Alerte de votre conseiller – IFRS

Aperçu d'IAS 36 – Dépréciation d'actifs

Novembre 2021

Aperçu

L'équipe IFRS de Grant Thornton International a publié trois bulletins *Insights into IAS 36* (en anglais seulement) :

- *Identifying cash-generating units*;
- *Allocating assets to cash-generating units*;
- *Allocating goodwill to cash-generating units*.

La norme IAS 36 *Dépréciation d'actifs* n'est pas une nouvelle norme et, bien que bon nombre de ses exigences ne soient pas inconnues, un test de dépréciation à l'égard d'actifs (qu'il s'agisse d'immobilisations corporelles ou incorporelles) est souvent difficile à appliquer dans la pratique. Cela s'explique par le fait que les directives d'IAS 36 sont détaillées, prescriptives et complexes pour certains aspects.

La série *Insights into IAS 36* a été rédigée pour aider les préparateurs d'états financiers et les personnes responsables de la gouvernance des entités publiantes à comprendre les exigences énoncées dans IAS 36 et pour revoir certains aspects où une confusion avait été constatée dans la pratique.

Les trois bulletins suivants de la série *Insights into IAS 36* concernent exclusivement les unités génératrices de trésorerie (« UGT ») :

- *Identifying cash-generating units*;
- *Allocating assets to cash-generating units*;
- *Allocating goodwill to cash-generating units*.

L'identification des UGT est une étape critique du test de dépréciation et peut avoir une incidence importante sur ses résultats. Cela dit, l'identification des UGT requiert l'exercice du jugement. Après avoir identifié ses UGT, l'entité doit déterminer quels actifs se rattachent à quelles UGT, ou à quels groupes d'UGT. Le premier bulletin traite de la manière d'identifier les UGT et les deux autres bulletins traitent de la manière d'affecter les actifs et le goodwill aux UGT.

Ressource

Les bulletins mentionnés ci-dessus sont joints à la présente *Alerte de votre conseiller*.

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Insights into IAS 36

Identifying cash-generating units

IAS 36 ‘Impairment of Assets’ prescribes the accounting for impairment reviews. While the guidance in this area has not changed in recent years, it still remains a challenging area to apply by preparers of financial statements.

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.

The next three articles our ‘Insights into IAS 36’ series are all about cash-generating units (CGUs). In this article we discuss how to identify them, and in our following articles how to allocate assets to them and also then to allocate goodwill to them.

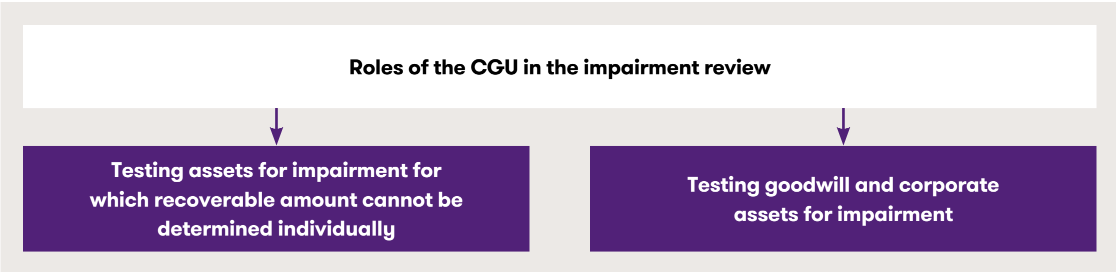
Identifying CGUs is a critical step in the impairment review and can have a significant impact on its results. That said, the identification of CGUs requires judgement. The identified CGUs may also change due to changes in an entity’s operations and the way it conducts them.

A CGU is defined as follows:
The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Roles of the cash-generating unit in the impairment review

A CGU serves two primary roles in the impairment review. It facilitates the testing of:

- assets for which the recoverable amount cannot be determined individually, and
- goodwill and corporate assets for impairment.



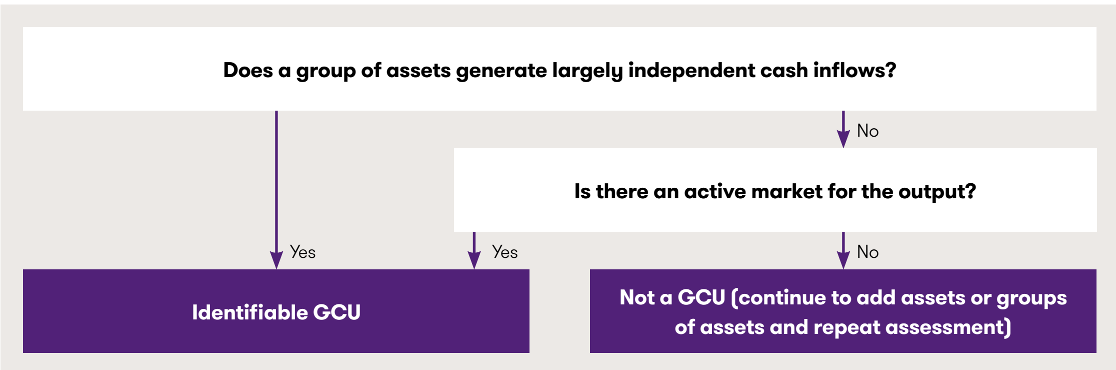
Goodwill and corporate assets by definition do not generate cash inflows on their own and therefore, must be allocated to a CGU or groups of CGUs for impairment testing purposes. The allocation of goodwill and corporate assets is discussed in our articles '**Insights into IAS 36 – Allocating assets to cash-generating units**' and '**Insights into IAS 36 – Allocating goodwill to cash-generating units**'.

Identifying cash-generating units

The objective of identifying CGUs is to identify the smallest identifiable group of assets that generates largely independent cash inflows. CGUs are identified at the lowest level to minimise the possibility that impairments of one asset or group will be masked by a high-performing asset.

To identify a CGU, an entity asks two questions:

1 Does a group of assets generate largely independent cash inflows?
2 Is there an active market for the output?



Does a group of assets generate independent cash inflows?

Put simply, identifying CGUs involves dividing the entity into clearly identifiable components. Because the CGU definition is based on cash inflows, the division process should focus on an entity's sources of revenue and how assets are utilised in generating those revenues. Management will need to consider various factors including how it monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas) or how management makes decisions about continuing or disposing of the entity's assets and operations.

Practical insight – Operational structure over legal structure

It may be the case that the design and management of an entity's operations does not reflect the legal structure of the group. Depending on the circumstances, a CGU might correspond to a legal entity, a division, product line, geographic region, physical location (such as a hotel or retail store) or collection of assets.

The following examples illustrate the identification of the lowest aggregation of assets that generate largely independent cash inflows in different circumstances.

Example 1 – Identifying the CGU: lowest level of largely independent cash inflows

A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.

Analysis

Because the entity does not have the option to curtail any of those bus routes, the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the five routes together. The CGU is the bus company as a whole.

Example 2 – Identifying the CGU: supermarket chain

Entity A owns and operates 10 supermarkets in a major city (City B), each store residing in a different suburb throughout City B. Each supermarket in City B purchases its inventory through Entity A's purchasing centre. Pricing, marketing, advertising and human resources policies (except for the hiring of each supermarket's local staff) are decided by Entity A. Entity A also operates 50 other supermarkets in other major cities across the country.

Analysis

The supermarkets in City B probably have different customer bases as they reside in different suburbs. Accordingly, although operations are managed at a corporate level by Entity A, each supermarket generates cash inflows that are largely independent of those of other supermarkets. Therefore, it is likely each supermarket in City B is a separate CGU.

In making its judgement about whether each supermarket is a separate CGU, Entity A might also consider if:

- management reporting monitors revenues on a supermarket-by-supermarket basis in City B, and
- how management makes decisions about continuing or closing its supermarkets (eg on a store-by-store or on a region/city basis).

The IFRS Interpretations Committee (IFRIC) was asked to develop an Interpretation on whether a CGU could combine more than one individual store location. The submitter developed possible considerations including shared infrastructures, marketing and pricing policies, and human resources. The IFRIC noted IAS 36 requires identification of CGUs on the basis of independent cash inflows rather than independent net cash flows and so outflows such as shared infrastructure and marketing costs are not considered. In its March 2007 agenda decision, the IFRIC took the view developing guidance beyond that already given in IAS 36 on whether cash inflows are largely independent would be more in the nature of application guidance and therefore decided not to take this item onto its agenda.

Is there an active market for the output?

When management has identified a group of assets that generate an output, but those assets do not generate largely independent cash inflows, it needs to consider if there is an active market for the output.

For the purposes of applying IAS 36, even if part or all of the output produced by an asset (or a group of assets) is used by other units of the entity (ie products at an intermediate stage of a production process), this asset (or group of assets) represents a CGU if the entity could sell the output on an active market. This is because the asset (or group of assets) could generate cash inflows that would be largely independent of the cash inflows from other assets (or groups of assets).

Practical insight – Vertically integrated businesses and an active market for output

This is a common issue for vertically integrated businesses whereby some groups of assets do not generate independent cash inflows, only because each operation's output is used internally, rather than being sold externally. IAS 36 addresses this issue by clarifying that even if part or all of the output produced by an asset (or a group of assets) is used by other units of the entity, this asset (or group of assets) forms a separate CGU if the entity could sell the output on an active market. An active market is defined in IFRS 13 'Fair Value Measurement' as 'a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis'. This may be the case for certain commodities such as oil or gold.

Example 3 – Identifying the CGU: active market for the output

Entity X produces a single product (widgets) and owns production plants 1, 2 and 3. Each plant is located in a different region of the world. Plant 1 produces a component of the widgets that is assembled in either plant 2 or plant 3 and sold worldwide from either plant 2 or plant 3. Neither plant 2 nor plant 3 is operating at full capacity.

The utilisation levels depend on the allocation of order fulfillment between the two locations of order fulfillment between the two locations.

Scenario 1: There is an active market for plant 1's component.

Scenario 2: There is no active market for plant 1's component.

Analysis

Scenario 1: It is likely plant 1 is a separate CGU because there is an active market for its output. As cash inflows for plants 2 and 3 depend on the allocation of production across the two locations, it is unlikely the future cash inflows for plants 2 and 3 can be determined individually so they would probably be combined into a single CGU.

Scenario 2: It is likely the three plants (1, 2 and 3) are a single CGU because:

- there is no active market for plant 1's output and its cash inflows depend on sales of the final product by plants 2 and 3
- cash inflows for plants 2 and 3 depend on the allocation of production across the two locations. It is unlikely the future cash inflows for plants 2 and 3 can be determined individually.

Where the cash inflows generated by an asset or CGU are affected by internal transfer pricing, an entity uses management's best estimate of future prices that could be achieved in an arm's length transaction in estimating:

- the future cash inflows used to determine the asset's or CGU's value in use (VIU), and
- the future cash outflows used to determine the VIU of any other assets or CGUs that are affected by the internal transfer pricing.

Example 3 continued – Identifying the CGU: active market for the output
In Scenario 1, in determining the VIU of plants 1, 2 and 3, Entity X will adjust its financial budgets/forecasts to reflect its best estimate of future prices that could be achieved in arm's length transactions for plant 1's output while also incorporating future cash outflows used to determine the VIU of other assets impacted by the internal transfer pricing.

When the group of assets does not generate cash inflows that are largely independent and there is no active market for its output (even if used internally), the group is not a CGU. Management then has to combine these assets with others that contribute to the same revenue stream until a CGU is identified.

Changes in identified cash-generating units

Unless a change is justified, CGUs are identified consistently from period to period for the same asset or types of assets. If a change in CGUs is justified (eg an asset belongs to a different CGU than in previous periods or previously recognised CGUs are combined or subdivided), and an impairment loss is recognised or reversed for the CGU, the entity should disclose additional information.

Practical insight – Triggers for a change in CGU structure
IAS 36 does not provide examples of events or circumstances that would justify a change in CGUs. Such a change would generally be appropriate only if there has been a change in the entity's operations – ie different revenue-generating activities or different utilisation of assets in undertaking those activities. Typical triggers for a change might include:

- business combinations or divestments
- restructurings
- introduction or withdrawal of products or services, or
- entry to or exit from new markets or regions.

Practical insight – A change in CGU structure over time
The factors that justify a change in CGU structure sometimes develop over time rather than being driven by a specific event. For example, an entity might gradually change the way it allocates order intake across its production facilities or how it utilises assets to generate a revenue stream. In our view, the change in CGU structure is justified if an asset's cash inflows become, or cease to be, independent even if this cannot be attributed to a specific event. One practical suggestion for determining the effective date of the change is to consider when management began reviewing or assessing the CGUs differently (eg when management reporting changed).

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.

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Insights into IAS 36

Allocating assets to cash-generating units

The accounting requirements regarding impairment of tangible and intangible assets are governed by IAS 36 'Impairment of Assets'. The requirements are not new, however remain challenging as the guidance is detailed and complex in some areas.

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.

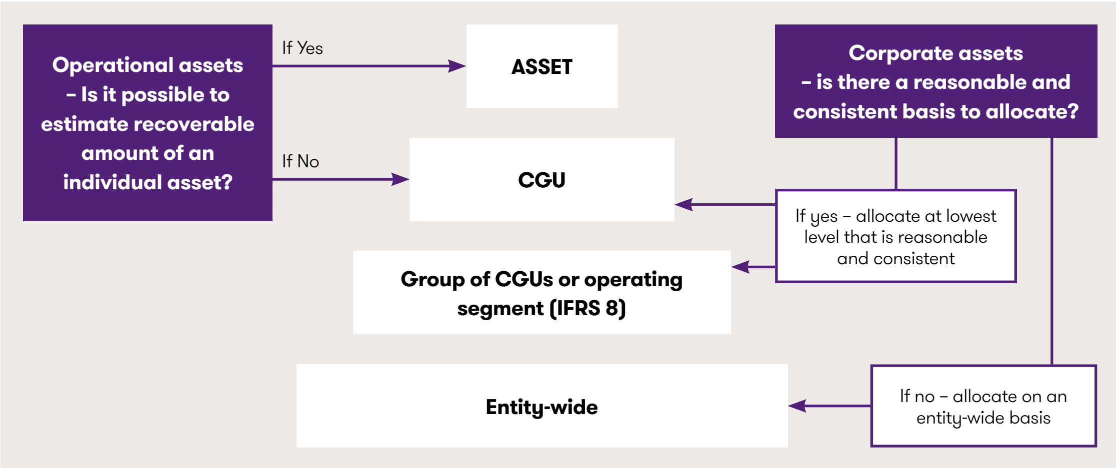
This article is the second of a three-part series on cash-generating units (CGUs). In this article we discuss how to allocate assets to CGUs, which follows an article on how to identify CGUs and then finally we will discuss how to allocate goodwill to CGUs.

Identifying CGUs is a critical step in the impairment review and can have a significant impact on its results. That said, the identification of CGUs requires judgement. The identified CGUs may also change due to changes in an entity's operations and the way it conducts them.

After the entity identifies its CGUs it must determine which assets belong to which CGUs, or groups of CGUs. The basis of allocation differs for:

- operational assets
- corporate assets, and
- goodwill.

The below diagram summarises the different allocation bases for assets:



Operational assets

As discussed in our previous article, recoverable amount is determined (if required) at the level of individual assets when possible. Where it is not possible to estimate the recoverable amount of the individual operational asset it is allocated to the CGU to which it belongs.

Assets that contribute to the cash flows of a CGU also need to be allocated to that CGU even if it is possible to determine recoverable amount individually (because, for example, an asset's value in use (VIU) can be estimated as similar to its fair value less costs of disposal (FVLCOD)). This is to ensure a like-for-like comparison when the CGU is tested and its recoverable amount is compared to its carrying value.

The discussion in **'Insights into IAS 36 – Identifying cash-generating units'** provides guidance on identifying the CGU to which an asset belongs.

Corporate assets

In some cases, management may identify certain assets that contribute to the estimated future cash flows of more than one CGU. It would be inappropriate to allocate these assets entirely to a single CGU. Such assets are referred to as 'corporate assets' or 'shared assets' and may include (for example):

- a headquarters building
- IT equipment
- research centre, or
- corporate or global brands.

Defining corporate assets
Corporate assets are assets other than goodwill that contribute to the future cash flows of both the CGU under review and other CGUs.

Distinctive characteristics of corporate assets are that they do not generate cash inflows independently of other assets or groups of assets and their carrying amount cannot be fully attributed to the CGU under review.

If there is an indication of impairment for the corporate asset itself, recoverable amount cannot be determined at the individual asset level, unless management has decided to dispose of it (because corporate assets do not generate separate cash inflows).

Corporate assets therefore need to be incorporated into the impairment review at the CGU level – not only to test the asset in question (when necessary), but also to test the CGUs that benefit from those assets. To do so, the entity should:

- identify corporate assets that relate to the CGU under review, and
- allocate the carrying amount of the corporate assets on a reasonable and consistent basis to the CGU under review (if a reasonable and consistent basis can be identified).

Where a portion of the carrying amount of a corporate asset cannot be allocated on a reasonable and consistent basis, the assets are incorporated into the impairment review at a higher level and the analysis becomes more complicated. This will be addressed in a later article.

Example 1 – Identification and allocation of corporate assets to CGUs

Entity E has four CGUs: A, B, C and D. The carrying amounts of those units do not include goodwill. During the period, significant adverse changes in the legal environment in which Entity E operates take place. Entity E conducts impairment tests of each of its CGUs in accordance with IAS 36. At the end of the period, the carrying amounts of CGUs A, B, C and D are CU100, CU200, CU300 and CU250, respectively.

The four CGUs all utilise a central office and a shared global brand (carrying amounts of CU100 and CU75, respectively). Management of E has determined the relative carrying amounts of the CGUs are a reasonable approximation of the proportion of the central office building devoted to each CGU, but the carrying amount of the global brand cannot be allocated on a reasonable and consistent basis to the individual CGUs.

The remaining estimated useful life of CGUs A, B, C and D are 10, 15, 15 and 20 years respectively. The central office has a remaining useful life of 20 years and is depreciated on a straight-line basis.

Analysis (ignoring tax effects)

Entity E identifies all corporate assets that relate to the individual CGUs under review (the central office and shared global brand).

Entity E concludes the carrying amount of the central office can be allocated on a reasonable and consistent basis to the CGUs under review while the carrying amount of the global brand cannot.

Although not the only way to do so, Entity E allocates the carrying amount of the central office to the carrying amount of each individual CGU using a weighted allocation basis because the estimated remaining useful life of A's CGU is 10 years, whereas the estimated remaining useful lives of B and C's CGUs are 15 years and D's CGU is 20 years.

	CGU A	CGU B	CGU C	CGU D	Total
Carrying amount	100	200	300	250	**850**
Useful life	10	15	15	20	–
Weighting	1	1.5	1.5	2	–
Carrying amount after weighting	100	300	450	500	**1,350**
Pro-rata allocation of the central office	7.4%	22.2%	33.3%	37.1%	**100%**
Allocation of the carrying amount of the central office (based on pro-rata above)	7.4	22.2	33.3	37.1	**100**
Carrying amount (after allocation of the central office)	107.4	222.2	333.3	287.1	**950**

Practical insight – Allocating corporate assets

IAS 36 provides only limited guidance as to what is meant by 'allocated on a reasonable and consistent basis' for allocation of corporate assets to CGUs or groups of CGUs. Judgement is therefore required. This judgement will depend on the nature of the asset and should aim to reflect the extent to which each CGU benefits from the corporate asset. In our view, however, a reasonable and consistent basis of allocation should normally be possible in most circumstances by taking a pragmatic approach, even if the benefits obtained by the CGU are less clear-cut or observable. the example above shows one such pragmatic approach (allocating corporate assets using CGUs' carrying amounts, weighted by their useful lives) but several other methods could also be supportable (for example, headcount, revenue, floor space or utilisation metrics depending on the circumstances).

Practical insight – Corporate assets and shared corporate costs in the regulatory spotlight

In estimating VIU for a CGU that benefits from a corporate asset, an entity must ensure it also allocates shared corporate costs relating to that corporate asset. A regulatory decision published in the April 2013 European Securities and Markets Authority (ESMA) Report (ESMA/2013/444) highlights this point whereby an issuer did not allocate the costs of corporate officers to the individual CGUs on the basis the cash flows benefited the company as a whole rather than the individual CGUs (highlighting the criterion of independency of cash flows when determining the cash inflows and outflows of a CGU). In the regulator's view, the corporate costs were cash outflows that were necessarily incurred to generate the cash inflows from continuing use of the assets and could be allocated on a reasonable and consistent basis to the asset. The regulator concluded excluding certain corporate costs from the costs allocated to CGUs did not comply with the requirements of IAS 36 and all cash outflows had to be included in the cash flow forecasts. The corporate costs were cash outflows that, according to IAS 36, were necessarily incurred to generate the cash inflows from continuing use of the CGU's assets and could be allocated on a reasonable and consistent basis to the CGU.

How we can help

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Insights into IAS 36

Allocating goodwill to cash-generating units

IAS 36 'Impairment of Assets' assesses when and how to conduct an impairment review. It contains complex areas of guidance and therefore is challenging to apply in practice.

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.

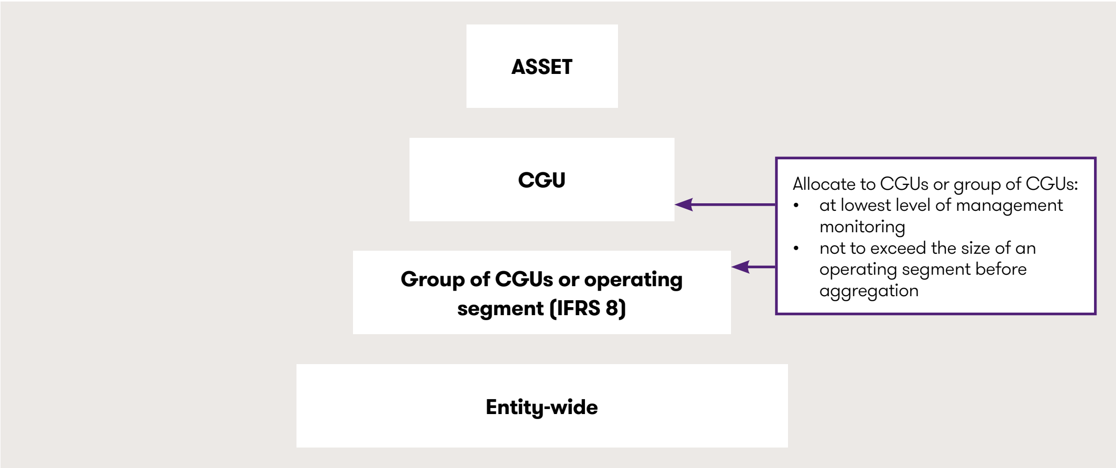
This article is the third of a three-part series on cash-generating units (CGUs). In this article we discuss how to allocate goodwill to CGUs, which follows articles on how to identify CGUs and how to allocate assets to CGUs.

Identifying CGUs is a critical step in the impairment review and can have a significant impact on its results. That said, the identification of CGUs requires judgement. The identified CGUs may also change due to changes in an entity's operations and the way it conducts them.

After the entity identifies its CGUs, it must determine which assets belong to which CGUs, or groups of CGUs. The basis of allocation differs for:

- operational assets
- corporate assets, and
- goodwill.

The below diagram summarises the different allocation bases for goodwill:



It is not possible to determine the recoverable amount of goodwill independently from other assets because goodwill does not generate cash flows of its own; rather it contributes to the cash flows of individual CGUs or multiple CGUs.

As such, goodwill must be allocated to individual CGUs (or groups of CGUs) for the purpose of impairment testing. The guidance in IAS 36 requires the goodwill acquired in a business combination to be allocated to each of the acquirer's CGUs or groups of CGUs that are expected to benefit from the synergies of the combination. Further, the level to which the goodwill is allocated must:

- represent the lowest level within the entity at which the goodwill is monitored for internal management purposes, and
- not be larger than an operating segment before aggregation as defined by IFRS 8 'Operating Segments'.

Defining an operating segment – in accordance with IFRS 8

An operating segment is a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity)
- whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and reassess its performance, and
- for which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

Example 1 – Allocating goodwill acquired in a business combination
Entity A acquires competitor E for CU1M and determines that this new acquiree is a single CGU (E). Entity A performs an analysis of its existing business and determines that CGUs B, C and D will all benefit from the acquisition of E and expect to realise potential synergies from the transaction. The identifiable net assets of E total CU750,000. Total goodwill from the acquisition equals CU250,000 (CU1M – CU750,000).

Analysis (ignoring tax effects)
Because some of Entity A's existing CGUs are expected to benefit from the synergies of the combination, a portion of the goodwill of CU250,000 should be allocated to these CGUs. IAS 36 provides little guidance on how to do this. However, if Entity A is able to estimate how much of the purchase price (and goodwill) relates to expected synergy benefits for its existing business, this can provide an initial basis for allocation. For example, if the estimated fair value of E is CU800,000 (ie excluding acquirer synergies), Entity A may allocate CU50,000 of goodwill to E (CU800,000-CU750,000) and allocate the remaining goodwill of CU200,000 between CGUs B, C and D, representing the expected synergies to be generated between E, B, C and D.

Allocating goodwill to groups of CGUs

IAS 36 acknowledges that sometimes goodwill cannot be allocated to individual CGUs on a non-arbitrary basis. It therefore allows or requires allocation to groups or clusters of CGUs, subject to the limits noted above.

If management has a monitoring process for goodwill, IAS 36 seems to require goodwill to be allocated to the lowest level at which it is monitored but limits this to the size of the operating segment before any aggregation. Allocation at such a level means goodwill can be monitored using existing reporting systems consistent with the way management monitors its operations.

If there is no separate monitoring process for goodwill, IAS 36 allows a choice of allocation to:

- individual CGUs
- groups of CGUs forming part of an operating segment before aggregation, or
- groups of CGUs forming an entire operating segment before aggregation.

Practical insight – Allocating goodwill acquired in a business combination

IAS 36 sets out requirements on the level of allocation and the basis of allocation of goodwill to CGUs or groups of CGUs.

Level of allocation

IAS 36 offers some flexibility on the level to which goodwill is allocated. The allocation can be to CGUs, or to groups of CGUs, provided the level of allocation:

- represents the lowest level within the entity at which the goodwill is monitored, and
- is not larger than an operating segment.

In our experience, the first condition rarely has a practical effect because few entities separately monitor goodwill outside the impairment review and external financial reporting process. The impact of the second condition is more varied. In some entities, an operating segment may comprise many CGUs while in others, the CGUs and operating segments might be similar or even identical. IAS 36 does not seem to envisage an operating segment could be smaller than a CGU – in our view, this is possible in theory but rare in practice.

The basis of allocation

The basis of allocation (the expected synergies from the combination) requires considerable judgement in practice. One approach is to perform a 'pre-combination' and 'post-combination' valuation and use this analysis as a basis to allocate the goodwill. Such an analysis may identify the factors that contribute to the synergies expected to arise from the acquisition (eg cost savings from economies of scale and reduced overheads or increased revenues from cross-selling opportunities to new markets). Others may use the relative carrying values of the CGUs to allocate the goodwill to impacted CGUs.

In our view, the entity should take a practical approach while aiming to arrive at the most representative allocation of goodwill to those CGUs that are expected to benefit from the combination. If the requirements in IAS 36 are overlooked, and goodwill is allocated entirely to the acquired business, this can sometimes lead to unnecessary future impairment losses and complications (eg when the CGUs are subsequently reorganised or disposed of).

Example 2 – Limit on the level at which goodwill can be allocated

Entity A manufactures and sells widgets. In year 20X1, it purchases Entity B, Entity C, and Entity D which also produce widgets, each in a different part of the world. Entity A recognised goodwill of CU1M with respect to the acquisition of Entity B, CU2M with respect to the acquisition of Entity C and CU4M with respect to Entity D, all attributable to the cost-savings opportunities from using Entity A's established centralised functions (purchasing, marketing, human resources).

Management has identified several CGUs, each of which is a component of one of entities A, B, C and D. The operating segments before aggregation for the purposes of IFRS 8 are Entities A, B, C and D as management reporting and resource allocation decisions are based on the corporate structure. Goodwill is not separately monitored.

Analysis

Management can choose whether to allocate goodwill among individual CGUs that are expected to benefit from the synergies of each combination, or at the level of its four operating segments. If management determines it cannot allocate goodwill among its individual CGUs except on an arbitrary basis it should allocate it at the operating segment level.

Changes in the allocation of goodwill

For various reasons, the initial allocation of goodwill to CGUs or groups of CGUs may change. Below we discuss these circumstances and outline the appropriate accounting for each in accordance with IAS 36:

Provisional allocation of goodwill	Reallocation of goodwill • disposal of an operation within a CGU • reorganisation of the reporting structure

Provisional allocation of goodwill

The initial allocation of goodwill acquired in a business combination should be completed before the end of the annual period in which the business combination takes place, if possible. However, if this is not possible, and the accounting is incomplete by the end of the reporting period in which the business combination occurs, provisional amounts should be included for the items where the accounting is incomplete.

IFRS 3 'Business Combinations' sets out guidance on provisional accounting for a business combination, including a requirement to finalise the IFRS 3 accounting within the 'measurement period'. This period ends as soon as the required information is received about facts and circumstances that existed at the acquisition date or learns more information is not available. However, it should not exceed twelve months from the acquisition date. In our view, if goodwill has been determined only provisionally in accordance with IFRS 3, then that provisional amount should be allocated to CGUs or groups of CGUs if possible (and then adjusted as necessary when the IFRS 3 accounting is complete). However, IAS 36 acknowledges an initial allocation may not be possible, in which case the initial allocation should be completed before the end of the first annual period following the combination. For more on IFRS 3 accounting and the provisional accounting for goodwill, please see our **Insights into IFRS 3 series**.

In the event the entity is unable to allocate even the provisional amount of goodwill before the end of the period in which the combination takes place, it should disclose:

- the amount of unallocated goodwill, and
- the reasons why it remains unallocated.

Example 3 – Compliance with IAS 36 when an initial allocation of goodwill is not possible

Entity P has acquired a subsidiary (Entity T) on 30 June 20X0 which will be accounted for in accordance with IFRS 3. At the reporting date of 31 December 20X0, Entity P has not completed its determination of the acquisition date fair values and therefore it cannot finalise its measurement of goodwill (ie the IFRS 3 measurement period remains open and the amounts reflected in the consolidated financial statements are stated as provisional). Entity P also concludes it cannot complete the initial allocation of the provisional goodwill by 31 December 20X0.

Question

Does Entity P have to carry out an impairment test on the goodwill prior to 31 December 20X0 in accordance with IAS 36?

Analysis (ignoring tax effects)

When the initial allocation of goodwill has not been made but facts and circumstances indicate the goodwill may be impaired (eg an overpayment for the acquisition), Entity P should use reasonable endeavours to ensure the goodwill is not carried at an amount above its recoverable amount. This will ensure compliance with the overall principles of IAS 36 which require some form of recoverability test to take place. The fact the allocation process remains incomplete does not exempt the entity from performing an impairment assessment using the best information available at the time. Depending upon the particular facts and circumstances, the form of this test may vary (for example, the entity may need to estimate the recoverable amount on an entity-wide basis).

Reallocation of goodwill

Various circumstances may necessitate a reallocation of goodwill among CGUs (or groups of CGUs) including:

- the disposal of an operation to which goodwill has been allocated, and
- the reorganisation of an entity's reporting structure.

Disposal of an operation within a CGU to which goodwill has been allocated

When goodwill has been allocated to a CGU and the entity disposes of an operation within that unit, the goodwill associated with the disposed operation must be:

- included in the carrying amount of the operation when determining the gain or loss on disposal, and
- measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained (unless another method better reflects the goodwill associated with the disposed operation).

Example 4 – Disposal of an operation to which goodwill has been allocated

An entity sells for CU100 an operation that was part of a CGU to which goodwill has been allocated. The goodwill allocated to the CGU cannot be identified or associated with an asset group at a level lower than that CGU, except arbitrarily. The recoverable amount of the portion of the CGU retained is CU300.

Analysis

Because the goodwill allocated to the CGU cannot be non-arbitrarily identified or associated with an asset group at a level lower than that CGU, the goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the unit retained. Therefore, 25 per cent of the goodwill allocated to the CGU is included in the carrying amount of the operation that is sold.

Reorganisation of the reporting structure

When an entity reorganises its reporting structure in a way that changes the composition of one or more CGUs to which goodwill has been allocated, the goodwill must be:

- reallocated to the units affected, and
- measured using a relative value approach (again, unless another method better reflects the goodwill associated with the reorganised units).

Example 5 – Reorganisation of the reporting structure

Goodwill had previously been allocated to CGU A. The goodwill allocated to CGU A cannot be identified or associated with a lower-level asset group, except arbitrarily. CGU A is to be divided and integrated into three other CGUs: B, C and D.

Analysis

Because the goodwill allocated to CGU A cannot be non-arbitrarily identified or associated with an asset group at a lower level, it is reallocated to CGUs B, C and D on the basis of the relative values of the three portions of CGU A before those portions are integrated into CGUs B, C and D.

Other methods that may better reflect the goodwill associated with the operation disposed of or reorganised
When an entity disposes of part of a CGU to which goodwill has been allocated, IAS 36 sets out a benchmark 'relative value' approach for re-apportioning the goodwill within that unit, while also permitting some flexibility. Similar guidance applies when an entity reorganises its reporting structure – if the reorganisation changes the composition of one or more CGUs to which goodwill has been allocated, the goodwill needs to be reallocated to the affected units.

In our view, an alternative method of reallocation would be appropriate when the relative value approach does not take into account relevant differences between reorganised units (because the relative value approach assumes that each CGU has the same proportion of goodwill).

For example, assume an entity reorganises from three to two CGUs and the assets and activities of the third CGU (CGU C) are integrated with the remaining two (CGUs A and B). CGU C includes allocated goodwill of CU300 which must now be reallocated to CGUs A and B. Under the benchmark approach the reallocation would be based on the relative values of the portions of CGU C that are integrated into CGUs A and B. However, assume also that the portion of CGU C integrated with CGU A is a manufacturing operation and the portion integrated with CGU B is a service-based operation. Using the figures in the table below, the relative value basis would result in the allocation of CU150 to CGU A and CU150 to CGU B. The entity may deem it more appropriate in this case (given the different nature of the activities integrated into CGUs A and B) to allocate goodwill based on the notional goodwill of each portion resulting in an allocation of CU60 to CGU A (100/500*300) and CU240 to CGU B (400/500*300).

On date of reorganisation	Portion of C integrated with CGU A	Portion of C integrated with CGU B	Total
Fair value of assets	500	200	**700**
Fair value of portion	600	600	**1,200**
Notional goodwill	100	400	**500**

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.