Grant Thornton

Technical Accounting Alert

Impact of IFRS 8 on goodwill impairment testing

Introduction

The purpose of this alert is to explain how the implementation of IFRS 8 may affect entities' methods for annual impairment testing of goodwill acquired in a business combination ("goodwill") in accordance with IAS 36.

Relevant Standards

References are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IFRS 8 Operating segments	AASB 8 Operating segments
IAS 14 Segment reporting	AASB 114 Segment reporting
IAS 36 Impairment of assets	AASB 136 Impairment of assets

Overview

The implementation of IFRS 8 will require some entities to change their allocation of goodwill for the purpose of annual impairment testing. The allocation of goodwill for impairment testing purposes will need to be revised if:

- The previous allocation of goodwill to cash generating units (CGUs) or groups of CGUs was affected by the primary or secondary segment structure determined in accordance with IAS 14; and
- The operating segment structure determined in accordance with IFRS 8 differs from the structure determined in accordance with IAS 14.

If a reallocation of goodwill is necessary, goodwill impairment testing should be based on the new IFRS 8 segment structure from the annual period in which IFRS 8 is first implemented. Any impairment identified should be recorded as an expense in current period earnings. In other words, the new approach to goodwill impairment testing (based on the IFRS 8 segment structure) should be applied prospectively.

Detailed guidance

Link between segments and goodwill impairment testing

IAS 36 requires annual impairment testing of goodwill (IAS 36.10). This involves estimating the recoverable amount of the goodwill, which is the higher of its value in use and fair value less costs to sell (IAS 36.6).

Goodwill does not generate cash flows independently of other assets and can be sold only as part of a business. Accordingly, it is not possible to determine the recoverable amount of goodwill on a stand-alone basis. IAS 36.80 therefore sets out the following methodology for allocating goodwill for the purpose of determining its recoverable amount:

- Goodwill is allocated to CGUs or groups of CGUs that are expected to benefit from the synergies of the business combination in which the goodwill arose;
- The CGU or group of CGUs to which goodwill is allocated must:
  - Represent the level at which management monitors goodwill internally; and
  - Not be larger than an operating segment determined in accordance with IFRS 8.

IFRS 8 and IAS 14 segments

IAS 36.80 was amended to refer to IFRS 8 as a consequential amendment on introduction of that Standard. Previously IAS 36 referred to the primary or secondary segment format determined in accordance with IAS 14.

Many entities will have different segments on transition from IAS 14 to IFRS 8. Broadly, IAS 14 identified business segments based on the activities of one component of an entity being subject to different risks and returns compared to the activities of other components. IAS 14 also defined geographical segments. IAS 14 required entities to determine whether business or geographical segments were the primary segments based on the dominant source and nature of risks and returns. The less dominant segment format then comprised the secondary segments. IAS 14's approach to segment identification can therefore be characterised as objective (or non-entity specific).

By contrast, IFRS 8 identifies business segments based on any business activities whose operating results are regularly reviewed by the chief operating decision maker (CODM). This is often described as a management approach. The concept of primary and secondary segments does not exist in IFRS 8.

Although IFRS 8 takes a very different approach to IAS 14, the segment structure of some entities will be the same. This will be the case in particular for smaller entities and those operating only one line of business.

The segment structure acts as an upper limit on aggregation for goodwill allocation purposes and will not therefore affect impairment testing if goodwill is allocated at a lower level. For example, if an entity has allocated goodwill to individual CGUs which are smaller than segments (as defined in both IFRS 8 and IAS 14) the segment limit has no effect. However, where the revised segment limit does result in a lower level allocation of goodwill the likelihood of impairment is increased. This is because a lower level of aggregation reduces the extent to which goodwill allocated to poorly performing CGUs is sheltered by strongly performing ones.

Segments or reportable segments?

Although IFRS 8 defines segments based on information reviewed by the CODM, not every segment is reported separately in the financial statements. IFRS 8.11-19 also includes a concept of "reportable segments" which result from the aggregation of operating segments. IFRS 8's rules on reportable segments and aggregation are quite complex and are set out in detail in IFRS 8.11-19. Broadly, operating segments that have similar economic characteristics may be aggregated for external reporting purposes. Segments (or aggregations of segments) become reportable segments if their size exceeds various 10% thresholds.

This raises the question of whether IAS 36.80's reference to operating segments for goodwill allocation purposes is a reference to reportable segments or to underlying operating segments. Grant Thornton believe the reference is to the underlying operating segments. This is consistent with IAS 36's emphasis on how management monitors goodwill.

Basis of reallocation

If implementation of IFRS 8 requires a new or more detailed goodwill allocation, how should this be done?

One approach is to revisit the original allocation as though IAS 36.80 referred at that time to operating segments determined in accordance with IFRS 8 (a retrospective approach). This would entail estimating the extent to which each IFRS 8 segment was expected to benefit from the synergies of the combination in which the goodwill arose. The new allocation should in other respects use assumptions consistent with the original allocation.

Such a retrospective approach may be impracticable. A more practical approach is to apply by analogy IAS 36's guidance on reallocation of goodwill resulting from a reorganisation. This approach involves allocating goodwill to each operating segment using a relative value approach. An alternative method may also be used if the entity can demonstrate that it better reflects the goodwill associated with each segment (see IAS 36.86 and 87).

Prospective or retrospective application?

The effect of IFRS 8 on goodwill impairment (if any) should be dealt with prospectively as testing goodwill at a lower level of allocation is a not change of accounting policy. Rather, the accounting policy is the requirement for goodwill to be tested annually and carried at no more than its recoverable amount. Although the new allocation may affect goodwill impairment, this is in Grant Thornton's view a change in accounting estimate the effect of which is recorded in earnings in the current period based on IAS 8.36.

An alternative view is that IFRS 8 does not contain any relief from retrospective application and that any effects of implementing the Standard for the first time should be considered as a change of accounting policy. The consequences of this view would be that (to the extent practicable):

- Goodwill would be allocated to the IFRS 8 segments using the retrospective basis described above;
- Prior year impairment tests would need to be re-performed based on the new allocation and segment structure. These re-performed tests should otherwise reflect circumstances and use assumptions consistent with the original tests (ie the use of hindsight should be avoided); and
- Any additional impairment loss resulting from retrospective application would be recorded against opening retained earnings for the earliest comparative period presented in accordance with IAS 8.22.

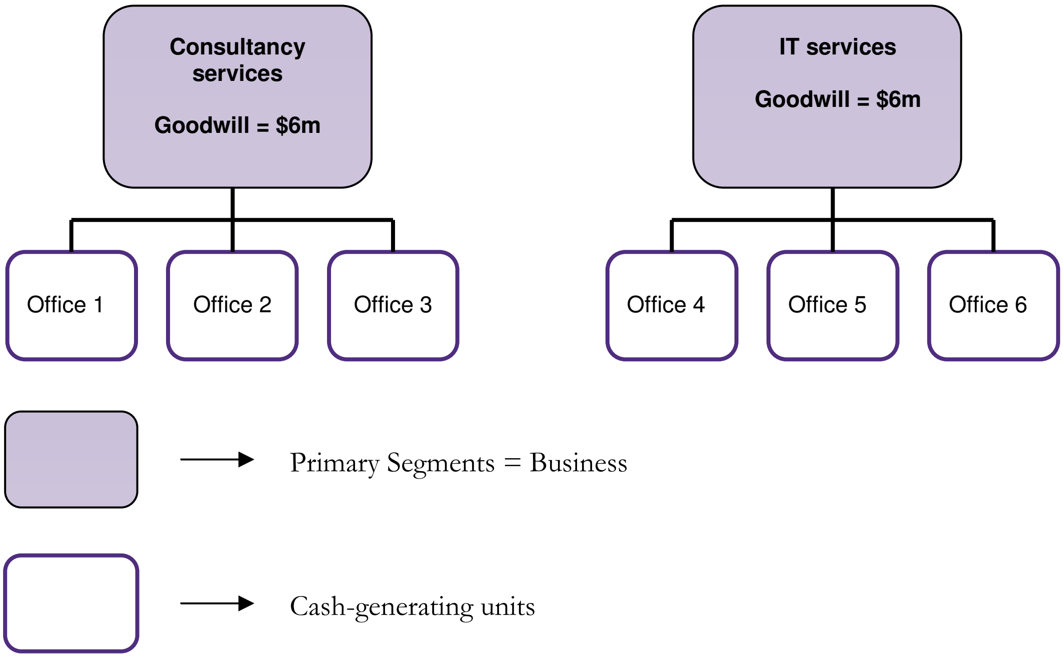
Although Grant Thornton considers that this alternative view is supportable from a technical standpoint, we believe the arguments for prospective application are equally valid. IAS 8.35 requires that where it is difficult to distinguish between a change in an accounting policy and a change in an estimate, the change is treated as a change in an estimate. Grant Thornton's preference for prospective application is also based in part on the considerable practical challenges of full retrospective application.

Example

Services business

Company S provides professional services via two main lines of business: Consultancy Services and IT Services. The business is conducted in six offices, three of which provide Consultancy Services and three provide IT Services. Each office generates cash inflows largely independently of the other offices. The IT Services business was acquired several years ago in a business combination in which goodwill of $10m arose. Part of the rationale for the acquisition was to create cross-selling opportunities, such that the Consultancy Services line was expected to benefit from the synergies of acquiring the IT Services business.

Company S has applied IAS 14 and determined that its primary segments are its two services lines. It has no secondary segments.



In accordance with the previous version of IAS 36, management allocated the goodwill of $1m to Consultancy Services and IT Services businesses (both of which comprise a group of three CGUs). This is also the level at which goodwill is monitored by management. The allocation exercise resulted in goodwill of $4m being allocated to Consultancy Services and $6m to IT Services.

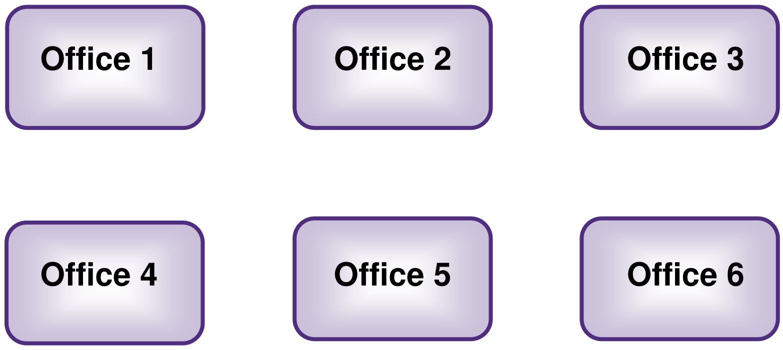
Annual impairment tests have been performed for each of these two groups of CGUs based on IAS 36.81 and 83-99.

Company S is implementing IFRS 8 in the current annual period. Its CODM regularly monitors operating results for each of the six offices meaning that segments are now set at office level. How will this affect its approach to goodwill impairment testing?

Analysis

Company S's operating segments for IFRS 8 purposes are its six offices. Each office is also a separate CGU as each one generates largely independent cash inflows (IAS 36.6). The existing goodwill allocation to Consultancy Services and IT Services is therefore to groups of CGUs that are larger than operating segments, which is not permitted by IAS 36.80 (as revised). Management must reallocate the goodwill to each of the six CGUs in order to comply with IAS 36.

CGU's:



The goodwill of $4m previously allocated to Consultancy Services is therefore reallocated amongst the three CGUs. This reallocation can be based on the relative value of the three CGUs unless another approach better reflects how each CGU benefits from the synergies of the combination (see IAS 36.87). A similar reallocation is required for the goodwill of $6m previously allocated to IT Services.

The recoverable amount of each CGU then needs to be estimated in the current and in future annual periods. If any CGU is found to be impaired, the impairment loss is attributed first to the goodwill allocated to that CGU. If goodwill does not absorb 100% of the impairment loss the remaining loss is allocated amongst the CGU's other assets on a pro-rata basis (IAS 36.104).

Any impairment loss recognised as a result of this more detailed exercise may result in part from current period developments and in part from the change in the approach to the impairment test. However, in our view the entire impairment loss should be recorded in the current period income statement.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au, or see TA alert 2008-03 for more detailed analysis of AASB 8.