Examination

International Financial Accounting
FEAD11
Goodwill and impairment of goodwill

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1. Summary

In my paper I have choose to discus goodwill and impairment of goodwill more precisely purchased goodwill. As to start I speak about what goodwill is, what is the definition of goodwill and discus some differences and similarities between intangible assets and goodwill. Furthered I have described how IFRS 3 and IAS 36 deal with questions concern recognition, determination, allocation on the acquisition date of the purchased goodwill and impairment of goodwill and allocation of the impairment loss if any. I also chose some scientific articles that I found relevant to my paper to discus some aspects and difficulties that arise from purchased goodwill.

2. What is Goodwill?

In the article “Debating Accounting Principals and Policies: the Case of the Goodwill, 1880-1921” Julie Cooper (2007) describes the evolution of goodwill and how it was treated. In her paper she quoted an old definition of goodwill given by Lord Eldon 1810 that she found in Dawson, 1903:196 “goodwill was ‘nothing more that the probability that the old customers will resort to the old place’.” (Cooper 2007). According Cooper (2007) “the earliest definitions saw goodwill as being derived from, or caused by, various business attributes or advantages” (Cooper 2007). Later definitions by several authors according Cooper (2007) goodwill represented advantage in form of “personality, locality, connections, premises, reputations and skill, and quality of goods” (Cooper 2007) and, that it was recognized that these advantage or cause of goodwill as having “a particular effect that of enabling their owner to earn profit in excess” (Cooper 2007).

According to Cooper (2007) during the late 19 and early 20 centuries goodwill was recognized, by the business scientists (accountants) at that time, as an asset which could not be separated from the business but had the ability of being separately valued. But according to accountants at that time “internally generated goodwill had no please in the balance sheet as it had no recorded cost. However, there was agreement that purchased goodwill should be recognized because it had a cost” (J. Cooper 2007). In her article she describes even the treatment of the purchased goodwill after entering the balance sheet and she found that the most favorable was capitalization/amortization of the goodwill. (Cooper 2007)
Today goodwill is defined in IFSR 3 (in Appendix A) as “Future economics benefits arising from assets that are not capable of being individually identified and separately recognized.” (IFRS/IAS 2009)

In several accounting books it is mentioned two types of goodwill:

- Internal generated goodwill such internally generated brand, research and development costs, training and employ skills and so on.
- Purchased goodwill that acquires in business combinations.

A Business combination is “the acquisition of one business by another, and is a part of what is commonly referred to as mergers and acquisitions activity” (IASB – Business Combinations Phase II – Project summary and Feedback Statement January 2008)

3. Recognition and calculation of Goodwill?

In this paper I chose to highlight the treatment of the purchased goodwill in the IFRS/IAS but before I do so I want to describe the differences between intangible assets en goodwill.

In IASB Framework (para.49) defines: “an asset is a resource controlled by the entity as a result of the past events and from which future economic benefits are expected.” An intangible asset is defined in IAS 38 (para.8) as an “identifiable non-monetary assets without a physical substance”. The most important criteria are that the asset in question can be identified, is controlled by the company and that future benefits from the assets are expected. In the case of an intangible asset it is one more criteria (precondition) that must hold beyond identifiability and control and that is reliable measurability. (IFRS/IAS 2009)

Considering this purchased goodwill as a result of a transaction between two parts acquiree and acquirer, David Alexander et al. (2009) agreed here that goodwill at the acquisition date satisfy the condition that is necessary to be recognized as an asset because it is a result of past events and that future benefits are expected. In most of the cases the condition for a purchased asset of being controlled of the acquirer entity is also satisfied. To have control over an assets flows logically from that fact that if you by something it is assumed that you should have the right to do what ever you want with it: keep it or sell it. But by the definition in IFRS 3 Goodwill is “an asset that is not capable of being individually identified and separately recognized”. It is in contradiction
with the definition of an intangible asset which is an identifiable non-monetary asset. (David Alexander et al. 2009)

IAS 38 gives some indication of which intangible assets should or should not be recognized as an asset. Expenditure for advertising, training of employees, internal generated brands for example are intangible assets that falls under one or two of the precondition mentioned in IAS 38 which are identifiability, control and reliable measurability. For example employ skills falls under two of the preconditions and those are control and reliable measurability. Control because the employ can live the company any time and the value of the employ skills its hard to determined howsoever is it possible. Therefore the expenditure/cost of training of employ can therefore not be capitalized. An example of intangible assets which meets the criteria mentioned in IAS 38 and therefore must be recognized as an assets is an intangible asset held by a lessee under a finance lease. (David Alexander et al. 2009 and Sundgren et al 2007)

Purchased Goodwill arises from transaction between the acquirer and acquiree when the acquirer is willing to pay more for the acquired entity’s share equity than its book value. This exceeds of cost represents usually internally generated goodwill such a brand, the purchased company’s god image and so on. It can be considered strange that while the acquired company can not recognize internally generated brand as an assets in their balance sheet by IAS 38 (para. 63) but in the consolidated accounts the acquirer must allocate the purchased brand as an intangible asset if its fair value can be measured reliable. (David Alexander et al. 2009 and IFRS/IAS 2009)

For not so many years ago goodwill represented the difference between the amount that a business was purchased and its net booked value of the assets. Today the net book value of the assets is replaced by the net faire value of the assets. This means that the amount of goodwill get smaller because it do not includes any hidden reserves that arise from the acquired company’s assets. The calculation of the purchased goodwill on the acquisition is regulated of IFRS 3 (para. 36-37). The acquirer shall allocate the cost of the business combination on the acquisition date by first recognizing the acquiree’s identifiable assets (including the internally generated goodwill which value can be measured reliably), liabilities, contingent liabilities, (assets and liabilities that meets the criterions of recognition) at the fair value and noncurrent assts at their fair value minus sell cost. The difference between the cost of the business combination and the net fair value of the assets that has been recognize should be accounted as goodwill and recognized as an assets according to IFRS 3. This excess of the
cost on the acquisition date represent the payment made by acquirer in hope of future economic benefits that are “not capable of being individually and separately recognized” (IFRS 3) This difference can be also negative which means that the acquirer have paid less than the net fair value of the acquired company’s assets. In this case we speaking of a negative goodwill which must be derecognized and transferred to retained earnings. (David Alexander et al. 2009 and IFRS/IAS 2009)

4. Impairment of Goodwill and reversals.

IFRS 3 do not allow any amortization of the goodwill but instead it can do impairment in accordance with IAS 36. This means that the acquirer shall look after (annually or even more often) if there is any reason that indicates that the goodwill may be impaired. IAS 36 is the standard that gives directives concerning impairments of an entity’s assets except the assets mentioned in IAS 36 para.2, 3, 5. The scope of the standard is described in paragraph 1 and it is to make sure that an entity’s assets carrying amount is not higher amount that it’s recoverable amount. In paragraph 59 is stays that “The carrying amount of an assets should be reduced to its recoverable amount if and only if its recoverable amount is less than the assets carrying amount and that reduction is an impairment loss.” (David Alexander et al. 2009 and IFRS/IAS 2009)

In IAS 36 para. 6 we find the following definitions for the carrying amount, impairment losses and recoverable amount.

- “Impairment loss is the amount by which the carrying amount of an asset or a cash generating unit exceeds its recoverable amount.
- Carrying amount is the amount at which an assets is recognized after deduction of any accumulated depreciations and accumulated impairment losses
- Recoverable amount of an assets or cash generated unit is the higher of its fair value minus sell cost and its value in use. “ (IFRS/IAS 2009 and David Alexander et al. 2009)

In the standard we find the procedure of how to identify the assets that may be impaired and the measurements of the impairment loss described in two steps. For the first indication that the assets or cash generated unit has been impaired must be found. For the second if such an indication exist than the recoverable amount of the asset or cash generated unit must be indentified. As I mentioned the recoverable amount is “the higher of the asset’s fair value minus sell cost
and its value in use” (IAS 36 para. 6). The fair value “is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm’s length transaction” (IFRS 1 Appendix A). The fair value can also be estimated by comparing similar assets and their value on an active market for such assets which in goodwill’s case can be difficult to find. The value in use is the estimated future cash flows that arrive from the assets in used which can also be difficult in goodwill’s case because goodwill by definitions “is an asset that is not capable of being individually identified and separately recognized” (IFRS 3). The estimation of the value in use of an assets or cash generating unit requires an appropriate discount rate to these future cash flows. (David Alexander et al. 2009 and IFRS/IAS 2009)

In IAS 36 Appendix A (p.16) it stays that the entity can uses the following rates to estimate the value in use:

- “the entity’s weighted average cost of capital determined using techniques such as the capital asset pricing model
- The entity’s incremental borrowing rate
- Other market borrowing rates” (David Alexander et al. 2009 and IFRS/IAS 2009)

and (p.17) that these rates must be adjusted so that:

- “to reflect the was that the market would assess the specific risks associated with the projected cash flows
- to exclude risks that are not relevant to the projected cash flow.” (David Alexander et al. 2009 and IFRS/IAS 2009)

Paragraph 80-99 in IAS 36 concern issues of goodwill in business combinations. The definition of the goodwill logically leads as to that fact that it can not generate independent cash flows separately from other assets or group of assets. This means that its recoverable amount can not be determined for goodwill as an individual asset. This is the reason why in IAS 36 it stays that goodwill beginning from the accusation date and so on should be allocated to the smallest amount of cash generating asset or group of assets where the goodwill belongs. Therefore when testing the goodwill for impairment, if there is any indication of that, it is the cash generating asset (unit) which includes the goodwill that must be tested and its recoverable amount that must me determined. The recoverable amount of the cash generated unit then must be compared with the carrying amount of the asset or group of assets included in the unit to determine the impairment loss. (David Alexander et al. 2009 and IFRS/IAS 2009)
This test of impairment of cash generating unit or units, where the goodwill is present, according to the standard it can be done any time annually during the reporting year. But there are some requests:

- The cash generated unit must be tested for impairment at the same time at every year and no other cash generated unit should be tested at that same time.
- The cash generated unit to which goodwill has been allocated on the accusation date in the current year must be tested for impairment in the end of the current year. ((David Alexander el al. 2009 and IFRS/IAS 2009)

Recognition of the determined impairment loss that results from testing the cash generating unit must happen if its carrying amount exceeds its recoverable amount. Depending on the size of the determined impairment loss the allocation of it must done according to IAS 36 as follows:

- First we have to reduce the carrying amount of the cash generated unit where the goodwill is allocated beginning with the goodwill part.
- For the second if the impairment loss exceeds the carrying amount of goodwill than the rest of impairment loss should be allocated to the carrying amount of other asset or group of assets in the cash generating unit. But this can not happen bellow the highest of the assets fair value less sell cost or its value in use (if one or both are determinable) or zero. (David Alexander el al. 2009 and IFRS/IAS 2009)

The main reason of allocation of the impairment loss in the above mentioned order is that at first to eliminating goodwill. The other reason is to make sure that the carrying amount of any individual assets is not reduced to that level that gives a wrong picture or economically not relevant information of the assets in the financial statement. (David Alexander el al. 2009 and IFRS/IAS 2009)

Reversals of impairment of the goodwill in business combinations in the previous year is not allowed according to IAS 36 paragraph 124. The reason for this prohibition is described in paragraph 125 in the same standard. As I previously mentioned goodwill from business combination is, or represents, more or less internally generated goodwill that was purchased in hope that will generate future economic benefits. But because by IAS 38 internally generated goodwill is not allowed to be recognized as an assets in the balance sheet an
increase of the recoverable amount of the goodwill that was in previous year
impaired is more likely a result of new internally generated goodwill and not a
reversal of the impairment loss in the previous year of the purchased goodwill.
(IFRS/IAS 2009)

5. Aspect and difficulties of goodwill impairment loss

Difficulties around accounting and treating of purchased goodwill acquire in
every step from its acquisition date, recognition of it to testing the goodwill for
impairment and allocating the impairment loss. As earlier mentioned the
difference between the cost of the business combination and the net fair value
of the acquired company’s assets that has been recognize should be accounted
as goodwill and recognized as an assets according to IFRS 3. The amount of
goodwill accounted in the balance sheet should not include any acquisition
related costs. The cost should be separately accounted and recognized as
expenses in profit or loss. Contingent considerations that arise from an
agreement between a seller and a buyer also can not be included in the amount
of goodwill. For example the buyer may agree to pay more for the acquired
business in the future if the specified outcome in the contract is realized or that
the buyer receive some refund if not. These contingent considerations are also
prohibited to be included and recognized as goodwill. Instead according to
IFSR 3 should be recognized at fair value and disclosed as contingent liabilities.
(Business combinations Phase II – Project Summary and Feedback Statement
January 2008 by IASB).

After the recognition of the goodwill in the balance sheet the goodwill amount
must be tested for impairment annually and allocate the impairment loss if any.
Duangploy et al. (2005) in theirs study argue that impairment loss off goodwill
is value relevant. When impairment loss is determined must be reported in the
profit and loss. In their Article they refer to SFAS no. 142 in which stays the
value of goodwill do not decline in a straight line instead impairment loss if it
acquire can be relatively large. This explains that no longer amortization of
goodwill in a straight line basis is used. Instead the regulatory bodies require the
impairment test of goodwill annually which means that the reporting entity
should search for if there is any indication that the goodwill has been impaired.
These indications can be both external and internal indication. Alexander, D et
al. (2009) mentioned some indication for impairment that must be taken in to
account, indications that we also can find in IAS 36 (para. 12). These
indications are the following:
External indication for impairment loss is:

- “During the period, an asset’s market value has declined significantly more than would be expected as a result of the passage of time or normal use.
- Significant changes with an adverse effect on the entity have taken place during the period or will take place in the near future in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.
- Market interest rate or other market rates of return on investments have increased during the period and those increases are likely to affect the discount rate used in calculating an asset’s value in use and decrease the asset’s recoverable amount materially.
- The carrying amount of the assets of the reporting entity is more than its market capitalization.” (David Alexander et al. 2009 and IFRS/IAS 2009: IAS 36 para.12)

Internal indication for impairment can include the following:

- “Evidence is available of obsolescence or physical damage of an asset.
- Significant changes with an adverse effect on the entity have taken place during the period or are expected to take place in the near future in extent to which, or manner in which, an asset is used or expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date and reassessing the useful life on an asset as finite rather than indefinite.
- Evidence is available from internal reporting that indicates that economic performance of an asset is, or will be, worse than expected.” (David Alexander et al. 2009 and IFRS/IAS 2009: IAS 36 para.12)

In IAS 36 paragraph 13 it stays that the above listed indication (in IAS 36 para.12) are not the only one. The reporting entity may also find other sources that indicates that the goodwill has been impaired. In these cases the company must also determine the recoverable amount of goodwill and if it is lower than its carrying amount than the impairment lost must be allocated. (IFRS/IAS 2009)
Hayn and Hughes (2006) in their research tried to find a formula for impairment of goodwill that may help external users (investors and other users) to predict goodwill write-offs or write-downs. They argue that impairment of goodwill becomes an important issue because the amortization of goodwill is abolished. They developed a predicting model similar to the models that are used for predicting bankruptcies. The reason of that at first is that they could not find any research that is about prediction of assets impairments and the second reason is that they think that both goodwill impairment and bankruptcies “involves determining when the financial viability of an entity (a firm or, in case of goodwill, a reporting unit or units) has deteriorated”. (Hayn and Hughes 2006) The main components in their model for goodwill impairment are the goodwill’s acquisition characteristics and performance indicators. This is determined as a function of these two main variables.

\[ Pr(\text{write-off} _{i,t}) = f([\text{Acquisition Characteristics} _{i,A} , \text{Performance indicators} _{i,n}]) \]

Where  
\( i= \text{firm} \)  
\( A=\text{the acquisition year} \)  
\( t=\text{time} \)  
\( n=\text{the amount of year that passed between the acquisition year and write-off year}. \) (Hayn and Hughes 2006)

Among the acquisitions characteristics that may be associated and can lead to goodwill impairment are:

- “Payment of significant premium
- Presence of multiple bidders or an auction-like situations
- A significant amount of goodwill relative to the acquisition price, and
- Use of the acquiring firm’s stock as the primary mode of consideration.”  
  (Hayn and Hughes 2006)

As performance indicators they mention in their paper

- “Operating income to identifiable assets, ROA (return on assets)
- A change in ROA from one year to the next year,
- Operating losses,
- Percentage change in sales from one year to the next.”  
  (Hayn and Hughes 2006)

Hayn and Hughes (2006) in their research studied 2852 acquisitions made between 1988 and 1998 acquisitions that were carefully selected and included in their sample only if those meet the following criteria:
• “Acquiring and acquired firms were publicly traded on U.S. stock exchange.
• Data were available on the acquisition announcement date, the purchase price, liabilities assumed, the mode of considerations, and the number of bidders.
• The transaction became effective within one year of the acquisition announcement.
• The transaction was accounted for using the purchased method and gave rise to goodwill.
• The amount of the goodwill associated with the acquisition was known.” (Hayn and Highes 2006)

In their research they found that the most predicting indicators where those associated with the acquisitions namely “the premium paid in acquisition, the percentage of the purchase price allocated to goodwill, and the use of stock as primary mode of consideration” (Hayn and Highes 2006). Their result shows that only the segment-level ROA and change in ROA measures are significant in predicting goodwill write-offs (impairment) among the performance indicators. But theirs predicting ability is limited due to the low quality of the, and few, segment disclosure where the goodwill is present. (Hayn and Highes 2006)

Hayn and Highes (2006) show concern about the result of their study which suggest that the outside users of the financial statements can not determine the appropriateness of goodwill impairment made by the managers. This can result in goodwill that will remains in the balance sheet indefinitely. The ongoing value of the goodwill will be more difficult to track as time goes and for the outsider to determine its value. This is because goodwill can be assigned to more the one segment on different levels and reporting units or the firm can make restructures or reallocates the goodwill among its segments. Their study was made almost on Goodwill that was acquired before the introduction of SFAS 142 but they argue that “the results are generalizable to the current reporting regime” (Hayn and Highes 2006).
6. Conclusion

Goodwill in many studies is considered a part of the acquisition price. Recognizing goodwill as an asset has several impact on the firm valuation. Duandploy et.al (2005) concludes in their research that impairment loss of goodwill is value relevant. An impairment loss of goodwill has an impact on the company’s total asset and net income because of its size. Because by definition of goodwill which represents future economic benefits to the firm they argue that an impairment loss may apply a diminishing cash flow or important changes in the company’s earnings. It can also increase the firm’s debt to equity ratio which can suggest a possible insolvency of the firm and therefore can have a negative impact on the share price of the firm (Duandploy et.al 2005). This may explain the reason for what Hayn and Highes (2006) find in they study “that large number of goodwill write-offs appear to be taken only after a considerable period of time has elapsed after economic deterioration of the associated entity” (Hayn and Highes 2006). Further they write that “this delay has implications for the carrying value of goodwill and for the credibility of financial statement for which goodwill is a substantial asset” (Hayn and Highes 2006).

7. Comments to my paper

The articles that I choose are referring to SFAS 142 because I did not found any research made on impairment of the goodwill in which they refer to IAS/IFRS accounting principals. But I believe that these articles are interesting and perhaps relevant to my paper because of the cooperation between the International Accounting Standard Board (IASB) and the U.S. Financial Accounting Standard Board (FASB) to develop “a single set of accounting standards that would be accepted globally in financial markets” (Shoaf and Zaldivar 2005). But on the other side Shoaf and Zaldivar (2005) conclude in their article that despite the cooperation between IASB and FASB they still do not achieved complete convergence between the two accounting standards. They argue that despite similarities between SFAS 141, 142 and IFRS 3 and IAS 36, 38 there is still significant differences relating to impairment test.
References


”Internationell redovisningsstandard i Sverige IFRS/IAS 2009” by FAR SRS Förlag AB

”Business combinations Phase II – Project Summary and Feedback Statement” January 2008 by International Accounting Standard Board (IASB)


