Critically evaluate how effective the treatment of goodwill is in meeting the objectives and qualitative characteristics outlined in the IASB conceptual framework

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Abstract

This paper introduces the connotation, role, and international norms related to goodwill. Then from two perspectives of the conceptual framework and IFRS, this paper deeply analyzes whether the initial recognition, initial measurement, subsequent measurement and presentation of goodwill is effective, whether it can provide the information needed by investors within the cost constraint. Fianlly this paper reveals some of the current problems, as well as unmet needs, and propose corresponding improvements.

Keywords

IASB Conceptual Framework, Goodwill, IFRS.

1. Introduction

Financial reporting which is preparing and presenting financial statements by companies for its stakeholders like investors and creditors is of significant use to understand the companies' financial performance and position. Stakeholders will make various economic decisions on the basis of the financial information reported, for example, whether to buy the company's ordinary shares or whether to lend more to the company. Qualitative characteristics of financial reporting include relevance, faithfully representation, comparability, verifiability, understandability, and timeliness. Financial reporting always follows specific systematic accounting framework in order to ensure financial information reported are useful and contains those qualitative characteristics.

Goodwill can be defined as good relationship developed with customers or good reputation of providing high-quality products or service. From the perspective of the source of value, goodwill refers to that enterprise can obtain higher rate of return on investment than before. In other words, goodwill brings additional value into the enterprise. There are two types of goodwill. One is internally generated goodwill while another one is acquired goodwill from business combination. In financial reporting, only acquired goodwill is taken into consideration. There are totally over $2 trillion amount of acquired goodwill in S&P 500 campaniles' statements of balance sheet [1]. Thus, acquired goodwill is a material item.

Besides, attention is also paid to accounting standards which govern treatment of acquired goodwill. All over the world, there are quite a few different accounting standards for acquired goodwill. As Hogna and Matuszewski summarized in their article, generally there are five sets of standards which can be applied to a private company's goodwill treatment. They are Big GAAP, IFRS, Little GAAP, IFRS for SMEs, and FRF for SMEs [2]. Discussing and analyzing all these standards is difficult and almost impossible in one time. Thus, to narrow the scope and dig deeper, only basic conceptual framework and IFRS issued by IASB will be discussed and analyzed throughout this paper.

2. Accounting Conceptual Framework

A conceptual framework contains all generally accepted accounting principles which act as guidelines for financial reporting and for further specific accounting standards setting. It identifies basic acknowledged rules relating to item recognition and measurement in financial reporting [3]. Without a conceptual framework, inconsistencies and contradictions will appear as one fundamental principle may be dealt with and interpreted differently in different standard setting situations. Generally accepted accounting principles contained in a framework often take account of local company law, local accounting standards, national statutory requirements and international accounting standards. Thus, different countries may choose to use different conceptual framework. With different accounting conceptual frameworks, it's difficult to establish unified worldwide accounting standards, which make comparisons of cross-national financial reports more difficult and less accurate. In order to unify worldwide financial reporting standards, the IASB and FASB, whose frameworks are the two most often used, have collaborated to decrease differences between them and to create a common conceptual framework since 2004 [4].

The IASB which used to be IASC is an accounting standards setter. IASC had set 42 IASs before and IASB has adopted those 42 IASs and issued additional 14 IFRSs so far [5]. In 2010, IASB replaced the 1989 Framework for Presentation of Financial Statements by the Conceptual Framework for Financial Reporting, due to the collaboration with FASB reflecting by chapter 1 and 3. A further revise on chapter 4 was completed in 2015 [6]. Taking account of continuing changing environment, IASB makes efforts to keep its framework up to date. ISAB sets IFRS through a due process. Advisory committee gives advice on specific proposals. Then IASB prepares discussion paper for public comment. After taking those comments into consideration, an exposure draft will be provided again for further public comment. Finally, an international financial reporting standard will be issued [5].

The purpose of the IASB framework is to assist future IFRS setting, promote harmonization to presentation of financial statements, and provide a basis to reduce accounting treatment choices permitted. Therefore, standards used by companies in preparing financial statement are the same, which make comparison of financial statement easier and more effective. IASB also provides a benchmark for auditors to audit companies reported financial statements. With the conceptual framework, IASB is able to set effective international accounting standards which ensure the accuracy and unification of accounting treatment and the qualitative characteristics of financial information reported.

3. Goodwill Treatment Under IFRSs

IFRS is more widely used. All companies listed in Europe are required to adopt IFRS for financial reporting start from 2005. Example standards that guide the treatment of acquired goodwill include IAS 36 impairment of assets and IFRS 3 business combination [7]. IFRS 3 is used in early recognition stage of goodwill. For later measurement of goodwill, IAS 36 is followed.

For initial recognition and measurement, only purchased goodwill arising from business combination is recorded in the purchaser's statement of financial position. Internally generated goodwill is not recognized or presented in the statement of financial position. Only when consideration paid is greater than the fair value of acquired net assets, an acquired goodwill will appear. The initial amount recorded of acquired goodwill is the difference between consideration paid and the fair value of all identifiable net assets. Intangible assets that can be identified separately should be recorded in a separate account. Only inseparable intangible assets remaining are included in goodwill [8]. This amount should be recorded as an intangible non-current asset in the purchaser's statement of financial position. If the fair value of acquired net assets exceeds consideration paid, there will be a negative goodwill which will be charged as a gain or loss to profit or loss.

For later measurement, amortization used for other intangible non-current assets is not applicable to purchased goodwill. Instead the purchased goodwill is treated as if it has indefinite useful life and annual impairment loss test is conducted. When the total recoverable amount of assets in a CGU is below their carrying amount, then an impairment loss occurs and the amount of the loss is the difference between the two amounts. Recoverable amount of assets in a CGU will be the higher of fair value and value in use. Fair value is the market price that the asset can be sold in current condition. Value in use can be calculated by using the DCF method. Goodwill impairment loss cannot be reversed like that of tangible non-current assets revaluation. In other words, after the business combination the amount of purchased goodwill cannot be increased but only can be decreased by impairment loss [9]. Determined amount of impairment loss will be allocated to goodwill of the CGU first, and then the remaining will be allocated to other assets in the CGU pro rata.

Compared to its definition and valuation, presentation requirement of goodwill under the guidance of IFRS 3 Business Combination is easier to understand and to follow. Generally, internally generated goodwill is not presented in statement of financial position. Only purchased goodwill will be displayed in the acquirer's statement of financial position. As the standard requires, difference between the purchase consideration and the fair value of all identifiable net assets is the value of goodwill and this amount should be recorded as an intangible non-current asset in the acquirer's statement of financial position. Under IFRS 3, amortization used in other intangible non-current assets is not applicable to goodwill. Instead the purchased goodwill is treated as if it is indefinite and annual impairment loss review is conducted. Only when the value of purchased goodwill decreases below its original recorded value, will the amount of decrease be expensed at that period which follows the conceptual framework that expense is recorded at the period when it incurs.

4. Unsatisfied Fulfillment of Goodwill Standards Requirements

In 2013, European Securities and Markets Authority conducted a systematic review of goodwill impairment on the basis of IFRS requirements. 235 European listed corporations which had large amount of goodwill in their accounts and gave fair representations of all European corporations were selected as research objects. First of all, requirements of IFRS relating to goodwill were reviewed. Secondly to verify whether all sample organizations had fulfilled these requirements, information presented in their consolidated financial statements were collected and analyzed. Main issues examined relating to goodwill impairment included determination and disclosure of key assumptions, determination of recoverable amount, and sensitivity analysis.

First of all, although most organizations did provide some information about key assumptions, the amount was not sufficient and didn't completely fulfill standard requirements. One third of organizations provided vague and general explanations and disclosures about reasons for goodwill impairment loss instead of detailed and specific information. In addition, half of those organizations didn't provide any description of composition or changes of CGU on which impairment loss analysis and allocation were based.

Secondly, determination of recoverable amount is a complicated process. However, most of these companies didn't provide enough explanation of how recoverable amount was obtained. There are two ways to determine recoverable amount: fair value less cost of sale and value in use. Fair value less cost of sale can be obtained from the market for example recent sale of similar asset or from an independent valuation expert. Compared to fair value less cost of sale, value in use is more subjective and is obtained through discounted cash flow calculation. To perform a discounted cash flow calculation, management will estimate a pattern of later annual cash flows and discount them by a predetermined discount rate. As the description above shows, it is difficult for investors to understand how recoverable amount is determined without sufficient information. The important point here is that organizations should explain and disclose sufficient information based on which recoverable amount is determined, so that investors can have a better understanding of the reasonableness and accuracy of recoverable amount.

Thirdly, sensitivity analysis which measures how goodwill impairment is affected by changes to related calculation components is required to be performed. Information of sensitivity analysis is required to be disclosed as any changes in components like CGU or recoverable amount would affect the determination of impairment loss. However, only a quarter of organizations disclosed sensitivity analysis information of a few factors which have a larger influence of impairment loss [10].

5. Conclusion

Guided by the IFRS 3, the financial reporting of goodwill is more unified within international business environment and reduces the possibility of conflicts among various goodwill treatment methods. It is more systematic and reliable. Users can attach more reliance on the reported amount of goodwill and auditors can have a qualified standard to verify companies' financial reporting accuracy relating to goodwill. Reinforcing the aim of IASB conceptual framework, IFRS 3 unifies the standard of goodwill treatment which increases the harmonization of international accounting. In financial reporting, the treatment of purchased goodwill as an intangible non-current asset after acquisition will increase acquirer asset level in statement of financial position.

More complicated and controversial influence of goodwill treatment is the determination of latter impairment loss by management judgment. The amount of annual impairment loss will affect annual profit. This increases the possibility of management manipulation and profit volatility. Some critics even exaggerate the negative effect of management discretion in determining impairment loss. They insist that impairment loss will be abused by management to conceal actual company performance and to smooth profit. However, a study using a sample of 528 firm with a "pooled multivariate orbit regression" demonstrated the combined influence of economy, managerial discretion, and corporate governance mechanism on determining the goodwill impairment loss [11]. The amount of impairment loss is not determined solely by management. Other factors over which management have little control like external economy and internal corporate governance policies all take part in the decision process. It manifested that under the guideline of IFRS 3 management actually report their true financial information objectively and reliably.

IFRS is widely used as a basis for international financial reporting in more than 100 countries around the world and is mandatory for all European listed companies. As a result IFRS play a more important role than U.S. GAAP as international financial reporting standards [12]. Specifically, goodwill is a controversial area in accounting. The IFRS 3 plays an important role in reducing goodwill complication and ensures goodwill information reported is objective, accurate and reliable. With its benefits overweight its little shortcomings, IFRS 3 is a typical standard that reflect the purpose of IASB conceptual framework and help ensure those qualitative characteristics of financial information reported.

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