Implications of the IFRS goodwill accounting treatment

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IMPLICATIONS OF THE IFRS GOODWILL ACCOUNTING TREATMENT

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IMPLICATIONS OF THE IFRS GOODWILL ACCOUNTING TREATMENT

Purpose – This paper critically examines the change in accounting treatment for goodwill pursuant to international financial reporting standards (IFRSs) by reference to the Australian reporting regime.

Methodology/approach – The paper discusses and compares the former Australian and the new IFRS treatments for goodwill. This comparison focuses on the advantages and potential complexities of the new method, with the aim of identifying the issues and challenges that preparers, independent auditors and those involved in corporate governance face in complying with the new requirements.

Findings – The paper highlights that the identification and valuation of cash-generating units and goodwill require numerous assumptions to be made in estimating fair value, value in use and recoverable amount. Considerable ambiguity and subjectivity is inherent in the IFRS requirements.

Research implications: – Findings suggest that future research should examine how financial report preparers and corporate governance mechanisms are dealing with the complex change required by the new goodwill accounting treatment and how the many critical issues involved in auditing the resulting figures are being addressed.

Practical implications: – The research has practical implications for financial report preparers in identifying the issues that must be addressed in complying with the international goodwill accounting treatment. In turn, the paper highlights conceptual issues of relevance to auditors in their role of providing assurance on the resulting accounting numbers. It also has implications for others involved in corporate governance, such as audit committee members, in emphasising the areas in which they should be providing oversight of the accounting judgments. These issues are of relevance in any reporting regime based on IFRSs.

Originality/value – While much has been written about the mechanics of the new goodwill accounting requirements, there has been a lack of critical research highlighting the many problems and ambiguities that will arise in the application of those rules.

Key words – goodwill, impairment testing, cash-generating units, international financial reporting standards

Paper type: Conceptual paper
Introduction

The Financial Reporting Council (FRC) in 2002 formalised its support for the Australian adoption of international financial reporting standards (IFRSs) from 1 January 2005 (Financial Reporting Council, 2002). The move to international standards has highlighted that goodwill accounting continues to represent a controversial issue (Alfredson, 2001). The accounting treatment for goodwill has challenged financial report preparers and standard setters for decades, and has been the focus of extensive lobbying, principally by financial report preparers (Gowthorpe and Amat, 2005).

Accounting for goodwill changed in Australia from 1 January 2005 through the combined effects of the new internationalised Australian financial reporting standards AASB 3 Business Combinations and AASB 136 Impairment of Assets[1]. Goodwill acquired in a business combination will no longer be amortised but will be tested for impairment annually or whenever events or circumstances indicate its value may have been impaired (AASB 3, para.55). Pursuant to the new IFRS treatment, the carrying amount of goodwill must be written down to the extent of any impairment and the impairment loss recognised in the calculation of profit (AASB 136, para.60). This compares to the previous accounting treatment of systematic amortisation over a maximum 20 year period (AASB 1013, para.5.2). The previous standard did require the carrying value of goodwill to be reviewed at each reporting date and written down to the extent that future benefits were no longer probable (AASB 1013, para.5.4). However, this requirement was not as critical as the impairment testing required under the new rules, given that goodwill...
balances were previously subject to mandatory amortisation and therefore completely written off over a period of time.

To enhance relevance, Schipper (2003, p.64) agrees that goodwill should be recognised at the date of a business combination and be subject to periodic impairment testing rather than automatic amortisation. Further, the qualitative characteristic of “relevance” implies that the acquired assets and liabilities, including goodwill, should be recorded at fair values on the date of acquisition (Schipper, 2003). Nevertheless, the new treatment of goodwill is fraught with subjectivity and ambiguity for financial report preparers and auditors, and potentially has serious impacts on financial reports. For example, the introduction of the requirement for more explicit estimates of fair values subsequent to initial acquisition may introduce increased uncertainty and a lessening of transparency, as the new reporting regime will rely on increased professional judgment by preparers and auditors. Specifically, company management, in collaboration with the accounting profession, will need to use their valuation and measurement expertise and skills to estimate fair values rather than refer to verifiable transaction amounts. By replacing the amortisation of goodwill with impairment testing relying on fair value estimates, further opportunity for creative earnings management at the individual company level may have been established (Gowthorpe and Amat, 2005).

This paper commences with a discussion of the recognition, measurement and valuation of goodwill and the associated difficulties for preparers in assigning “fair values” to assets and liabilities. This is followed by an examination of the former Australian and new IFRS policies for goodwill using an illustrative example and highlighting the
subjective aspects of the new standard. The paper then discusses the various implications for financial report preparers, auditors and corporate governance.

**Recognition, measurement and valuation of goodwill**

According to Nethercott and Hanlon (2002), the future benefits that stem from an efficient and effective organisation, including market penetration and superior operating teams, represent unidentifiable assets. Goodwill is defined in AASB 3 (Appendix A) as “future economic benefits arising from assets that are not capable of being individually identified and separately recognised.” Goodwill can only be recognised when an entity has acquired another entity or part thereof, as goodwill cannot be purchased or sold as a separate item (Hoggett and Edwards, 2000). Goodwill recognition requires the valuation of all identifiable assets, both tangible and intangible, at fair value (Nethercott and Hanlon, 2002). Goodwill then becomes a balancing item, the difference between the purchase consideration given (cost of the business combination) and the fair value of the identifiable net assets acquired.

Fair value is defined in Australian and international financial reporting standards as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction” (see, for example, AASB 3, Appendix A). Unfortunately, determination of the fair value of an asset in individual situations is not always straightforward. Horton and Macve (2000) believe that fair value appeals to standard setters as holding out the promise of an “objective” way of resolving the problems of reporting financial position and financial performance. Further, they argue that the fair value concept has been elevated to a “catch-all” concept in an
attempt to resolve measurement issues objectively. This is despite the fact that it is often estimates of fair value, based on subjective assumptions and judgment, which form the basis for numbers entered into the accounting reporting system.

When capital markets are not perfect or are incomplete and the fair value concept is ambiguous with respect to measurement and valuation, it is possible in individual situations that several fair values could exist (Barth and Landsman, 1995; Bradbury, 2000). In incomplete market settings, the alternative fair value constructs of entry value (replacement cost), exit value (market/liquidation value) and value-in-use (earnings capitalisation/present value of future cash flows) are likely to differ (Beaver, 1981; Barth and Landsman, 1995). Consequently, measurement error in fair value estimates can exist, affecting their relevance and reliability. The application of fair value concepts to the determination of goodwill can result in wide variations in valuation depending on the assumptions inherent in the various calculations required.

**Superseded Australian accounting treatment for goodwill**

Prior to the adoption of IFRSs, the Australian accounting treatment for goodwill was specified in accounting standards AASB 1013 *Accounting for Goodwill* and AAS 18 *Accounting for Goodwill* (AASB 1996, AARF 1996)[2]. Goodwill was defined within these standards as “future benefits from unidentifiable assets” (para.13.1). The standard explained that these future benefits, because of their nature, were not normally individually recognised, with examples of these unidentifiable assets being market penetration, effective advertising, good labour relations and a superior operating team (para.5.1.1). The main aspects of the superseded accounting treatment were that only
purchased and not internally generated goodwill could be recognised (para.4.1), that
goodwill was to be measured as the excess of the cost of acquisition over the fair value of
the identifiable net assets acquired (para.5.7), and that goodwill was to be amortised to an
expense account on a straight-line basis over the period of time, not exceeding 20 years,
during which benefits were expected to arise (para.5.2). This superseded accounting
treatment is illustrated in the following example.

**Illustrative example:**

Assume that A Ltd purchased the net assets of B Ltd for cash consideration of $800 000
on 30 June 20X1. The identifiable net assets acquired, valued at fair value at the date of
acquisition, comprised the following, with goodwill being calculated as the excess of the
cost of acquisition over the fair value of the net assets acquired:

<table>
<thead>
<tr>
<th>Assets acquired:</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on deposit</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>75,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Land and buildings</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>Patents and trademarks</td>
<td>100,000</td>
<td>905,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>905,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities acquired:</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>65,000</td>
<td></td>
</tr>
<tr>
<td>Bank loan</td>
<td>140,000</td>
<td>205,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>205,000</strong></td>
<td><strong>205,000</strong></td>
</tr>
</tbody>
</table>

Net assets acquired (at fair value) | 700,000

Cost of acquisition | 800,000

Goodwill | 100,000

The difference between the acquisition cost ($800,000) and the net assets acquired
($700,000) amounts to $100,000. Pursuant to the superseded AASB 1013 treatment, this
amount would be recorded in A Ltd’s books as goodwill, a non-current asset (para. 5.1). This asset is essentially a balancing item resulting from the acquiring entity paying $100,000 more than the fair value of the identifiable net assets acquired.

AASB 1013 required purchased goodwill to be amortised as an expense against profit and loss on a straight-line basis over the period of time during which benefits were expected to arise, subject to a maximum amortisation period of 20 years (para. 5.2). The treatment prescribing straight-line amortisation was introduced in June 1996 to prevent companies employing amortisation methods such as the inverted sum of the years’ digits method, under which a smaller portion of goodwill was amortised in the earlier years to lessen the impact on reported net profit (Gaffikin et al., 2001, p106)[3]. AASB 1013 also required the unamortised balance of goodwill to be reviewed at each reporting date and expensed against profit to the extent that future benefits were no longer probable (para. 5.4).

Implications of the AASB 1013 Treatment

Probably the most controversial aspect of the AASB 1013 treatment of goodwill was the amortisation period. Lamond (1995, p.68) argues that “there is no explanation for the magical 20 year selection of the maximum amortisation period for goodwill in Australia.” Australian based companies were potentially disadvantaged in comparison to overseas companies not subject to a 20 year maximum amortisation period. Nobes and Parker (2000) highlight this as a potential for competitive disadvantage. Further, it is feasible that goodwill that arose from an acquisition could still be wholly or partly intact after 20 years, although the AASB 1013 treatment would result in a nil balance for goodwill by that time given that revaluations of goodwill were not permitted.
Johnson and Tearney (1993) identified the following problems caused by the former AASB 1013 requirements for Australian companies with respect to international reporting comparability:

- When competing for foreign business acquisitions, Australian companies are penalised due to lower reported post-combination earnings;
- Capitalisation of goodwill and subsequent amortisation are arbitrary and understate net profit; and
- The goodwill account includes any errors, both positive and negative, made when identifying and valuing other assets and liabilities at acquisition date.

On the other hand, due to the requirement for periodic amortisation, goodwill could not be capitalised indefinitely, reducing the possibility for creative accounting in this respect. While there was some scope for creative accounting with the AASB 1013 treatment, for example by using goodwill write-offs for profit smoothing or “big bath” purposes, it is suggested that the new IFRS treatment has potentially many more avenues for preparers to be creative.

**IFRS goodwill accounting treatment**

The IFRS goodwill accounting treatment is now prescribed in Australia’s AASB 3 *Business Combinations* and AASB 136 *Impairment of Assets*. Pursuant to these standards, goodwill acquired in a business combination is not to be amortised but will be tested for impairment annually or whenever events or circumstances indicate its value may have been impaired (AASB 3, para.55). The carrying amount of goodwill will then be written down to the extent of any impairment and the impairment loss recognised in the calculation of net profit (AASB 136, para.60). Pursuant to this accounting treatment,
an asset is considered to have been impaired if its carrying amount exceeds its “recoverable amount” (AASB 136, para.8).

The initial carrying amount of goodwill under the IFRS accounting treatment is arrived at in basically the same way as under AASB 1013, but with one notable exception. While goodwill is still the balancing item between the cost of acquisition and the fair value of the identifiable net assets acquired, AASB 3 (para.36) requires contingent liabilities of the acquiree to be included when considering the identifiable net assets acquired. These contingent liabilities are to be recognised at their fair values at the acquisition date. This is in stark contrast to the superseded AASB 1044 *Provisions, Contingent Liabilities and Contingent Assets*, which previously prohibited the recognition of contingent liabilities (para.7.1). It also represents an exception to the rules expressed in the revised IFRS based Australian financial reporting standard, AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*, which prohibits the recognition of contingent liabilities in normal circumstances (para.27)[4].

Hence, returning to the earlier example where A Ltd purchased the net assets of B Ltd for $800,000, assume that B Ltd at acquisition date had contingent liabilities in the form of potential legal liability claims and potential indemnities/performance guarantees. Further, assume that in accordance with AASB 3 (para.37) these contingencies were assessed as having a reliably measured fair value of $50 000 each. In this situation, goodwill will be initially valued at $200 000 pursuant to AASB 3 rather than at $100 000 pursuant to the superseded AASB 1013. This is calculated as follows:
Assets acquired:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on deposit</td>
<td>$30,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$75,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$100,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>$200,000</td>
</tr>
<tr>
<td>Land and buildings</td>
<td>$400,000</td>
</tr>
<tr>
<td>Patents and trademarks</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$905,000</strong></td>
</tr>
</tbody>
</table>

Liabilities acquired:

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$65,000</td>
</tr>
<tr>
<td>Bank loan</td>
<td>$140,000</td>
</tr>
<tr>
<td>Provision for legal liabilities</td>
<td>$50,000</td>
</tr>
<tr>
<td>Provision for indemnities/performance guarantees</td>
<td>$50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$305,000</strong></td>
</tr>
</tbody>
</table>

Net assets acquired (at fair value)            | $600,000 |

Purchase consideration                        | $800,000 |

Goodwill                                       | $200,000 |

The above example highlights that, where contingent liabilities of the acquired entity or operation are recognised, higher initial values for goodwill will be recorded pursuant to the IFRS based AASB 3 in comparison to the superseded AASB 1013. More on this issue will be discussed later.

Once goodwill is initially recognised, the AASB 136 accounting treatment requires entities to subsequently consider whether the value of that goodwill has been impaired. An impairment loss is recognised for an asset when its carrying amount exceeds its recoverable amount (para.59). If no impairment loss is to be recognised, the goodwill balance remains unaltered in the entity’s balance sheet from year to year.

A problem in determining whether goodwill has been impaired stems from the fact that goodwill does not produce profit in isolation. Rather, the profit is produced from a parcel
or package of net assets of which goodwill is the residual and not capable of separate identification. In circumstances where it is not possible for the recoverable amount of an individual asset to be estimated, this being the case with goodwill, AASB 136 requires the “cash-generating unit” to which that asset relates to be identified (para.66). A cash-generating unit 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” (para.6). With respect to goodwill, cash-generating units represent “the lowest level within the entity at which the goodwill is monitored for internal management purposes” (para.80(a)). Further, the cash-generating unit should not be larger than a primary or secondary segment determined in accordance with AASB 114 Segment Reporting (para.80(b)).

In summary, goodwill acquired in a business combination is allocated to cash-generating units and an impairment loss is recognised for that unit if its recoverable amount is less than its carrying amount. The carrying amount for a cash-generating unit is represented by the carrying value of the individual assets (including goodwill) and applicable liabilities pertaining to that unit[5].

Hence, a key starting point is to determine the recoverable amount of the cash-generating unit to which the goodwill relates. Recoverable amount is defined as the higher of the cash-generating unit’s “fair value less costs to sell and its value in use” (AASB 136, para.6). Fair value less costs to sell is defined as “the amount obtainable from the sale of an asset or cash-generating unit in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal”, while value in use is defined as “the present
value of the future cash flows expected to be derived from an asset or cash-generating unit” (para.6).

If recognition of an impairment loss is required (that is, where the carrying amount of the cash-generating unit’s net assets exceeds the unit’s recoverable amount), that loss is firstly written off against the value of the goodwill allocated to that cash-generating unit (para.104) and cannot be reversed in a subsequent reporting period (para.124). If the amount of the impairment loss exceeds the carrying amount of the goodwill, the excess is allocated to other assets of the unit on a pro-rata basis based on their carrying amounts (para.104).

In summary, the following steps outline the process involved in recognising an impairment loss on goodwill:

**Step 1:** Ascertain the recoverable amount of the relevant cash-generating unit. The recoverable amount is the higher of the unit’s a) fair value less costs to sell, and b) value in use (net present value of the estimated future net cash inflows).

**Step 2:** Determine the carrying amount of the net assets (including goodwill) of the relevant cash-generating unit. If the carrying amount exceeds the recoverable amount, an impairment loss must be recognised.

**Step 3:** Reduce the carrying amount of goodwill by the amount of the impairment loss. If the amount of the impairment loss exceeds the carrying amount of goodwill, the excess should be written off against other assets of the unit on a pro-rata basis. The impairment loss is recognised in the calculation of profit or loss except to the extent it represents a reversal of a previous revaluation increment for which the revaluation reserve still exists in the accounts.

To illustrate the above process, and extending the earlier illustrative example, assume that at 30 June 20X6 (five years after acquisition) the net assets acquired by A Ltd have been
held within a single division that represents a single cash-generating unit. Further, assume that no impairment losses have been recognised in the period since acquisition and that, at 30 June 20X6, the carrying amounts of the assets and liabilities of the division are as follows:

<table>
<thead>
<tr>
<th>Assets:</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on deposit</td>
<td>33,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>70,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>98,000</td>
<td></td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>195,000</td>
<td></td>
</tr>
<tr>
<td>Land and buildings</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>Patents and trademarks</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>200,000</td>
<td>1,096,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>68,000</td>
<td></td>
</tr>
<tr>
<td>Bank loan</td>
<td>138,000</td>
<td>206,000</td>
</tr>
</tbody>
</table>

Carrying amount of cash-generating units net identifiable assets 890,000

The directors of A Ltd estimated that, at 30 June 20X6, the “fair value less costs to sell” (net market value) of the cash-generating unit amounts to $800,000, while the value in use of the division (net present value of the estimated net cash inflows) is $850,000. The “recoverable amount” of the division (cash-generating unit) is the higher of these two values and therefore amounts to $850,000.

Accordingly, as the recoverable amount of the cash-generating unit ($850,000) is less than the carrying amount of the unit’s net assets ($890,000), a $40,000 impairment loss on goodwill must be recorded. This is recorded by the following journal entry:

DR Goodwill Impairment Loss $ 40,000
CR Accumulated Impairment Losses- Goodwill $ 40,000
In the balance sheet, goodwill would be disclosed as follows:

<table>
<thead>
<tr>
<th>Non-current assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>Less: Accumulated Impairment Losses</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 160,000</strong></td>
</tr>
</tbody>
</table>

**Advantages of the new treatment of goodwill**

There are a number of claimed advantages for the new IFRS based goodwill accounting treatment. First, the underlying logic for removing the traditional amortisation method is that amortisation on a straight-line basis over a set number of years contains no information value for those using financial reports (Ravlic, 2003). In comparison, Donnelly and Keys (2002) argue that the goodwill impairment test will be operational and will adequately capture any decline in the value of goodwill in a more meaningful manner than the previous accounting treatment.

Second, it has been claimed that the new treatment satisfies the need for analysts and the other users of financial statements for better information about intangible assets. It does not require goodwill to be automatically written down irrespective of the individual situation (Colquitt and Wilson, 2002).

Third, an advantage over the amortisation method relates to time period estimation. An estimate of the useful life of goodwill becomes less reliable as the length of the useful life increases (Waxman, 2001). The IFRS based standard’s impairment testing accounting policy moves away from an arbitrary assessment of useful life.
Potential difficulties with the new goodwill accounting method

Despite the claimed benefits of the new goodwill accounting method, it is fraught with subjectivity and ambiguity that will have serious implications in a number of critical areas. In fact, the new IFRS treatment introduces considerable scope for uncertainty and therefore creative accounting. General difficulties with the new goodwill accounting treatment are outlined in this section, while challenges for auditors specifically and for corporate governance generally are discussed in subsequent sections.

The first potential difficulty relates to identifying cash-generating units. The identification of a cash-generating unit could be difficult in cases where a company has acquired another entity and the latter consists of a number of separate subsidiaries, divisions and/or branches. Should the cash-generating unit be identified as the complete initial entity purchased or should a number of sub-units be identified?

As an example, consider the simple situation where an acquired entity has separate manufacturing units in two states, say New South Wales and Queensland. Assume further that the New South Wales manufacturing unit has “overvalued” goodwill of $50,000 (that is, carrying value exceeds recoverable amount by $50,000) and the Queensland manufacturing unit has “undervalued” goodwill of $50,000. If the cash-generating units were to be considered at the individual state level, a goodwill impairment loss of $50,000 would need to be recorded for the New South Wales manufacturing unit. The Queensland unit could not revalue its goodwill upwards by $50,000 as this would be considered by financial reporting standards to represent the recognition of internally generated goodwill (AASB 136, para.125; AASB 138, paras 48-50).
However, if the manufacturing units in both states combined were considered to represent a single cash-generating unit, goodwill for the combined New South Wales and Queensland units would not be overvalued and therefore no goodwill impairment loss would need to be recorded. For this reason, company management may have incentives to identify cash-generating units at as high a level as possible within the AASB 136 definition.

AASB 136 does specify that cash-generating units should not be larger than segments determined in accordance with AASB 114 Segment Reporting (para.80). However, prior research indicates that the latitude provided with respect to segment identification has resulted in great diversity in practice, particularly given the proprietary or competitive costs of such disclosures (see, for example, Rennie and Emmanuel, 1992; Edwards, 1995; Edwards and Smith, 1996; Wines, 1997; Emmanuel et al., 1999; Doupnik and Seese, 2001). Given the scope available for the identification of segments and the potential competitive costs associated with segment disclosures, segments identified for financial reporting purposes tend to be at relatively broad levels. These levels would generally be at aggregations considerably above the individual cash-generating unit level.

Further potential difficulties arise with the overlap between the identification of cash-generating units and the assessment of the recoverable amount of the unit. Determining recoverable amount involves calculating fair value less costs to sell and value in use of the unit. However, the identification of the initial cash-generating unit/units could have a strong bearing on those calculations. For example, if a cash-generating unit was identified at the level of a subsidiary company, the recoverable amount of that subsidiary might be estimated with relative ease. However, if that subsidiary was broken down into a number
of individual cash-generating units, the estimation of the fair value less costs to sell for each of the units could be extremely subjective to estimate. Similarly, the calculation of the net present value for each of the individual cash-generating units becomes far more complex, and can therefore become subject to much ambiguity, interpretation and management discretion. The estimation of the present value of net cash inflows could also vary dramatically depending on the underlying assumptions employed about discount rates and future time periods. The difficulties in assessing the recoverable amount of an individual asset and in estimating future cash inflows of independent assets, and the subjectively in the identification of a cash-generating unit, imply that the process is open to abuse (Cearns, 1999).

As recoverable amount is calculated as the higher of a cash-generating unit’s fair value less cost to sell and value in use, the many assumptions adopted in the various calculations required become critical. For example, how objective is determination of the fair value of a cash-generating unit based on a “hypothetical” sale between knowledgeable willing parties in an arm’s length transaction if the unit represents a unique facility? Similarly, an estimate of value in use can be maximised by estimating annual cash flows and salvage value of the cash-generating unit at the maximum amount possible and adopting the lowest possible discount rate.

An associated concern stemming from the above difficulties relates to cost and time issues. Conducting a detailed impairment test on every applicable asset and associated goodwill at the end of each reporting period will, in many cases, be time consuming and costly (McGreachin, 1997; Rockness et al., 2001). For this reason, company management
will have incentives to recognise cash generating units at as high a level of aggregation as possible.

The goodwill accounting treatment will also make little, if any, difference to inter-company comparability. It has been argued that comparability could well be reduced in industries with heterogeneous companies (that is, in terms of company age and growth style). For example, companies that grew without acquisitions will have long lived assets at depreciated values in their accounts, while companies that grew primarily through acquisition will have assets recorded at current values (Rockness et al., 2001).

In summary, there is much scope for creative accounting given the manner in which the new goodwill accounting treatment has been operationalised. It may well be that goodwill will remain on balance sheets and that reported profits will not be significantly affected by impairment losses over time. Management will certainly have financial reporting incentives not to record impairment losses if possible.

Auditing challenges

The transition to the AASB 136 goodwill accounting treatment will present challenges for auditors of financial reports. As noted earlier, goodwill will no longer be routinely amortised but will be assigned to an entity’s cash-generating units and tested for impairment annually or whenever circumstances indicate its value may have been impaired. With respect to auditing fair value information, Australian Auditing and Assurance Standard AUS 526 Auditing Fair Value Measurements and Disclosures, based on International Standard on Auditing ISA 545, provides specific guidance for fair value
issues, while AUS 516 *Audit of Accounting Estimates*, based on international standard ISA 540, provides further general guidance (AUS 526.05).

AUS 526.08 states that the “measurement of fair value may be relatively simple for certain assets or liabilities”, citing the example of “assets that are bought and sold in active and open markets that provide readily available and reliable information on the prices at which actual exchanges occur.” However, AUS 526 specifically recognises that the measurement of fair value for other assets or liabilities may be more complex, particularly where the asset “may not have an active market or may possess characteristics that make it necessary for management to estimate its fair value” (AUS 526.08). The notion of the simple market exchange process would often not apply to business combinations, and therefore the associated areas of goodwill, cash-generating units and impairment testing are precisely within the “more complex” arena envisaged by AUS 526.

Potential problems for auditors will commence with the initial entries recording a business combination. The assignment of fair values to the identifiable net assets acquired determines the amount of goodwill or discount on acquisition, given that goodwill/discount on acquisition is the difference between the fair value of the identifiable net assets acquired and the cost of the business combination. However, with respect to the initial recording of a business combination, the new AASB 3 introduces two major possibilities for uncertainty and creative accounting that did not exist under the previous accounting treatments for asset acquisitions and goodwill.
The first possibility for additional uncertainty and creative accounting relates to the recognition of contingent liabilities. It was noted earlier that, where contingent liabilities of the acquired entity or acquired operation are recognised, higher initial values for goodwill will be recorded pursuant to the new IFRS treatment in comparison to the amounts that would have been recognised under the superseded AASB 1013. In the case of business combinations, the recognition criterion for any contingent liability is solely that the fair value of that contingent liability can be measured reliably (AASB 3, para.37). In the context of the initial business combination accounting entry in which a contingent liability is recognised, and in contrast to the situation for liabilities generally, there is no requirement for any “probable” outflow of resources to settle the contingent liability. For recognition of liabilities generally, an outflow of resources or other event is regarded as probable if “the event is more likely than not to occur, that is, the probability that the event will occur is greater than the probability that it will not” (AASB 137, para.23). However, a contingent liability can be recognised for a business combination solely if its fair value can be measured reliably, even though the probability of the contingency arising might be less than 50 percent.

The potential difficulty for auditors is clear. Company directors will, pursuant to the revised accounting treatment, be able to recognise a host of contingent liabilities that were not previously allowable, including potentially for such items as future reconstruction and reorganisation expenses, future maintenance and the like. This will increase the amount of goodwill appearing in the accounts that will not be subject to an automatic annual amortisation policy. Applicable future expenses can then be written off.
against the contingent liability account initially created rather than directly through profit and loss.

A second potential problem relates to the revised treatment for discount on acquisition. Discount on acquisition (negative goodwill) arises when the cost of acquisition is less than the fair value of the net identifiable assets acquired, effectively representing a “bargain purchase”. Under the superseded AASB 1013, any discount on acquisition was accounted for by reducing proportionately the fair values of the non-monetary assets acquired (AASB 1013, para.8.1). However, pursuant to the revised AASB 3, the acquirer in such circumstances is required to firstly reassess the identification and measurement of the acquiree’s identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination (AASB 3, para.56(a)). Any discount on acquisition remaining after such reassessment is recognised immediately in profit and loss (para.56(b)). Hence, in comparison to the former AASB 1013, there is a potential reporting incentive for company directors to assess the fair values of identifiable assets at maximum values. This will maximise any discount on acquisition, which can then be recognised immediately in profit and loss.

Auditors will not only have to deal with the unexpected complexities and ambiguities regarding the assignment of fair value. Auditors will have to verify identification of cash-generating units, calculation of the estimated selling price of the unit, and calculation of the value in use of the cash generating unit based on estimates of discounted cash flows. Hence, all the complexities involved in confirming the level at which cash-generating units should be recognised, estimating a “hypothetical” market transaction and in
estimating bet cash inflows, residual values and discount rates will result in great scope for disagreement between auditors and financial report preparers.

In 2001, the United States introduced a similar impairment testing system. The American Institute of Certified Public Accountants (AICPA) suggests that the audit of business combinations and associated goodwill and other intangible assets is complex, costly and time-consuming, as many of the audit objectives require considerable substantive testing to substantiate the valuation of goodwill (see AICPA, 2003, pp.57-77). Moreover, if a company’s reported earnings are to be reduced significantly, perhaps even resulting in a reported loss as a result of goodwill write downs, the new accounting treatment is vulnerable to manipulation and creative accounting, particularly by management who might desire a more favourable outcome for compensation and/or market considerations as suggested by agency theory (Gowthorpe and Amat, 2005). There is considerable possibility for tension between auditors and company management given the ambiguity and subjectivity inherent in the valuation of goodwill and in the determination of whether, and to what extent, any impairment loss should be recorded.

Audit, corporate governance and management oversight

AUS 526 indicates that management is responsible for making the fair value measurements included in the financial statements, and that fair value measurements are inherently imprecise. Consistent with Beaver (1981), AUS 526 highlights that alternative valuation methods, such as replacement cost, market value and discounted cash flow approaches, might be used by management in determining fair value (AUS 526.41). Hence, alternative measurement constructs are available to operationalise the fair value
concept in individual situations. This can result in uncertainty, ambiguity and scope for creative accounting. In addition to prescribing annual impairment testing, the new standard requires an entity to test goodwill for impairment between annual tests if events arise or circumstances change that would likely reduce the fair value below carrying amount. Further, auditors will have to ensure sufficient, competent and verifiable evidence is obtained to provide a basis for their conclusion that the estimated value management has assigned to goodwill is “fair”, reasonable and supportable. For example, an audit objective in an AICPA suggested audit program for goodwill valuation relates to the evaluation of goodwill accounting policies, with the auditor required to:

Assess management’s or third party’s capabilities to perform appropriate valuations and the process and assumptions used by management to develop fair values... Also determine whether the audit team has sufficient knowledge and experience to review evaluations, including underlying methods and assumptions. (AICPA, 2003, p.67)[6]

AUS 526 requires the auditor’s professional judgment for the tasks of not only assessing management’s capabilities but also assessing the audit team’s ability to evaluate whether management can perform appropriate valuations and assumptions to determine fair values. The valuation of goodwill and any goodwill impairment recognition relies on the integrity of the auditor client-management relationship, where management has ultimate responsibility for the assumptions used in the valuation methods. Where goodwill is reported, the many assumptions and complex calculations that would have been used to calculate its value are not transparent in the financial statements. The audit and associated corporate governance oversight involves the auditor’s professional judgment and management’s integrity. How management makes assumptions about goodwill valuations, and how auditors exercise their professional judgment about those
assumptions, are not transparent to external users, and hence a strong corporate governance system is required.

AUS 526.65 suggests that with respect to communicating with management, auditors refer to AUS 710 Communicating with Management on Matters Arising from an Audit. AUS 710.03 notes that an auditor uses professional judgment to a) evaluate the significance of individual matters that may need to be communicated to management and b) to determine the appropriate level of management with whom to communicate and the appropriate method of communication. The International Standard on Auditing on which AUS 710 is based, ISA 260 Communication with Those Charged with Governance, highlights that the diversity of corporate governance models globally is such that auditors should use professional judgment to “determine those persons with whom audit matters of governance interest are communicated”, with particular reference to the audit committee (ISA 260.06). Currently, while there is a considerable amount of guidance available, especially for listed companies (see, for example, ASX Corporate Governance Council 2003), audit committees and their composition are not mandatory for Australian companies generally. Furthermore, corporate governance mechanisms involving board appointments, as well as the various board sub-committee responsibilities and composition, are largely self-regulated and lack transparency. Hence, the critical issue is whether corporate governance mechanisms will result in effective and independent oversight of managements’ knowledge and economic power regarding the goodwill valuation process.

This is particularly an issue for individual members of company audit committees who, among other responsibilities, need to evaluate processes supporting external reporting. As
an example of this responsibility, the corporate governance principles of the Australian Stock Exchange require the audit committee to report to the company’s board on matters relevant to the committee’s role and responsibilities. This includes reporting on an assessment of management processes supporting external reporting (ASX Corporate Governance Council, 2003, Recommendation 4.4, p.32). This presumably encompasses an evaluation of the various assumptions and bases for calculations and valuations employed in deriving significant financial report balances. This is of obvious relevance to the valuation of goodwill and the determination of the amount of any required goodwill impairment write-down. The requirement for the evaluation of the many assumptions and decisions required in operationalising the goodwill impairment test might place audit committee members in a difficult position.

**Conclusion**

Accounting for goodwill continues to represent a controversial issue with the Australian adoption of international financial reporting standards from 1 January 2005. Goodwill acquired in a business combination is no longer amortised but is tested for impairment annually. This paper explored the potential impacts of the new accounting treatment. We compared and discussed the previous and international accounting treatments, demonstrating the advantages and complexities of the new treatment for preparers and auditors. In particular, we highlighted that the identification and valuation of cash-generating units will require numerous assumptions to be made in estimating fair value, value in use and recoverable amount. Because cash-generating units will generally not be subject to active or complete capital markets, considerable ambiguity and subjectivity will be introduced. This, in turn, will create opportunities for creative accounting.
Auditors will be required, in many instances, to use their professional judgment and rely on managements’ abilities and integrity, and sound corporate governance mechanisms (such as audit committees), for the “fair” valuation of goodwill and associated transactions. In light of the issues raised in this paper, future research should examine how financial report preparers and corporate governance mechanisms are dealing with the complex change required by the IFRS goodwill accounting treatment and how the many critical issues involved in auditing the resulting figures are being addressed.
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NOTES

1 These standards were issued in July 2004 and apply to annual reporting periods commencing on or after 1 January 2005. Both standards are based on material in the earlier ED 109 exposure draft (AASB, 2002).

2 AAS 18 Accounting for Goodwill was first issued in March 1984. Based on AAS 18, the original version of AASB 1013 Accounting for Goodwill was issued in April 1988. The latest versions of the now superseded AAS 18 and AASB 1013 were issued in June 1996.

3 For a background to this issue, see Brown (1995), Miller (1995) and Grant (1996).

4 Highlighting that this treatment of contingent liabilities represents an anomaly, exposure draft ED 139 Proposed Amendments to AASB 3 Business Combinations (AASB 2005) proposes that these types of contingent liabilities will no longer be recognised. However, if approved, the change will not be operative until annual reporting periods commencing from 1 January 2007. For companies with 30 June balance dates, the change will therefore first take effect in financial reports for the year ending 30 June 2008 (although it is proposed that earlier application will be permitted from the date the amendments are made by the AASB).

5 AASB 136 (para. 76) specifies that the carrying amount of a cash-generating unit includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the unit, and does not include the carrying amount of recognised liabilities unless the recoverable amount of the cash-generating unit cannot be determined without consideration of those liabilities.

6 AICPA’s “Auditing Fair Value Measurement and Disclosure: A Toolkit for Auditors” (AICPA, 2003) is a 110 page document with 20 pages of suggested tests for goodwill impairment.