill impairment	b)	40
• amortisation of Brand X	c)	(13)
• impairment of Brand Y	d)	(20)
• litigation settlement	e)	150
Net profit for equity accounting purposes		347
Investor A's 40% interest		139

- Adjustment to record additional depreciation based on the fair value of Entity B's PP&E – CU100/10 years
- Goodwill recognised by Entity B is excluded from the fair value statement of financial position, so the impairment charge needs to be reversed for equity accounting purposes
- Amortisation of Brand X – CU130/10 years
- Impairment charge of CU20 to write-off Brand Y
- Entity B has recorded an expense of CU200 for the litigation settlement but the contingent liability was recorded at an amount of CU150 in the fair value statement of financial position. This contingent liability is reversed for equity accounting purposes.

Investor A records the following entry to recognise its share of Entity B's profits:

31 Dec 20X3	Debit	Credit
Investment in associate	139	–
Statement of comprehensive income (share of profit of associate)	–	139

Consequently, the carrying value of the investment at 31 December 20X3 becomes CU439.

Example 4 – Step 2: Reviewing the investment in the associate or joint venture as a whole for impairment
If there is any objective evidence of impairment of this net investment amount as at 31 December 20X3, its recoverable amount should be estimated. The goodwill identified at acquisition (CU60) is included in the overall net investment for this purpose.

The impairment assessment performed should be in accordance with the principles and procedures outlined in IAS 36 (therefore, the entity will compare the carrying amount of the investment to the higher of its FVLCOD and VIU). VIU is determined by estimating:

- its share of the estimated future cash flows expected to be generated by the associate or joint venture (including proceeds from the ultimate disposal of the investment), or
- estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Both should yield the same result.

Interaction between IAS 36 and other IFRS Standards

This section highlights how IAS 36's requirements can interact with the requirements of certain other IFRS.

IAS 36 and IAS 34 'Interim Financial Reporting'

IAS 36 calls for an assessment 'at the end of each reporting period' for any indication that an asset may be impaired. For entities that prepare half-yearly or quarterly financial statements in accordance with IAS 34, the assessment will be more frequent than for entities that prepare only annual financial statements, subject to the 'reliefs' highlighted in our article **'Insights into IAS 36 – Comparing recoverable amount with carrying amount'**.

IAS 34 requires an entity to apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

IAS 34 also states the frequency of an entity's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. However, the frequency of reporting can in fact affect annual results when an entity recognises an impairment loss on goodwill in an interim period. This loss cannot be reversed even if conditions change at the end of the annual period and indicate that the impairment loss would have been reduced or avoided (had the entity only reported annually).

IFRIC 10 'Interim Financial Reporting and Impairment' effectively confirms that the prohibition on reversing goodwill impairment in IAS 36 overrides the statement in IAS 34.

Example 5 – Interim financial reporting and impairment
Entity A prepares quarterly filings and therefore in accordance with IAS 36, Entity A assesses at the end of its first quarter (31 March 20X0) whether there is any indication that its assets are impaired. As an indicator is present, Entity A performs impairment testing for various assets and CGUs which include allocated goodwill. Ultimately, Entity A writes down certain assets and its goodwill balances as at 31 March 20X0.

By 31 December 20X0, conditions improve and indicate that the impairment loss recognised in the first quarter no longer exists, triggering Entity A to determine the recoverable amount for the same assets and CGUs.

Entity A reverses impairment losses recognised in prior periods for all assets (subject to the ceilings discussed in **'Insights into IAS 36 – Reversing impairment losses'**), with the exception of goodwill as reversals of impairment losses for goodwill are prohibited.

IAS 36 and IAS 10 'Events after the Reporting Period'

IAS 10 provides guidance on whether an entity should adjust its financial statements for events that occur after the reporting period and prescribes related disclosures. In summary, adjustments are made for events that provide evidence of conditions that existed at the end of the reporting period while no adjustments are made for events that are indicative of conditions that arose after the end of the reporting period. An event such as physical damage arising after the reporting period would clearly be non-adjusting.

The impact of evidence that becomes available after the reporting period about adverse changes in economic performance or the external environment may require more detailed evaluation. Judgement may be required to decide whether the underlying adverse condition existed at the period-end.

If an entity concludes that an event after period-end is indicative of conditions that arose after the reporting period (ie a non-adjusting event), disclosure in accordance with IAS 10 may still be necessary.

Practical insight – IAS 36 and IAS 10

Practical issues arise in this area where management receives information after the period-end that may be evidence of an impairment loss (or reversal) indicator as at the period-end (eg, after the period-end, a competitor launches a new, superior product that will significantly and negatively impact the business or new information becomes available related to a key input in the entity's VIU estimate, such as a change in commodity prices, which makes current assumptions unsupportable). Management must carefully consider all particular facts and circumstances when such instances arise. Generally, these practical issues arise only when an entity uses VIU to estimate the recoverable amount of an asset, CGU (or group of CGUs) as fair value estimates are generally not updated for changes in fair value after the period-end (IAS 10 and IFRS 13 'Fair Value Measurement').

IAS 36 and IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations'

Once an asset meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale), it is excluded from the scope of IAS 36 and included within the scope of IFRS 5. However, immediately prior to reclassification to IFRS 5, any impairment is recognised in accordance with the provisions outlined in IAS 36.

Practical insight – IAS 36 and IFRS 5 as noted by regulators

Plans to dispose of assets may be an indicator that the asset(s) may be impaired and may accordingly trigger impairment testing procedures. Any impairments (or reversals of previous impairments) are recognised before the entity classifies the asset(s) as held for sale. A red flag for potentially indicating that IAS 36 has not been applied correctly is where the statement of comprehensive income shows a loss from discontinued operations (including asset disposals), but the entity did not recognise any impairment loss in prior periods. When this situation has arisen some regulators have investigated further.

IAS 36 and IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'

The interaction between IAS 36 and IAS 37 in relation to restructuring plans and VIU is explained in **'Insights into IAS 36 – Value in use: estimating future cash inflows and outflows'**.

Another interaction arises in relation to onerous contracts. IAS 37 requires that an entity recognises any impairment loss that has occurred on assets dedicated to completion of a contract before recognising an onerous contract provision. For example, a lessee in an operating lease of property that might have become onerous would test any leasehold improvements for impairment before recognising and measuring a provision for the onerous lease.

How we can help

We hope you find the information in this article helpful in giving you some insight into IAS 36. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

grantthornton.global