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Implications of the IFRS goodwill accounting treatment

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Abstract

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

Design/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 are inherent in the IFRS requirements.

Research limitations/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.

**Introduction**

The Financial Reporting Council in 2002 formalised its support for the Australian adoption of international financial reporting standards (IFRSs) from 1 January 2005 (FRC, 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 (2002, 2005) 3 Business Combinations and AASB (2004c) 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, particularly 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) 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). 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).

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, p. 106)[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).

Wines and Ferguson (1993) provide evidence that companies, in the past, had adopted accounting policies to avoid the requirement for goodwill amortisation. Examining the period 1985-1989, the study provided evidence that companies had been recognising identifiable intangible assets, which were not subsequently amortised, to reduce the impact on reported profit of the requirement for goodwill amortisation. This suggests that managements sought to avoid the goodwill amortisation requirement if possible.

Hence, a controversial aspect of the AASB 1013 treatment of goodwill was the amortisation requirement. The assumption that goodwill is a wasting or finite-life asset ignores the fact that some unidentifiable assets may have an indefinite useful life. Lamond (1995, p. 68) also 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 still provides many avenues for preparers to be creative. This aspect is discussed later in the paper.

**IFRS goodwill accounting treatment**

The IFRS goodwill accounting treatment is now prescribed in Australia’s AASB (2004a) 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).

A parallel development with the Australian adoption of IFRS-based standards has been the promulgation of a specific accounting standard for identifiable intangibles. AASB (2004e) 138 *Intangible Assets* (para. 8) defines an intangible asset as “an identifiable non-monetary asset without physical substance”. The first aspect of this definition relates to identifiability, with identifiable intangible assets being those capable of individual identification so they can specifically be brought to account as separate assets. This distinguishes identifiable intangible assets from goodwill, the latter representing future economic benefits from assets that are not capable of individual identification or separate recognition. Accordingly, pursuant to the IFRS-based standard, goodwill only arises in the context of a business combination.

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 acquire 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 (AASB, 2001) *Provisions, Contingent Liabilities and Contingent Assets* (para. 7.1), which previously prohibited the recognition of contingent liabilities. It also represents an exception to the rules expressed in the revised IFRS-based Australian financial reporting standard, AASB (2004d) 137 *Provisions, Contingent Liabilities and Contingent Assets* (para. 27), which prohibits the recognition of contingent liabilities in normal circumstances[4].

An illustrative example of the superseded AASB 1013 and the new IFRS goodwill accounting treatments, where contingent liabilities are involved, is shown in Appendix. The 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 (para. 66) requires the “cash-generating unit” to which that asset relates to be identified. 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. 80a). Further, the cash-generating unit should not be larger than a primary or secondary segment determined in accordance with AASB (2004b) 114 Segment Reporting (para. 80b).

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).

**Advantage of the new goodwill treatment**

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 a review of capital markets research, Clinch (1995) concludes that there is no clear evidence of any association between goodwill amortisation and share values. That is, there is little, if any, firm evidence that goodwill amortisation expense included in the calculation of periodic profit reflects information that is used by investors in setting share prices and returns.

In comparison to the periodic amortisation policy, 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. Colquitt and Wilson (2002) argue that this will satisfy the need for analysts and the other users of financial statements for better information about intangible assets, as the new treatment does not require goodwill to be automatically written down irrespective of the individual situation.

A problem of 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). By being based on an actual valuation of goodwill, the IFRS-based standard’s impairment testing policy moves away from an arbitrary assessment of useful life.

Another advantage is the interrelationship with the intangible asset financial reporting standard. It was noted earlier that Wines and Ferguson (1993) provide evidence that management had, in earlier times, recognised identifiable intangible assets to reduce the impact on reported profit of the requirement for goodwill amortisation. As there is now a specific accounting standard, AASB 138, applicable to identifiable intangible assets, there is now more clear guidance for companies in this area.

The overall advantage, from a balance sheet perspective, is that the valuation of goodwill will be more closely aligned to a real assessment of asset value, rather than reflecting an arbitrary “cost less accumulated amortisation” calculation. Also, from an income statement perspective, any recognition of a loss as a result of a write-down in the valuation of goodwill will be more closely aligned to a real
economic decline in value rather than an arbitrary amortisation calculation. The new treatment should therefore be more aligned with the decision-making needs of financial report users.

**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 different geographical locations, Location A and Location B. Assume further that the Location A manufacturing unit has “overvalued” goodwill of $50,000 (that is, carrying value exceeds recoverable amount by $50,000) and the Location B manufacturing unit has “undervalued” goodwill of $50,000. If the cash-generating units were to be considered at the individual location level, a goodwill impairment loss of $50,000 would need to be recorded for the Location A manufacturing unit. The Location B 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 locations combined were considered to represent a single cash-generating unit, goodwill for the combined Location A and B 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 (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.

Just as management could bias the estimated recoverable amount of a cash-generating unit in an upward direction to avoid impairment loss recognition, valuations in the transition period to the new IFRS treatment could be biased in a downward direction. In this way, the company could deliberately recognise possibly excessive impairment losses in the transition period. Henning et al. (2004) found evidence of this in the parallel transition to the new rules in the USA. They argued that the transition period could thus have been used to minimise the recognition of future impairment losses, based on the belief that the market would view the losses recorded in the transition period as relating to a past problem and as not affecting the current value of the company.

An associated concern 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 to avoid recording impairment losses if possible.

In summary, major potential accounting difficulties with the new IFRS goodwill accounting treatment, and scope for creative accounting, arise from the following:

- With respect to the identification of cash-generating units, there is the potential for considerable subjectivity. Major uncertainties can be involved in initially identifying the level
or levels at which cash-generating units are to be recognised, and impairment losses could potentially be avoided by aggregating units at too high a level.

- While the valuation of cash-generating units will be straightforward for certain entities, such as a separate subsidiary company, this will be far more difficult for units comprising branches, divisions or unique facilities that are not subject to active capital markets.
- The new standard will require companies to spend additional time in complying with its requirements and thereby result in greater costs. A detailed valuation of every applicable asset and associated goodwill for each cash-generating unit will be required.
- As the recoverable amount of a cash-generating unit is calculated by reference to the higher of fair value less costs to sell and value in use, there is scope to bias either or both of these bases to avoid the need to recognise an impairment loss. Fair value based on a “hypothetical” sale between knowledgeable willing parties in an arm’s length transaction, and value in use comprising a present value calculation based on expected future net cash inflows and estimates of discount rates, do not represent objective measures for many cash-generating units.

**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 ASA 545 (AASB, 2006c) Auditing Fair Value Measurements and Disclosures, based on International Standard on Auditing (International Auditing and Assurance Standards Board, 2004b) ISA 545, provides specific guidance for fair value issues, while ASA 540 (AASB, 2006b) Audit of Accounting Estimates, based on international standard ISA 540 (International Auditing and Assurance Standards Board, 2004a), provides further general guidance (ASA 545, para. 10).

ASA 545 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” (para. 13). However, ASA 545 (para. 13) 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”. 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 ASA 540.

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 per cent.

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 acquirer’s identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination (AASB 3, para. 56a). Any discount on acquisition remaining after such reassessment is recognised immediately in profit and loss (para. 56b). 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 but also regarding the assignment of fair value. Auditors will also have to verify the identification of cash-generating units, calculations of the estimated selling price of the unit, and calculations 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, in estimating a “hypothetical” market transaction and in estimating net cash inflows, residual values and discount rates will result in great scope for disagreement and tension between auditors and financial report preparers.

A company may engage a professional valuation services firm to value its cash-generating units and goodwill, and this practice is occurring with greater frequency (Wiese, 2005). In such consulting engagements, the valuation firm is not restricted by applicable accounting standards, and is not required to specifically consider the needs of individual financial report users and qualitative characteristics such as relevance and reliability. The company may choose a compliant valuer to supply a valuation consistent with management’s wishes. This then potentially places the auditor in a difficult position when faced with such an “expert” valuation. Because the many required assumptions implicit in valuations are often not capable of auditing by reference to wholly objective
evidence, it is the auditor who is put on the “back foot” and in a defensive position to disprove any valuation procured by the company's management.

In 2001, the USA introduced a similar impairment testing system. The American Institute of Certified Public Accountants (AICPA, 2003) 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. 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).

By forcing firms to systemically re-evaluate the value of goodwill each year, standard setters thought that the underlying economic value of goodwill in the balance sheet would provide more relevant information to financial report users. Critics such as Massoud and Raiborn (2003), however, raise concerns about company managers' discretion to justify decisions about the magnitude of goodwill and measurement of impairment losses that might mislead financial report users as well as introducing volatility into earnings. Further, managers have the flexibility to calculate impairment or non-impairment using their selected assumptions, with which auditors will have to deal. While accountants and externals auditors have dealt extensively with measurement and verification pitfalls in relation to fair value, they have had less experience with estimates based on discounted cash flows and other valuation techniques used by managers (Benston, 2006).

There is, therefore, considerable possibility for tension between auditors and company management. For example, the implementation of AASB 3 may result in multiple charges against earnings in a given year. Recognition of these charges could adversely affect the value of stock options and the ability to generate sufficient capital. Executive bonus plans and compensation, when tied to reported earnings, will also be affected. Hence, management may make decisions regarding impairment loss recognition for short-term purposes (Urbancic, 2002). For these reasons alone, managers will have incentives to inflate valuations either because of the tendency to be overly optimistic, opportunistic or both (Benston, 2006). Thus, auditor independence in relation to the client and its management is critical “considering the inherent difficulty of auditors challenging managers' fair values estimates” (Benston, 2006, p. 482). Moreover, auditors still have strong monetary incentives to keep their clients happy, particularly when auditors are economically reliant on their clients (Mautz and Sharaf, 1961; Windsor and Ashkanasy, 1995; Benston, 2006).

In summary, the major auditing challenges arise from the following:

1. Company directors may bias initial valuations of assets, liabilities and contingent liabilities in business combination to:
   o maximise the valuation of goodwill, which is now not subject to periodic amortisation; and
   o maximise the excess of the fair value of net assets acquired over purchase consideration to enable the immediate recognition of this excess (discount on acquisition) as a gain in profit and loss.

2. There is the potential for disagreement between company directors and auditors on the identification of cash-generating units and in the valuations of those units by reference to recoverable amount (higher of fair value less cost to sell and value in use, both of which may require a large number of arbitrary assumptions to be made in calculation).
3. The auditor does not have reference, in many cases, to wholly objective evidence pertaining to the valuation assumptions adopted by management, especially in situations where the relevant cash-generating unit and the assets it comprises are not subject to active capital markets (and especially where the unit comprises unique facilities).

4. A compliant valuer could well provide a valuation for a cash-generating unit, and related goodwill, that suggests that no impairment loss needs to be recognised. This puts the auditor in an unenviable position of having to disprove that valuation, especially in situations where there is a lack of objective evidence to support any valuation.

Audit, corporate governance and management oversight

ASA 545 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), ASA 545 (para. 49) 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. 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 (2003, p. 67) 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[6].

ASA 545 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.

ASA 545 (para. 74) suggests that, with respect to communicating with management, auditors refer to ASA 260 (AASB, 2006a) Communication of Audit Matters with those Charged with Governance. ASA 260 (para. 9) requires the auditor to “determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated”. The standard highlights that the diversity of corporate governance models globally is such that auditors should use their professional judgment to determine those persons with whom audit matters of governance interest are communicated, but makes particular reference to audit committees (paras 10 and 11).
ASA 260 (para. 16) specifically notes that issues related to the selection of significant accounting policies and practices represent audit matters of governance interest. There is a considerable amount of guidance available regarding audit committees, especially for listed companies (ASX Corporate Governance Council, 2003), and audit committees and their composition are mandatory for large Australian listed companies generally[7]. However, many aspects of corporate governance mechanisms involving board appointments, 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. It certainly emphasises the need for audit committee members to understand the complexities of the new goodwill requirements.

**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 cash-generating units, 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-based goodwill accounting treatment and how the many critical issues involved in auditing the resulting figures are being addressed.
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Table AII.

References

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**Further Reading**
Appendix. Illustrative example of superseded AASB 1013 and new IFRS goodwill accounting treatments

Panel A: AASB 1013 goodwill accounting treatment

Assume that A Ltd purchased the net assets of B Pty 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 (Table AI) with goodwill being calculated as the excess of the cost of acquisition over the fair value of the net assets acquired.

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.

Panel B: IFRS goodwill accounting treatment

Assume now that B Pty 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 in Table AII.

Table AII

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