

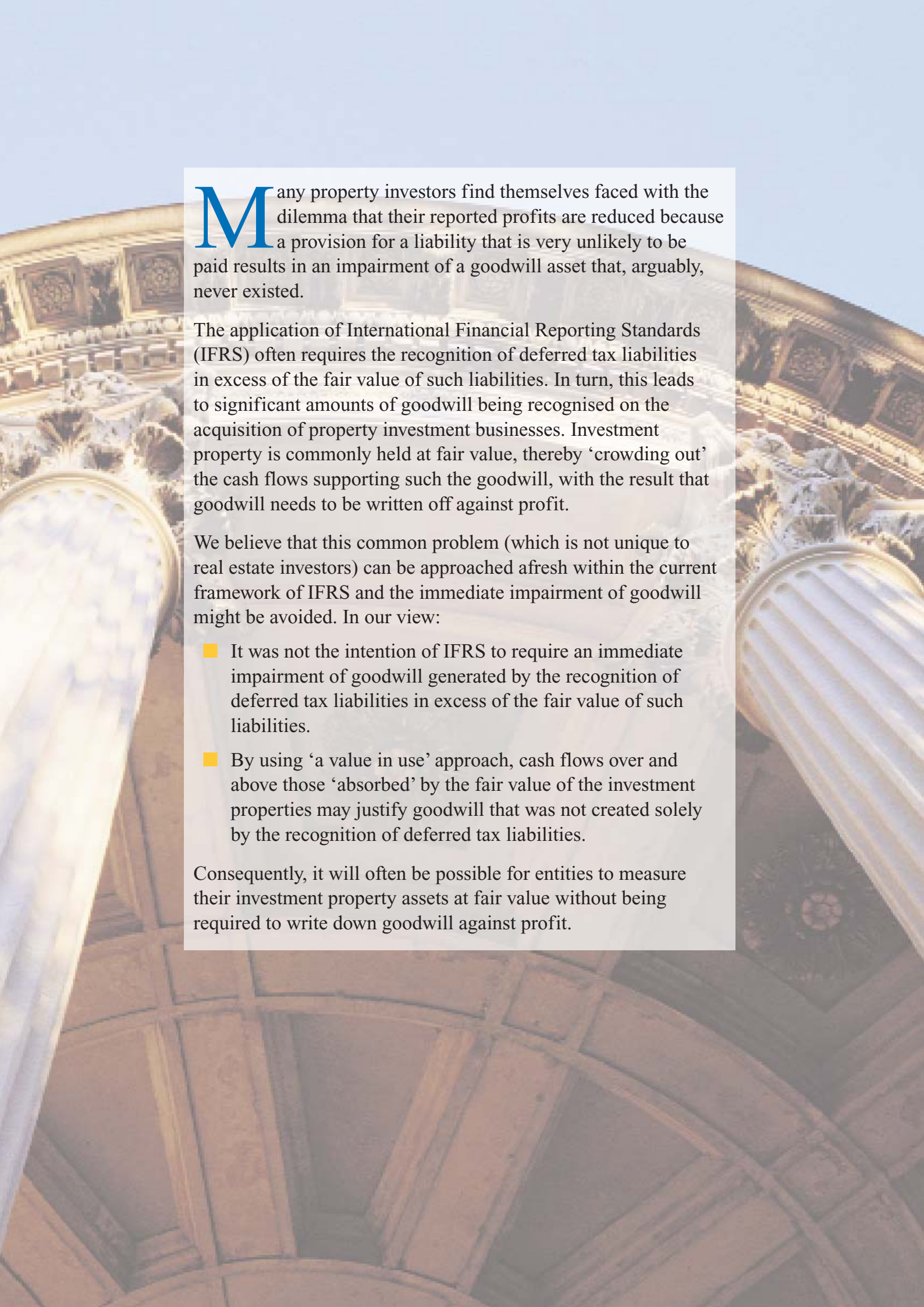


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Goodwill Hunting

Looking for property investors' missing profits



Many property investors find themselves faced with the dilemma that their reported profits are reduced because a provision for a liability that is very unlikely to be paid results in an impairment of a goodwill asset that, arguably, never existed.

The application of International Financial Reporting Standards (IFRS) often requires the recognition of deferred tax liabilities in excess of the fair value of such liabilities. In turn, this leads to significant amounts of goodwill being recognised on the acquisition of property investment businesses. Investment property is commonly held at fair value, thereby ‘crowding out’ the cash flows supporting such the goodwill, with the result that goodwill needs to be written off against profit.

We believe that this common problem (which is not unique to real estate investors) can be approached afresh within the current framework of IFRS and the immediate impairment of goodwill might be avoided. 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.
- By using ‘a value in use’ approach, 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.

Consequently, it will often be possible for entities to measure their investment property assets at fair value without being required to write down goodwill against profit.

Introduction

It is sometimes argued that property investor 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.

Under IFRS, this issue has become much more acute. On a business combination, deferred tax is provided in accordance with IAS 12 *Income Taxes* and this is usually far in excess of the fair value of the expected tax liability. As it is the fair value of the expected tax liability that is generally considered in setting the price for the business acquired, the requirements of IAS 12 tend to increase the amount of goodwill arising.

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 likelihood that more or less tax will be paid, or even the timing of any tax payments or receipts in the future.

In contrast, IFRS 3 *Business Combinations* requires a fair value approach for assets and liabilities apart from deferred tax – and a fair value calculation does take account of the likelihood and timing of cash flows.

In their 2006 financial statements, the UK property company, Land Securities PLC, described the issue succinctly:

“During the year, the Group acquired 100% of Tops Estates PLC. The fair value exercise gave rise to goodwill of £64.5m. Similarly, during the prior year the Group acquired a retail property portfolio from Slough Estates PLC. The fair value exercise gave rise to goodwill of £12.7m. The goodwill arises primarily from the difference between how deferred tax is calculated for accounting purposes and the value ascribed to it in negotiations. The former is based on the difference between the values of the assets and liabilities concerned for accounts purposes and those applying for taxation. The latter is based on tax payments likely to be made. In the Group’s opinion, the carrying amount of this goodwill cannot be justified by reference to future cash flows and it has, accordingly, been impaired.”

What is goodwill?

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 just a few properties will not be a business combination, rather it is an asset purchase. Even an acquisition of a company owning a large portfolio of properties may be an asset purchase. Each transaction must be judged on its own merits.

An illustration

The problem is best illustrated by way of an example:

Entity A, a property investor, which is taxed at 40%, acquires Entity B for €180m 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 (€m)	Tax base (€m)
Investment property	120	20
Other net assets	40	40

This will give rise to the following consolidation journal:

	(€m)	(€m)
Goodwill (balance)	60	
Investment property	120	
Other net assets	40	
Deferred tax ¹		40
Cost of investment		180

¹ 40% of ((€120m + €40m) - €60m)

The goodwill arising on the acquisition is €60m: this is made up of €40m arising solely from the recognition of deferred tax and €20m arising from the decision to acquire the business for more than the aggregate of the fair value of its net assets (excluding goodwill). For the purposes of this example, we have assumed that, due to tax planning opportunities, the entity does not expect to pay any of the tax implied by the deferred tax liability. For example, it is common in certain jurisdictions to achieve a lower or even zero tax charge on disposal of property by carrying that property in single asset companies and, upon a disposal, selling the shares of those companies. Consequently, for this illustration, the fair value of the liability is estimated to be negligible.

However:

- 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; and
- IAS 36 *Impairment of Assets* explicitly requires tax to be excluded from the estimate of future cash flows used to calculate any impairment.

So should there be an immediate writedown of the goodwill of €60m to zero? We consider this issue in detail below.

Goodwill acquired with investment property businesses

In developing IFRS 3, the IASB observed that, when goodwill is measured as a residual, 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.
- As the fair value of an employee workforce cannot be reliably measured, it is subsumed in goodwill.
- 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.

We now speculate why goodwill might arise on the acquisition of a property-owning business.

(a) 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 cash-generating unit (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. 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 properties. If so, goodwill can be allocated to, and supported by, the cash flows of all of the properties owned by an investor after an acquisition.

For a property company, these 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; and
- 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 investment property and are additional cash flows that might be included in a Value in Use (VIU) cash flow forecast.

Furthermore, 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 generally 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 'value in use' (VIU) and fair value less costs to sell.

IAS 36 *Impairment of Assets* would require the fair value of a group of investment properties to be calculated in the same way as it would for the purposes of IAS 40 *Investment Property* and IFRS 3, making it unlikely that such a fair value calculation will justify goodwill.

However, whilst estimating a VIU also 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 a VIU calculation may allow some future cash flows to be considered that a fair value calculation may not.

Therefore, the additional value that is expected to be realised from the portfolio acquired over and above the sum of the individual fair values of the assets, plus any additional value that can be derived from the existing portfolio as a result of the acquisition, might feature in the VIU calculation.

(b) Goodwill created by overpayments or errors in fair value measurement

Goodwill created by overpayments or errors will inevitably be exposed and written off in the impairment test process.

(c) 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—its fair value may be negligible or even zero. 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, irrespective of both whether or not this will result in additional (or less) tax being paid and when any tax cash flows may occur.

This often leads to the recognition of additional goodwill. This is illustrated in the example where some €40m 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 any impairment, 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. Rather, the post-tax discount rate needs to be adjusted in order to determine the appropriate pre-tax discount rate. 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 approximately zero, the goodwill tested for impairment would be €20m rather than €60m.

This is consistent with a view that goodwill can result from a measurement mismatch between two standards. The IASB acknowledged this can happen when, as noted above, it observed that goodwill 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”.

However, this offset approach can be used only 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 liability.

It should be possible to continue to apply the above approach when testing the goodwill for impairment in subsequent years, but the entity will need to be able to track the deferred tax liability. Consequently, to the extent that the deferred tax liability in excess of the fair value of that liability 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.

Conclusion

A literal interpretation of IFRS gives the anomalous result of reducing profits because significant goodwill balances are seen to be impaired. Whilst some property investment entities may still validly adopt this ‘write-off’ approach, we would urge entities to consider this treatment afresh and consider, as outlined above, whether this is necessary within the current framework of IFRS.

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