

# Accounting for goodwill: The transition from amortisation to impairment – an impact assessment

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## Abstract

When the FASB adopted an impairment test approach in 2001, rather than amortisation, the accounting for goodwill arising from an acquisition took a step in a new direction. The IASB, seeking international convergence and global harmonisation, also implemented this change when it issued *IFRS 3* in 2004.

Moving away from amortisation towards an impairment test involves a radical change. The research on which this paper is based was undertaken to examine these two very different accounting practices for the treatment of goodwill and to assess the possible impact that a transition from the one to the other may have on financial reporting.

## Key words

*Accounting practices*  
*Amortisation*  
*Earnings*  
*Goodwill*

*Acquisition*  
*Business combinations*  
*Financial reporting*  
*Impairment*

## 1 Introduction

Some debate regarding the most appropriate method of accounting for goodwill that arises from an acquisition (commonly referred to as “purchased” or “acquired” goodwill) raged during the early 1990s and again during the early 2000s.

During 1993, the International Accounting Standards Board (IASB) amended an International Accounting Standard (IAS), namely *IAS 22, Business Combinations* (IASB 1993), by removing the option of writing off purchased goodwill (hereafter referred to merely as goodwill) immediately on acquisition. The accounting treatment of goodwill that arises from an acquisition took a significant step in a new direction with this amendment, whereby goodwill now has to be recognised as an asset and amortised over its useful life.

A number of alternative treatments were used in South Africa at that time, as there was no definitive accounting standard for the accounting treatment of goodwill before the

introduction of the new accounting statement, *AC 131, Business Combinations* (SAICA 1999). *AC 131* was based on *IAS 22* and covered all periods commencing on or after 1 January 2000.

The Financial Accounting Standards Board (FASB) in the United States of America (USA) sparked an international debate during 2001 when it adopted a Statement of Financial Accounting Standards (SFAS), *SFAS 142, Goodwill and other intangible assets* (FASB 2001a), thereby replacing the existing requirement to amortise goodwill with an impairment testing approach.

The IASB, seeking international convergence and global harmonisation, followed the FASB, and issued a new International Financial Reporting Standard (IFRS), namely *IFRS 3, Business Combinations* (IASB 2004a) in March 2004. The South African Institute of Chartered Accountants (SAICA) adopted *IFRS 3* at the same time. According to *IFRS 3*, from the beginning of the first annual period beginning on or after 31 March 2004, all entities must discontinue amortising goodwill and must test the goodwill for impairment annually instead.

The debate in the early 1990's resulted in the amortisation of goodwill. The current change is to an impairment test rather than amortisation. This is a radical change, and it involves a very different accounting process (Moehrle 2001).

## **2 Aim and research method**

Accounting for goodwill is one of the most difficult aspects of financial reporting. The difficulty arises from the nature of goodwill, which is almost impossible to quantify. It is therefore also very difficult to find an accurate method for measuring the consumption of goodwill.

The aim of this study is to document the current amendments of national and international accounting and financial reporting practices in respect of the treatment of goodwill, and to compare them with previous practices. An example will serve to illustrate and compare these practices. Against this background, the study examines how goodwill originates. It then explores the effect that a change between these two very different accounting practices regarding the treatment of goodwill may have on companies in future.

*IFRS 3* requires all business combinations within its scope to be accounted for using the purchase method, whereas *IAS 22* permitted the use of the pooling of interests method, as well as the purchase method. This choice allowed companies to avoid the recognition of goodwill by structuring a business combination so that it could be classified as a uniting of interests. (The possible linkage between the abandonment of the pooling of interests method and the resulting change in the treatment of goodwill is not explored in this article.)

This article only discusses positive goodwill, because the accounting treatment of negative goodwill has already been discussed in a previous article (Wiese 2003).

## **3 Accounting practices for the treatment of goodwill**

Goodwill arising on acquisition refers to the excess of the cost of the acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired on the date of the exchange transaction.

### 3.1 IAS 22 / AC 131

According to *IAS 22* and *AC 131*, goodwill should be recognised as an asset and carried at cost, less any accumulated amortisation and any accumulated impairment losses. Goodwill amortised over a period exceeding 20 years has to be tested for impairment annually. Otherwise, the carrying amount of goodwill must only be reduced if there is an indication that it is impaired.

### 3.2 IFRS 3

In terms of the new standard, goodwill acquired in a business combination is an asset and must initially be measured at cost (*IFRS 3* par.51). After initial recognition, the acquirer must measure this goodwill at cost, less any accumulated impairment losses (*IFRS 3* par.54). The acquirer must test goodwill for impairment annually, or more frequently, if events or changes in circumstances indicate that it might be impaired, in accordance with *IAS 36, Impairment of Assets* (*IFRS 3* par.55).

*IAS 36, Impairment of Assets* (IASB 2004b) requires goodwill to be tested for impairment as part of the impairment testing of the cash-generating unit to which it relates, using a two-step approach. The carrying amount of goodwill must be allocated, from the acquisition date, to each of the smallest cash-generating units to which a portion of that carrying amount can be allocated on a reasonable and consistent basis. A cash-generating unit (hereafter referred to as a unit) is defined as the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash flows from other assets or groups of assets.

The two-step impairment test involves the following

Step 1: Compare the carrying amount of the unit, including the goodwill, with its recoverable amount. The recoverable amount of such a unit should be measured, consistent with the requirements in *IAS 36*, as the higher of value in use and net selling price. If the recoverable amount of the unit exceeds its carrying amount, goodwill is not impaired. If not, then follow Step 2.

Step 2: Compare the implied value of goodwill with its carrying amount. Implied goodwill is the excess of the recoverable amount of the unit to which the goodwill has been allocated over the fair value of the net identifiable assets that the entity would recognise if it acquired that unit in a business combination on the date of the impairment test. Any excess of the carrying amount of goodwill over its implied value is recognised immediately, in profit or loss, as an impairment loss. Any remaining excess of the carrying amount of the unit over its recoverable amount is recognised as an impairment loss and allocated to the other assets of the unit on a *pro rata* basis, based on the carrying amount of each asset in the unit.

### 3.3 SFAS 142

Goodwill must be recognised as an asset and tested for impairment annually. This will also involve a two-step process that begins with an estimation of the fair value of a reporting unit.

The main differences between *IFRS 3* and *SFAS 142* are that

*SFAS 142* uses fair value (the amount for which the whole unit could be bought or sold between willing parties) as the basis for the impairment testing of goodwill, whereas the recoverable amount is used as basis for the impairment test in *IAS 36*; and

*SFAS 142* refers to a reporting unit, whereas *IAS 36* refers to a cash-generating unit. A reporting unit is the level at which management reviews and assesses the operating segment's performance – in other words, units can be discrete business lines or grouped by geography and can produce stand-alone financial statements. The level at which goodwill is tested for impairment under *SFAS 142* will thus often be higher than the level at which it would be tested under *IAS 36* (IASB 2003a).

### 3.4 Example

Company X acquires a 100% interest in Company Y for R1 600 000 on 1 January 20X3. At this date, Y's identifiable net assets have a fair value of R1 200 000. At the end of 20X3, the following relates to Y (assume Y is a cash-generating unit):

Recoverable amount of Y	R1 600 000
Carrying amount of the identifiable net assets of Y	R1 350 000
Fair value of the identifiable net assets of Y which X would recognise if it acquired Y at this date	R1 500 000

The amounts relating to the investment in Y in the consolidated financial statements of X would be as follows, according to the two methods (assuming that the goodwill is amortised over five years):

<b>Amortisation (IAS 22)</b>	
Net assets of Y	R1 350 000
Goodwill ((1 600 000 – 1 200 000) – 80 000)	320 000
Net total	<u>R1 670 000</u>
<b>Impairment test (IFRS 3)</b>	
Net assets of Y	R1 350 000
Goodwill (400 000 – 300 000)	100 000
Net total	<u>R1 450 000</u>

*Step 1 of the impairment test:* The carrying amount of Y in the consolidated financial statements is R1 750 000 (R1 350 000 + R400 000), which is higher than the recoverable amount of R1 600 000.

*Step 2 of the impairment test:* Implied goodwill is calculated as the excess of the recoverable amount of Y (R1 600 000) over the identifiable net assets of Y which X would recognise if it acquired Y at this date (R1 500 000). Goodwill is therefore written off to this implied value of R100 000.

## 4 How goodwill arises

### 4.1 Purchased or acquired goodwill

An existing business with a successful operating history normally has an infrastructure in the form of a customer base, technical expertise, managerial expertise, and many other intangible factors that create value over and above the amortised historical costs of its identifiable assets. This goodwill can only be reported in the financial statements of a business enterprise after a business combination transaction (Herring 2002). In the

accounting sense, goodwill can be thought of as a “premium” for buying a business. One characteristic of goodwill that has emerged over the past century is that it cannot be separated from the business. It cannot be sold without selling the associated business (Fontanot 2003).

## 4.2 *Inherent goodwill*

According to Stickney and Weil (quoted by Cunningham, 2002), inherent goodwill is the non-physical, non-current rights of an entity that give it a preferred or exclusive position in the market. Unlike purchased goodwill, inherent goodwill is not subject to a market transaction. It is therefore not capable of valuation in the same way as purchased goodwill, and its value merely reflects the value to a particular party at a given point in time. In terms of IAS 38, *Intangible Assets* (IASB 2004c), internally generated goodwill shall not be recognised as an asset, because it is not an identifiable resource controlled by the entity and it cannot be measured reliably. The recognition and capitalisation of inherent goodwill is therefore largely conditional on the recognition of purchased goodwill (Tollington 1998). This would tend to support Van Mesdag’s view of goodwill as an accountants’ acceptable alternative in recognising inherent goodwill on the balance sheet (cited by Tollington 1998).

## 5 Amortisation

Conceptually, amortisation is a method to allocate the cost of goodwill over the periods it is consumed. This is consistent with the approach taken with regard to other fixed assets that do not have indefinite useful lives (IASB 2004d). Overpayment for the assets of an acquired company generally reflects an expectation of high future earnings. Amortisation of this overpayment ensures that the overpayment is matched with the expected future earnings (Fontanot 2003).

Systematic amortisation with additional impairment testing acknowledges that the factors that constitute acquired goodwill generally diminish in value over time, and that the related costs are systematically charged to income over the useful life of the goodwill (EFRAG 2003). Although the useful life of goodwill cannot be predicted with a satisfactory level of reliability, systematic amortisation provides an appropriate balance between conceptual soundness and operability at an acceptable cost. According to the respondents to *ED 3, Business Combinations* (IASB 2002), this is the only practical solution to an intractable problem (IASB 2004d).

### 5.1 *Arguments against amortisation*

Amortisation of goodwill is based on the assumption that goodwill is a wasting asset (that is, finite), and thus ignores the fact that some kinds of goodwill can have an indefinite useful life. The value of a business, and consequently of its goodwill, does not necessarily wear out. It can be maintained or even improved by careful management and by cash expenditure charged against the income stream. Such management action does not only replace purchased goodwill with inherent goodwill, but maintains the value measured at the date of acquisition. Reducing profits further through the application of regular amortisation does not lead to a meaningful measurement of earnings (Njeke 1991).

In considering the comments on *ED 3*, the IASB observed that it is generally not possible to predict the useful life of goodwill and the pattern according to which it diminishes. Hence, the amount amortised in any given period can at best be described as an arbitrary estimate of the consumption of goodwill during that period (IASB 2004d). The FASB (2001b) argued that it is virtually impossible to predict accurately what the useful life of goodwill would be and that amortisation is therefore not a faithful representation of the pattern of decline (FASB 2001b).

Moehrle (2001) argues that goodwill is a wasting asset because it has a definite life, but does not decline in value over a straight line for an observable period. The imposition of a maximum life and a systematic write-down, irrespective of the efforts of management and the ongoing business value, seems to be an overly mechanistic approach to judging the possible erosion of goodwill value.

Most of the controversy about goodwill over the last four decades has centred on the earnings drag of goodwill, rather than its usefulness (Waxman 2001). Financial statement users in the USA have indicated that they do not regard goodwill amortisation as useful information in investment analyses (FASB 2001b). For this reason, most analysts ignore goodwill amortisation when they calculate their ratios (Hattingh 2002).

## **6 Impairment**

One of the main arguments of the FASB in proposing the impairment approach was that it would lead to improved financial reporting, because the financial statements of entities that acquire goodwill would reflect the underlying economics of those assets better. As a result, financial statement users would be better able to understand the investments made in those assets and the subsequent performance of those investments (FASB 2001b).

The IASB (2004d), in considering the comments on *ED 3*, agreed with the FASB that achieving an acceptable level of reliability in the form of representational faithfulness, while at the same time striking some balance with what is practicable, was the primary challenge faced in deliberating accounting for goodwill. They acknowledged that, if goodwill is an asset, it must be true that goodwill acquired in a business combination is being consumed and replaced by internally generated goodwill, provided the entity is able to maintain the overall value of goodwill. They were, however, doubtful about the usefulness of an amortisation charge that reflects the consumption of goodwill, whilst the internally recognised goodwill replacing it is not recognised. They argued that a rigorous and operational impairment test would provide more useful information to users of an entity's financial statements.

According to Moehrle (2001), a good impairment test promotes transparency, because the trigger is a change in underlying economic or business conditions, not an arbitrary period. As a result, reporting is based on current events that affect the business. If it is properly managed, goodwill is an appreciating asset, and if it is not properly managed, the impairment test will recognise any reduction in value.

### **6.1 Arguments against impairment**

#### **6.1.1 Capitalisation of internally generated goodwill**

Acquired goodwill is generally an asset that is consumed over time and replaced by internally generated goodwill. One of the main arguments of the respondents to *ED 3* in

support of amortisation was that it prohibits the recognition of internally generated goodwill, which is consistent with the general prohibition in IAS 38 on the recognition of internally generated goodwill (IASB 2004d).

In some cases, the value of goodwill may appear not to decrease over time. This is because the potential for economic benefits purchased initially is progressively replaced by the potential for economic benefits resulting from subsequent enhancement of goodwill, which is brought about by the ongoing expenditure of the business (Moodie 2000). The operating policies, focus and levels of ongoing expenditure, which are, in turn, determined by the new controllers, are factors that establish or increase the inherent goodwill of the acquired company. Over time, these factors will have an impact on the value of the business, and then the purchased goodwill will be replaced by inherent goodwill (Njeke 1991).

Implied goodwill is calculated as the excess of the recoverable amount of the unit to which the goodwill has been allocated, over the fair value of the identifiable net assets that the entity would recognise if it acquired that unit in a business combination on the date of the impairment test. What is absurd about this algorithm, according to Ketz (2001b), is that it assumes that the residual amounts relate solely to the goodwill purchased as a result of a previous business combination. This computed goodwill, however, could easily be tainted by internally generated goodwill generated by other activities, events, resources and social arrangements. The calculated number may thus have little to do with the purchased goodwill.

Internally generated goodwill is not recognised on balance sheets, since there is no reliable measure of cost or value (Nobes & Norton 1996). It is therefore likely that many companies have unrecorded goodwill associated with the reputation of their products, service(s) and managerial expertise (Herring 2002). The impairment test does not distinguish between acquired goodwill and this pre-existing goodwill of the company that is being acquired, nor between acquired goodwill and the goodwill internally generated after the combination. The result is a cushion that would shield many large acquirers from ever having to recognise an impairment of goodwill. According to Moehrle (2001), analysts will now have to face the challenge of recognising when the goodwill asset is wasting, and is being replaced by internally generated goodwill, compared to instances in which value remains related to past business acquisitions.

### 6.1.2 *Effect on earnings*

One of the most important intangible assets on a company's balance sheet that can have a material effect on earnings is goodwill. The capitalisation of goodwill without amortisation may allow the most advantageous financial reporting figures due to net income not to be reduced periodically, but could also result in more abuse than any other method (Fontanot 2003).

Annual systematic charges to goodwill are more objective than periodic reviews for impairment. The latter would allow firms greater opportunities to manage their earnings (Schoderbek & Slaubaugh 2001). The change could generate a boost to earnings per share that could deceive the market into thinking that a company is doing better than anticipated, causing the stock market to move higher (Basi & Penning 2002).

Companies generally do not want a goodwill write-off to distort income and cause a negative earnings hit (Moehrle 2001). Many commentators strongly favour the impairment

model, simply because it will increase earnings and earnings per share (Waxman 2001). It should be noted that this would not apply to headline earnings per share, as *Circular 7/2002* (SAICA 2002) specifically excludes goodwill from the calculation of headline earnings. Headline earnings per share has become the accepted earnings per share measure of many South African listed companies, but is unique to South Africa and is not an accepted earnings per share measure in global markets (Moodie 2000).

There may also be more volatility in reported income than under previous standards, because impairment losses are likely to occur irregularly and in varying amounts (FASB 2001b).

### 6.1.3 Complexity

*IFRS 3* puts its faith in a potentially unreliable and very complex impairment test. This was the opinion of the two IASB members who dissented from the issue of *IFRS 3* (IASB 2004e). The projection of future cash flows is difficult, especially in developing and volatile industries (such as the “high tech” and telecommunications industries). The question is whether fair presentation will be achieved in the recognising and measuring of goodwill in view of the high dependency on the ability of an entity’s financial personnel to predict future cash flows accurately (White 2003).

In its analysis of the main issues raised during field visits and roundtable discussions, the IASB noted that its decision to adopt a non-amortisation approach for goodwill was contingent on its ability to devise a sufficiently rigorous yet operational impairment test. The Board noted that it was the second step of the proposed impairment test and the method for measuring any impairment loss for the goodwill that caused the greatest concern for both respondents and field visit participants (IASB 2003a).

In the USA, businesses indicated that they do not like the reporting unit requirement because of the difficulty they have in determining the reporting unit level on which goodwill is to be tested, as well as what specific methodology to use to calculate the fair value of the reporting unit. Will the fair value be derived from an independent third party valuation, an earnings model, a multiple of book value, or some other model? Stock prices represent an ideal estimate, for accounting purposes, of fair value, because they are objective and verifiable (Moehrl 2001). However, many finance managers believe that the current price at which their company stock trades does not reflect its fair value and may also not be representative of the fair value of the reporting unit as a whole (SmartPros 2001).

Non-amortisation of goodwill increases the reliance that must be placed on impairment tests of those assets. Therefore *IAS 36* requires additional disclosure to provide users with information needed to evaluate the reliability of the estimates used by management. Although the IASB has relaxed the disclosure requirements in *IAS 36*, based on the field visit participants’ and respondents’ concerns that the proposed disclosures go beyond their intended objective of providing users with relevant information for evaluating the reliability of the impairment tests (IASB 2003b), *IAS 36* still contains very rigorous disclosure requirements.

### 6.1.4 Cost

The costs of the impairment tests are likely to be high and the benefits may be diminished by their potential unreliability. For smaller companies, both quoted and unquoted, the costs



may outweigh any possible benefit. The proposed impairment test requires the fair valuation of all assets and liabilities in a cash-generating unit that are potentially impaired. Such a valuation will be expensive and time-consuming (White 2003).

To ensure compliance with *SFAS 142* and to avoid unexpected charges, many companies in the USA are paying more for professional valuation services to value goodwill and other intangibles. George D. Shaw, the Boston-based managing director of Grant Thornton Corporate Finance LLC, the accounting firm's M&A advisory subsidiary (quoted by Reason 2003), has commented that the adoption of *SFAS 142* in the USA had been good for the valuation business and that this trend would continue because ongoing testing is required. Valuation firms offer a structured process and a paper trail, which may be useful if a company's valuation practices are challenged. The US Securities Commission (SEC) released a review of the 2002 filings by Fortune 500 companies during February 2003 (cited by Reason 2003), noting that goodwill impairment was among the critical disclosures that often seemed to be materially deficient in explanation or clarity. Among the additional information that the SEC demanded were clearer descriptions of accounting policies for measuring impairment, as well as better information on how reporting units are determined and how goodwill is allocated to those units (Reason 2003).

#### 6.1.5 *Subjectivity*

The impairment test is subject to a high degree of subjectivity and uncertainty, which may make it no less arbitrary than amortisation.

Annual impairment testing is an onerous process, which requires companies to make subjective decisions about whether goodwill has declined in value. The corporate executive now has to absorb more questions because the recoverable amount of goodwill is one more item that needs to be audited (Basi & Penning 2002).

The determination of the fair value of a unit and the detailed measurement of the implied fair value of goodwill may be so subjective that the timing and amount of write-downs may not always be independently verifiable (Waxman 2001). Ketz (2001b) comments that managers will have the opportunity to deny impairments in many situations. He suggests that executives will simply find those appraisers and consultants who will provide the desired numbers leaving auditors with no benchmark by which to evaluate the treatments. The difficulty is that no one can value goodwill with precision. Ketz (2001a) is convinced that investment bankers, accountants and others will, for an appropriate fee, measure goodwill, but compares this to gazing into crystal balls. This is because goodwill cannot be sold separately and because there is no market for goodwill.

#### 6.1.6 *Different accounting treatments for goodwill and other assets*

*IFRS 3* does not differentiate goodwill in the same manner as *IAS 38* differentiates other intangible assets. In terms of *IAS 38*, intangible assets with finite useful lives should be accounted for at cost, less any accumulated amortisation and any accumulated impairment losses. Intangible assets with indefinite useful lives should not be amortised, but should be tested for impairment annually.

Goodwill and other intangible assets that are similar in nature will thus be subject to different accounting treatments, which will diminish comparability and reliability. All other assets are subjected to an impairment test only if there is an indication that they are

impaired, according to IAS 36, whereas IFRS 3 requires goodwill to be tested for impairment annually.

Goodwill is also subject to a two-step impairment test, whereas the other assets in IAS 36 that are written down to recoverable amounts are subjected to a one-step impairment test only. According to the Institute of Chartered Accountants in England & Wales (ICAEW 2003), the screening test is consistent with the impairment test for the other assets in IAS 36 that are written down to recoverable amounts and no further testing is required.

In order to test goodwill for impairment, the recoverable amount of the investment in the subsidiary has to be determined according to IAS 36. This implies that the investment in the subsidiary must also be tested for impairment annually, in comparison with other investments, which only have to be tested for impairment when there is an indication that they are impaired.

## 7 Effect of the transition from amortisation to impairment

### 7.1 Effect of the change to a compulsory annual impairment test for all goodwill

The change to an impairment test was, *inter alia*, intended to address the criticism against previous rules, which required amortisation and an impairment test only if there was an indication that goodwill may be impaired. These rules provided too much flexibility in the measurement of goodwill and gave firms too much discretion in timing the write-off. A study by Henning, Shaw and Stock (2004) suggests that in the USA firms delayed goodwill write-offs before the enactment of SFAS 142, since a disproportionately large number of the firms in their sample recognised impairments upon adopting SFAS 142. The transition to the new standard in the USA might have triggered the recognition of impairments by reducing the flexibility of previous Generally Accepted Accounting Practice.

In addition, transition period write-offs significantly exceeded predicted write-offs, suggesting that firms might have used the transition period to minimize future write-offs. This could be based on the belief that the market would view such impairments as relating to a past problem, and as having no impact on the current firm value (Henning *et al.* 2004).

The analysis set out in Table 1 of companies in the USA with high impairments in 2002, the year of adoption of SFAS 142, in comparison with significantly lower amortisation in 2001 and followed by lower impairments in 2003, may provide proof of these statements.

Table 1 Impairment versus the amortisation charges of USA companies

Company	2003 Impairment US \$ m	2002 Impairment US \$ m	2001 Amortisation US \$ m
Time Warner Inc (2004)	-	100	5
Comfort Systems Inc (2004)	3	229	11
Instinet Group Inc (2004)	22	571	8
Boeing Co (2004)	931	2 410	158
Omnova Solutions Inc (2004)	41	104	9
Storage Computer Corp (2004)	-	14	3
Exide Technologies (2004)	37	105	15

## 7.2 Effect on earnings

Basi and Penning (2002) note that the one-time charge-offs that may be made after a change to impairment could further depress already weak earnings in the financial records of some companies. In the example in Section 3.4 of this article, Company X would have to record an impairment charge of R300 000 at the end of 20x3 under *IFRS 3*, in comparison with an annual amortisation charge of R80 000 under *IAS 22*.

One estimate in the USA in 2001 was that nearly two-thirds of major companies would have to record some impairment of goodwill on adoption of SFAS 142 (Investor Relations Business 2001). According to Harrington (2003), losses due to the impairment of goodwill and other tangible assets decreased the combined reported profits of the Fortune 500 companies from \$260 billion to \$69.6 billion in the USA in 2002, due to notable charges by some firms in the changeover year of 2002. Henning *et al.* (2004) also predicted a significant increase in the number of recognised impairments in the transition year. In their examination, 205 of the 681 sample firms in the USA that announced the results of their transition impairment tests in the first quarter of fiscal 2002 reported an impairment of goodwill on adoption of SFAS 142.

The significant effect of the high impairment charges on the profits of certain companies in the USA in 2002, the year of adoption of *SFAS 142*, is set out below.

**Table 2 Impairment charges and net (loss)/profit of USA companies**

Company	Impairment	Net (loss)/profit	
	US \$ m	US \$ m	
	2002	2002	2001
Time Warner Inc (2004)	100	(99)	(5)
Comfort Systems Inc (2004)	229	(209)	13
Instinet Group (2004)	571	(735)	145
Boeing Co (2004)	2 410	492	2 827
Omnova Solutions Inc (2004)	104	(136)	(7)
Storage Computer Corp (2004)	14	(28)	(13)
Exide Technologies (2004)	105	(304)	(165)

## 7.3 Effect of previous amortisation period on transitional impairment cost

Amortisation results in a very small effect on the profitability of the acquiring company, especially where it is written off over a long period (Basi & Penning 2002).

This was confirmed by the significant effect of the changeover to an impairment test in 2002 on companies in the USA where goodwill had been amortised over long periods before. The companies recorded in Table 2 all amortised goodwill over periods longer than 15 years prior to 2002. In the case of companies that previously amortised goodwill over periods shorter than five years, the effect was insignificant. The amortisation cost for the Zi Corporation (2004), for example, was Canadian \$1.08 million in 2001, compared to an impairment charge of Canadian \$1.98 million in 2002. For Cognos Inc (2004), the amortisation cost was US \$2.5 million in 2001 and US \$4.4 million in 2002, compared to no impairment charge for the year ended 28 February 2003, when *SFAS 142* was implemented.

## 8 Characteristics of companies likely to be affected most by the transition to impairment

### 8.1 Significant abnormal returns

The study by Henning *et al.* (2004) suggests that when they adopted *SFAS 142*, firms with significant abnormal returns impaired a greater proportion of their goodwill. Of the transition firms with significant negative abnormal returns in their sample, 93% recognised goodwill impairments. The following cases also suggest evidence of this proposition.

**Table 3 Goodwill assets and net (loss)/profit of US companies**

Company	Goodwill asset US \$ m		Net loss after impairment charge US \$ m	Net loss after amortisation charge US \$ m
	2002	2001	2002	2001
Time Warner Inc (2004)	37	127	(99)	(5)
Omnova Solutions Inc (2004)	41	143	(136)	(7)
Storage Computer Corp (2004)	3	16	(28)	(13)

### 8.2 Significant goodwill assets

A balance sheet that consists substantially of intangible assets holds high risks for investors and bankers, as was demonstrated in the examples of W&A and Tollgate (*Finansies & Tegniek* 1995).

The study by Henning *et al.* (2004) suggests that goodwill is an important component of firm value and confirms that, on adopting *SFAS 142*, firms with older goodwill impaired a greater proportion of their goodwill. The average age of the impaired goodwill of the firms with significant negative abnormal returns (see Section 8.1) was 10.1 years.

In the case of Comfort Systems Inc, a leading provider of heating, ventilation and air conditioning services in the USA, goodwill as a percentage of total assets dropped from 50% in 2001 to 31% in 2002. The 2002 results included a charge of US \$229 million relating to the adoption of *SFAS 142*. A significant part of the company's growth from 1997 to 1999 resulted from acquisitions leading to significant goodwill asset amounts that required reduction under the new, more stringent standards of *SFAS 142* (Business Wire 2002).

Other companies which confirmed this trend on adoption of *SFAS 142* were Time Warner Inc (2004) (goodwill as a percentage of the total assets dropped from 61% in 2001 to 32% in 2002), the Instinet Group (2004) (goodwill as a percentage of total assets dropped from 5% in 2001 to 0% in 2002), the Boeing Co (2004) (goodwill as a percentage of total assets dropped from 10% in 2001 to 5% in 2002), the Storage Computer Corp (2004) (goodwill as a percentage of total assets dropped from 47% in 2001 to 30% in 2002) and Omnova Solutions Inc (2004) (goodwill as a percentage of total assets dropped from 22% in 2001 to 9% in 2002).

### 8.3 Number of cash-generating / reporting units

The market value of a company with only one reporting unit that acquires another company would have to fall below the company's book value before the goodwill acquired would be

subject to further impairment testing (for example, Cognos Inc acquired Adaytum in 2003 for US \$157 million in cash, resulting in goodwill of US \$154 million, but has only one reporting unit – the goodwill will therefore only be impaired if the book value of Cognos falls below the market value). In a case study done by Frucot, Jordan and Lebow (2004), the acquiring company also consisted of only one reporting unit. Here, a drop in the share price of the acquiring company's shares due to market fluctuations resulted in an impairment of 25% of the goodwill, arising from the acquisition of another company six years earlier, although the combined company was very profitable and paid very high dividends.

Large companies with multiple units would thus seem more vulnerable, although those units can often provide a substantial cushion against impairments (Reason 2003).

## 9 Conclusion

The accounting treatment of goodwill has been a matter of concern to accountants and accounting standards committees for more than a decade. International standard setters agreed in the early 1990s that goodwill should be recognised as an asset and amortised over its useful life. The issue was re-introduced at the start of the 21<sup>st</sup> century, resulting in the FASB replacing the amortisation requirement with an impairment testing approach in 2001. The IASB also adopted this approach with the acceptance of *IFRS 3* in 2004.

The examination of the nature of goodwill in Section 4 of this article has shown that goodwill exists because the fair value of a business as a going concern exceeds the fair value of its identifiable net assets. If this can be attributed to expectations of high future earnings, amortisation would result in the matching of the cost of the goodwill with expected future earnings from the acquisition. If the excess paid is due to internally generated intangibles that are not recognised as assets, or expected synergies from combining the businesses of the companies involved, the impairment approach would permit the capitalisation of these internally generated intangible assets. This could result in companies' never having to recognise an impairment of the acquired goodwill, which would give companies growing through acquisitions the advantage of recognising inherent goodwill as an asset.

A comparison between amortisation and impairment revealed that amortisation is well understood and that it is a well-established principle consistent with the approach taken to other tangible and intangible assets with finite useful lives, but that it ignores the fact that some forms of goodwill can have an indefinite useful life. The impairment test approach, on the other hand, seems to involve a very different and much more complex, costly and subjective accounting process. Fair value measurements can be difficult to do and may need to be done by valuation experts. In cases where stock prices are used as estimates for fair values, goodwill might have to be impaired, although the current price at which the company's stock trades might not reflect its fair value and thus not be representative of the fair value of the reporting unit as a whole. It may therefore be more appropriate to treat goodwill in the same way as other intangible assets: amortising finite life goodwill and subjecting it to an impairment test only where there is an indication that it has been impaired, while subjecting indefinite life goodwill, where the life of goodwill is difficult to assess, to an annual impairment test. This will ensure that accounting for goodwill takes into account the nature of goodwill as an intangible asset, as well as the reasons for its existence, without unnecessarily subjecting it to a complex and costly annual impairment test.

An examination of the effect that the transition from amortisation to impairment has had on companies in the USA suggests that many South African companies may have to record an impairment of goodwill when they adopt *IFRS 3*, especially those who were seen to be “growing” because they were acquiring new businesses and merging them with their own in the late 1990s and early 2000s.

Transition period write-offs significantly exceeded the predicted write-offs on adoption of *SFAS 142* in the USA in 2002, suggesting that firms might have used the transition period to minimize future write-offs. It is especially where companies delayed goodwill write-offs before the adoption of *SFAS 142*, that high impairment charges in the transitional year had a significant impact on their earnings. Companies where goodwill was amortised over long periods under the old accounting rule, as well as companies with significant and older goodwill assets, had to impair a greater proportion of their goodwill on adoption of *SFAS 142*.

Finally, it appears that amortisation provided the opportunity for goodwill to have a very small and systematic effect on the profitability of the acquiring company. Impairment losses, on the other hand, are likely to occur irregularly and in varying amounts, causing volatility in reported earnings. Although impairments are a non-cash charge, they obviously have a very big negative effect if a company is writing off a substantial amount of goodwill because an acquisition does not live up to expectation. Overstating goodwill can make an otherwise marginally lucrative deal look worthwhile, but companies will now have to be careful with deals based on “back-of-the-envelope” calculations, as more rigorous accounting now needs to be applied to the goodwill acquired.

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