Applying IFRS
Goodwill Hunting
Looking for property investors’ missing cash flows
February 2016
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What you need to know

• In business combinations, there will be a deferred tax liability, which is not measured at the fair value of the deferred tax liability under IAS 12 Income Taxes. As the fair value of the deferred tax liability is often lower than the carrying amount, this leads to a higher amount of goodwill.

• As investment properties are already measured at fair value, some take the view that there cannot be any ‘excess value’ to support the goodwill amount. As such, the goodwill should be impaired straight away.

• This publication looks at alternative treatments of goodwill that do not lead to immediate impairment.
1. Introduction

When accounting for a business acquisition under IFRS 3 *Business Combinations*, deferred tax assets and liabilities need to be accounted for based on the requirements of IAS 12. This implies that the deferred tax balances are not accounted for at fair value, for example, because discounting is not permitted under IAS 12.

If deferred tax liabilities need to be recognised, there is a corresponding increase of the amount of goodwill recognised on the acquisition of a property investment business. Investment property is commonly held at fair value, thereby already potentially using the cash flows that would support the goodwill. It is sometimes argued that property investment entities that measure their property at fair value cannot have goodwill on their balance sheets since goodwill needs to be justified by future cash flows – and a property investor’s future cash flows are already built into the fair value of the investment property.

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### Deferred taxation and business combinations - a clash of accounting models

IAS 12 requires that deferred tax is provided on the difference between the carrying amount of an asset or liability and the respective tax base of that asset or liability. In measuring deferred tax, no account is taken of the timing of any tax payments or receipts in the future, or the risks associated with these cash flows.

In contrast, IFRS 3 requires a fair value approach for assets and liabilities apart from deferred tax – and a fair value calculation does take account of the timing of cash flows and the risks associated with them.

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### What is goodwill?

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

Goodwill is measured as the residual cost of a business combination after recognising the acquiree’s identifiable assets, liabilities and contingent liabilities. IFRS requires goodwill acquired in a business combination to be tested for impairment at least annually.

Goodwill can only arise on a business combination. Importantly, the acquisition of a subsidiary is not automatically a business combination as defined in IFRS 3. In many cases, the acquisition of an entity owning only one, or just a few, properties will not be a business combination, rather it is an asset acquisition. Even an acquisition of a company owning a portfolio of properties may be an asset purchase. Each transaction must be evaluated on its own merits.
2. An illustration

The issue is best illustrated by way of an example:

| Entity A, a property investor, which is taxed at 40%, acquires Entity B for CU180mn in a transaction that is a business combination. The fair values and tax bases of the identifiable net assets of Entity B are, as follows: |
|---|---|---|---|
| | Fair value (CUm) | Tax base (CUm) |
| Investment property | 120 | 20 |
| Other net assets | 40 | 40 |

This will give rise to the following consolidation journal:

<table>
<thead>
<tr>
<th></th>
<th>(CUm)</th>
<th>(CUm)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill (balance)</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Investment property</td>
<td>120</td>
<td></td>
</tr>
<tr>
<td>Other net assets</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>Deferred tax¹</td>
<td></td>
<td>40</td>
</tr>
<tr>
<td>Cost of investment</td>
<td></td>
<td>180</td>
</tr>
</tbody>
</table>

¹ 40% of (CU120m– CU20m)

The fair value of the investment property is based on the price of the investment property to a buyer in an asset transaction that assumes the fair value will be deductible for tax purposes. The deferred tax liability is measured at a nominal amount, as required by IAS 12. The fair value of this liability is often lower as a result of the time value of money. In this situation the fair value of the deferred tax liability is assumed to be CU30m.

The goodwill arising on the acquisition is CU60m. This is made up of CU10m arising solely from the recognition difference for deferred tax (CU40m recognised minus CU30m fair value) and CU50m arising from the decision to acquire the business for more than the aggregate of the fair value of its net assets (excluding goodwill). This CU50m is sometimes referred to as ‘core goodwill’.

However, there are two key considerations:

- The acquired entity’s expected future cash flows arising from the investment property are already substantially built into the fair value of the investment property
- IAS 36 Impairment of Assets explicitly requires tax cash flows to be excluded from the estimate of future cash flows used to calculate any impairment when applying value in use (VIU)

So should there be an immediate writedown of (part of) the goodwill? We consider this issue in detail in the following section.
3. Goodwill acquired with investment property businesses

In developing IFRS 3, the IASB observed that, when goodwill is measured as a residual amount, it may have the following components:

- **The fair value of the ‘going concern’ element of the acquiree.** The ‘going concern’ element represents the ability of the acquiree to earn a higher rate of return on an assembled collection of net assets than would be expected from those net assets operating separately. That value stems from the synergies of the net assets of the acquiree, as well as from other benefits, such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry.

- **The fair value of the expected synergies and other benefits from combining the acquiree’s net assets with those of the acquirer.** Those synergies and other benefits are unique to each business combination, and different combinations produce different synergies and, hence, different values.

- **Overpayments by the acquirer.**

- **Overvaluation of the consideration paid by the acquirer stemming from errors in valuing the consideration tendered.** Although the purchase price in an all-cash transaction would not be subject to measurement error, the same may not necessarily be said of a transaction involving the acquirer’s equity interests.

IFRS 3 does not address impairment created by measurement issues in accordance with an accounting standard. However, this was clearly addressed in the previous version of the standard. In the Basis for Conclusions to IFRS 3 (2007), it is noted that goodwill, measured as a residual, could include “… errors in measuring and recognising the fair value of either the cost of the business combination or the acquiree’s identifiable assets, liabilities or contingent liabilities, or a requirement in an accounting standard to measure those identifiable items at an amount that is not fair value” (our emphasis).¹ IFRS 3, of course, continues to have exceptions to the basic principle that assets and liabilities be measured at fair value and goodwill continues to reflect measurement differences.

For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's (groups of) cash-generating units (CGUs) that is expected to benefit from the synergies of the combination. This is irrespective of whether other assets or liabilities of the acquiree are assigned to those CGUs or groups of CGUs. Each CGU, or group of CGUs, to which the goodwill is so allocated must:

(a) Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes

(b) Not be larger, before aggregation, than an operating segment as defined by paragraph 5 of IFRS 8 Operating Segments

There are several reasons for goodwill arising on the acquisition of a property-owning business, which we will describe in the next sections.

¹ *IFRS 3 (2007) BC130.*
3.1 Goodwill created by synergies of the acquired portfolio and synergies of combining portfolios

Goodwill may be the result of unrecognised synergies in the existing portfolio, plus synergies that may be obtained when bringing the acquired properties into an existing portfolio, plus other factors.

**Cash generating units**

A goodwill impairment test cannot be carried out on goodwill alone, since goodwill does not generate cash flows independently of other assets. Testing goodwill for impairment first necessitates its allocation to the CGU, or group of CGUs, that are expected to benefit from the synergies of the combination.

A CGU is defined as 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. It is likely, therefore, that each individual property will be a CGU.

Each CGU, or group of CGUs, to which the goodwill is so allocated must:

(a) Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes

(b) Not be larger, before aggregation, than an operating segment as defined by paragraph 5 of IFRS 8 Operating Segments

However, it is also likely that the synergy benefits from the acquisition, that is reflected in the goodwill, would be beneficial both to the acquired and existing CGUs. If so, goodwill can also be (partially) allocated to, and supported by, the cash flows of CGUs owned by an investor before the business combination.

For a property investment entity, these synergies may be made up of:

- Synergies such as increased purchasing power of a larger group. For example, leading to lower maintenance and other direct costs per property, or the assembled management team in the acquired business and, perhaps, the anticipated abilities of the acquired management team to outperform the market

- Other factors, such as an anticipated ability to obtain portfolio premiums on a sale (if a large number of units can be sold together), a more advantageous geographical or sectoral spread of property that reduces portfolio risk and would increase the value of the portfolio as a whole upon sale; or an ability to both reduce transfer tax paid by potential purchasers and share in that saving due to the structure of the acquired business

The synergies described above are not typically included in the fair value of the individual investment property and are additional cash flows that would be included when determining the recoverable amount for (a group of) CGUs based on either value in use (VIU) or fair value less costs of disposal (FVLCD). The unit of account, as provided in IAS 40 Investment Property, is the individual property, which is not necessarily equal to the unit of account for goodwill impairment testing.
The fair value of an investment property is based on the requirements of IFRS 13 *Fair Value Measurement*. When determining fair value for an investment property, a valuer would generally not take account of cash flows arising from portfolio premiums, the expected achievement of rentals that exceed market rates or expected transfer tax savings in an assessment of fair value. Instead, a valuer is required to value properties individually, to assume that market rentals will be achieved at the end of the existing leases and to assume that transfer taxes will be paid at the full rate.

**Value in use**

IFRS requires the carrying amount of the group of CGUs (in this case, property) and related goodwill to be compared with the recoverable amount. The recoverable amount is the higher of VIU and FVLCD.

Both IAS 36 *Impairment of Assets* and IAS 40 use the principles in IFRS 13 to determine fair value. However, for goodwill impairment testing under IAS 36, the fair value of (a group of) CGUs needs to be determined, whereas IAS 40 determines fair value for an individual property. This difference in the unit of account may already be a reason for justifying goodwill.

Furthermore, estimating the VIU involves estimating the future cash inflows and outflows that will be derived from the use of the asset and its ultimate disposal, and discounting them at the appropriate rate, crucially the VIU calculation includes entity-specific synergies that are not included in a fair value calculation.

**3.2 Goodwill created by the requirement to measure identifiable items at an amount that is not fair value – typically deferred tax**

If deferred tax on temporary differences arising on net assets acquired in a business combination were measured at fair value, in many cases – due to the tax planning opportunities available in many jurisdictions and taking into consideration the time value of money – their fair value would likely be lower than their nominal amount. However, as noted earlier, IAS 12 requires provision to be made for all differences between the carrying value of assets and liabilities acquired in a business combination and their tax base at their nominal amount, irrespective of whether or not this will result in additional (or less) tax being paid or when any tax cash flows may occur.

This often leads to the recognition of additional goodwill. This is illustrated in the example in section 2 where CU10mn of goodwill is recognised in this way.

Whilst, as noted above, IAS 36 explicitly requires tax to be excluded from the estimate of future cash flows used to calculate impairments, it is our view that it cannot have been the intention of IAS 36 to require an immediate impairment of such goodwill generated by the recognition of deferred tax liabilities in excess of their fair value. In effect, this means that, on acquisition, the deferred tax liability in excess of its fair value may be offset against the goodwill and the net amount tested to determine whether that goodwill is impaired. Therefore, in the example, because the fair value of the deferred tax liability is CU30m, the goodwill tested for impairment would be CU50mn rather than CU60mn.

This is consistent with the view that goodwill can result from a measurement mismatch between two standards.
However, this offset approach can only be used when it is clear that the deferred tax liability arising from an acquisition of a business is in excess of the fair value of that deferred tax liability. The same logic and approach can be carried forward from day 1 to future impairment tests. An entity might not continue to make this adjustment if it becomes impracticable to identify reliably the related deferred tax, in which case, the entity would use VIU without this adjustment or use FVLCD as the recoverable amount for the group of CGUs.

Consequently, to the extent that the deferred tax liability in excess of the fair value of that liability (as determined at initial recognition of the goodwill) is reduced or eliminated, perhaps through a change in the tax circumstances of the entity, then the goodwill arising from the initial recognition of the provision may become impaired.

4. Conclusion

We believe that this common theme (which is not unique to property investment entities) can be approached within the current framework of IFRS and the immediate impairment of goodwill would generally not be required. In our view:

- It was not the intention of IFRS to require an immediate impairment of goodwill generated by the recognition of deferred tax liabilities in excess of the fair value of such liabilities.

- As a result of entity specific synergies, cash flows over and above those absorbed by the fair value of the investment properties may justify goodwill that was not created solely by the recognition of deferred tax liabilities when using a VIU approach.

- The unit of account for the impairment test is different from the unit of account when measuring properties. Therefore, there can be differences between the sum of the fair values of the properties and the fair value of (the group of) CGUs at which goodwill as tested.

- Goodwill solely arising from the difference between the fair value of deferred tax and the carrying amount of deferred tax may be excluded from the impairment analysis in certain situations.

Consequently, it will often be possible for entities to measure their investment property assets at fair value without being required to impair goodwill straight away.
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