GOODWILL ACCOUNTING IN THE UNITED KINGDOM: THE EFFECT OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Amer Qasim, Al Ain University of Science and Technology- Abu Dhabi
Ayman E. Haddad, American University of Kuwait- Kuwait
Naser M. AbuGhazaleh, Gulf University for Science and Technology (GUST)- Kuwait

ABSTRACT

The accounting treatment of goodwill has been the source of much debate and controversy amongst standard setters and financial report preparers in UK and many other countries. There have been great difficulties in the definition, measurement and subsequent accounting treatment for goodwill. Despite this, goodwill is a significant asset in many companies, whose existence and value are maintained by considerable annual expenditure. Accounting for goodwill changed in the UK in 2005 through the combined effects of the new International Accounting Standards, IFRS 3, Business Combinations, and IAS 36 Impairment of Assets. This paper critically examines, based on the accounting literature and professional standards, the change in accounting treatment for goodwill pursuant to international financial reporting standards (IFRSs) by reference to the UK accounting standards. It critically discusses and compares the former UK and new IFRS policies for goodwill accounting demonstrating the advantages of and arguments against the impairment-only approach to goodwill. It also highlights the sources of managerial discretion in testing goodwill for impairment and provides concluding remarks. Further studies are needed to examine the long-term effects of the impairment only approach to determine whether managers' opportunistic choices or their incentives to convey their privately held information drive the recognition of goodwill impairments. The paper has implications for financial report prepares and users in highlighting conceptual issues of relevance that will arise in the application of the impairment-only approach to goodwill. It also provides a thorough review of the literature published on the accounting treatment for goodwill in the UK and provides avenues for future research.

JEL: M41

KEYWORDS: Goodwill Accounting, Impairment, International Accounting Standards, United Kingdom

INTRODUCTION

The controversy over accounting for goodwill has existed for many years. The issue of accounting treatment for goodwill has been seriously debated and has challenged financial report preparers and standard setters for decades. It has been the focus of extensive lobbying, principally by financial report preparers (Wines et al., 2007; Nobes, 1992; Bryer, 1995).

The term goodwill was initially used to mean value created by customer loyalty. One of the oldest definitions of goodwill is that of Lord Elton in 1810, given in a case at a bar in England more than one hundred ninety years ago, who defined goodwill to be "nothing more than the probability that the customers will resort to the old place." (cited in Owens, 1923, p. 282). However, accountants and others have criticized this definition because it connects goodwill with the idea of place (Owens, 1923). Later, this view was broadened to cover other intangibles capable of enabling a firm to generate profits in excess of the normal yield on other identifiable assets (Arnold et al., 1992). In short, goodwill was viewed as the present value of the future stream of superior earnings of the business to be acquired. Under this approach (the excess profits approach), earnings are determined and recorded as goodwill. However, goodwill, as conceptualized by this definition, is identified as an economic value, which is very difficult to measure

since future earnings cannot be predicted with certainty (Seetharaman et al., 2004; Russel et al., 1989). The view of goodwill, which has been most influential in accounting thought, is the residuum approach that views goodwill as the excess of purchase price over and above the fair value assigned to the net assets acquired exclusive of goodwill (Arnold et al., 1992). Such goodwill will normally be positive; however, negative goodwill arises when the aggregate fair values of the net assets acquired exceed the acquisition cost. In these terms, while it may be generated internally, goodwill (by definition) is incapable of realization separately from the business as a whole and is only recognized in an accounting system when an entity has acquired another entity or part thereof, as goodwill cannot be purchased or sold as a separate item (Wines et al., 2007).

Certainly, three different approaches to accounting for goodwill have been proposed in the UK in the last 25 years: immediate write-off to equity reserves; capitalization with systematic amortization, and capitalization with impairment reviews (ASC, 1984; ASB, 1997; IASB, 2004a). The latest change to goodwill accounting was introduced in 2005 through the combined effects of the new International Accounting Standards, IFRS 3, *Business Combinations*, and IAS 36 *Impairment of Assets*.

While IFRS 3 prohibits the amortization of goodwill and forces managers to test it for impairment annually, irrespective of whether there is any indication that it may be impaired, it also provides the opportunity for accounting discretion by requiring managers to make several important accounting choices, of which the determination of the cash-generating units, the subsequent allocation of goodwill to these units, and the recoverable amount estimates of the units are the most important. Some managers may use this discretion to convey their private information; alternatively, others may use it opportunistically to distort the underlying economics of the firm by being selective with respect to the underlying choices they make when testing goodwill for impairment. Therefore, ex-ante, it is unclear how the impairment-only approach has affected the reporting of goodwill impairment losses, including the related managerial flexibility exercised in determining them. Given the significant amounts of goodwill in UK firms, the impact of the different goodwill accounting approaches on firms' financial statements is often not trivial. An indication of the role of purchased goodwill is provided by the ratio of purchased goodwill to the acquirer's total assets. AbuGhazaleh et al. (2011) report the mean value of this ratio to be 19%, reaching a maximum of 79 %. The sample of their study is drawn from the top 500 UK listed firms for the years 2005 and 2006, a period characterized by a high volume of mergers and acquisitions according to the British Office of National Statistics.

Motivated by the significance of goodwill in the UK company accounts and the inadequacy of critical research on the application of the new goodwill accounting requirements, this paper critically examines, based on the accounting literature and professional standards, the change in accounting treatment for goodwill pursuant to IFRSs by reference to the UK accounting standards. The paper has implications for financial report prepares and users in highlighting conceptual issues of relevance that will arise in the application of the impairment-only approach to goodwill and is expected to extend our understanding of goodwill impairment accounting. Standard setters may also find this paper useful in their continuing deliberations on how best to structure and implement future standards that leave considerable room for managerial discretion and interpretation. The paper may also prove to be useful for researchers as it provides a thorough review of the literature published on the accounting treatment for goodwill in the UK and suggests area of potential future research. The issues raised in this paper may be of interest to any reporting regime based on IFRSs

The remainder of this paper is organized as follows. Section 2 briefly reviews the relevant prior literature. Section 3 critically discusses and compares the former UK and new IFRS policies for goodwill accounting. Sections 4 and 5 demonstrate the advantages of and arguments against the impairment-only approach to goodwill. Section 6 discusses the sources of managerial discretion in testing goodwill for impairment. Finally, Section 7 concludes.

LITERATURE REVIEW

Accounting for goodwill has long been a controversial area in the UK. The degree of controversy surrounding goodwill is presumably related to the quantities of goodwill that managers have to deal with (Nobes, 1992). Following the USA, the UK is considered the world's second largest market for corporate control. Higson (1998) reports that, as a proportion of the acquirer's net worth, the average goodwill in UK takeovers grew from negligible levels between 1976 and 1983, to an average of 60 % in 1988. There appear to have been two main reasons for the increase. The first was due to the increase in the market value of companies relative to the book value of their assets (Arnold et al., 1992, p. 3; Higson, 1998, p. 142). The second was the increasing proportion of companies taken over in the services sector, where a substantial part of the value consisted of intangible assets traditionally included in goodwill (Arnold et al., 1992, p. 3; Peasnell, 1996). In consequence, the accounting treatment for goodwill has become a major concern for financial report preparers and for accounting regulators. It has also been the focus of extensive lobbying, principally by financial report preparers (Nobes, 1992; Bryer, 1995).

Nobes (1992) identified several parties involved in the political process of standard setting in the UK, and concluded that different pressures resulted in a "cyclical standard setting" for goodwill in the 1980s. On the one hand, managers opposed standardization and income reductions, and on the other hand senior policy makers, government, press and international influences proposed it, which resulted in "dramatic swings in the content of documents on goodwill" issued by the UK standard setter (Nobes, 1992, p. 142).Bryer (1995, p. 283) develops another theory based on a Marxist analysis to explain goodwill accounting in the UK and argues that the immediate write-off of goodwill against equity reserves encouraged by SSAP 22 (ASC, 1984, 1989) was in the "collective interest of investors because it helped to hide from public view the fact that dividends were being paid from capital". In a study for the UK Accounting Standards Board (ASB), Arnold et al. (1992) conclude that, "although much has been written on the problem of accounting for goodwill during the past century, a solution remains elusive" (Arnold et al., 1992: p. vii).

Certainly, three different approaches to accounting for goodwill have been proposed in the UK in the last 25 years: immediate write-off to equity reserves; capitalization with systematic amortization, and capitalization with impairment reviews (ASC, 1984; ASB, 1997; IASB, 2004a). Given the significant amounts of goodwill in UK firms, the impact of these different approaches on firms' financial statements is often not trivial. The new requirements of IFRS 3 to review goodwill arising on acquisition for impairment as soon as possible after the acquisition date implies that any over-payments or under-performance have to be written-off immediately against income from operations, suggesting that the impairment approach may provide managers with incentives to use their accounting discretion to affect the timing and/or amount of such write-offs.

Motivated by the significance of goodwill in the UK company accounts and the inadequacy of critical research on the application of the new goodwill accounting requirements, this paper, based on the accounting literature and professional standards, critically discusses and compares the former UK and new IFRS policies for goodwill accounting demonstrating the advantages of and arguments against the impairment-only approach to goodwill. It also highlights the sources of managerial discretion in testing goodwill for impairment and provides concluding remarks

THE ACCOUNTING FOR GOODWILL IN THE UK

Superseded UK Accounting Treatment for Goodwill

By the beginning of the 1980s, practice in the UK was varied: some companies carried permanent goodwill; others amortized it, and most wrote goodwill off against reserves (Nobes, 1992).

The first official statement on accounting for goodwill in the UK was the publication in June 1980 of an Accounting Standards Committee Discussion Paper, *Accounting for Goodwill*. The Discussion Paper suggested that purchased goodwill should be systematically written off over its useful life, with a maximum of 40 years for amortization (ASC, 1980). Reactions to the Discussion Paper were mixed. Although there was some support for this conclusion from commentators, the majority of them believed that continued recognition of expenditure on purchased goodwill was of no value to the users of the accounts (Nobes, 1992).

This Discussion paper was followed by Exposure Draft 30, *Accounting for Goodwill*, issued in October 1982. ED 30 recommended that firms be allowed the option of either amortizing goodwill over its useful economic life (over up to twenty years), or writing it off against equity reserves in the year of acquisition. ED 30's theoretical justification for the immediate write off option was that purchased goodwill and non-purchased goodwill are of the same nature; hence, it is inconsistent to recognize the purchased goodwill in the financial statements and not to recognize the non-purchased goodwill (ASC, 1982, para 18). The public response to ED 30 indicated support for each of immediate write-off, amortization and a choice between them (Nobes, 1992).

The primary accounting standard for goodwill accounting in U.K was set out in Statement of Standard Accounting Practice No.22 (SSAP 22), *Accounting for Goodwill* issued by the ASC in December 1984 and revised in July 1989 (ASC, 1984, 1989). SSAP 22 permitted companies either to write off goodwill immediately against equity reserves or to capitalize and amortize it over its useful life. SSAP 22, although permitting either method, expressed a very strong preference for the immediate write off option (the preferred treatment) on the basis that it was consistent with the "accepted practice of not including non-purchased goodwill in accounts" (ASC, 1984, para 6). However, SSAP 22 remained silent on which reserves could be used for the purpose of writing off goodwill which resulted in a diversity of practice in this respect .A further change from ED 30 was that, in response to some criticism of the twenty-year amortization period, a time limit was not included in SSAP 22 (Nobes, 1992). The only significant practice to be outlawed was carrying goodwill as an asset without amortization.

Practice after SSAP 22 was almost universally to adopt its preferred method of immediate write off (Nobes, 1992; Arnold et al., 1992). Russell et al. (1989) reported that by 1986 the vast majority (98%) of large surviving UK firms were following the immediate write-off practice recommended by SSAP 22. The immediate write-off option was attractive to firms active in the market for corporate control since the firms' post acquisition reported profit figures were not adversely affected by the price paid for goodwill, thereby increasing the rate of return on capital and leading to the post acquisition results appearing more favourable (Peasnell, 1996). However, this accounting treatment soon led to some companies running against borrowing restrictions or stock exchange regulations due to the depletion of reserves. They were also concerned that their balance sheets were "weakened", making it less easy for them to take over and easier to be taken over (Arnold et al., 1992; Nobes, 1992; Russell et al., 1989). Furthermore, the UK practice of immediate write-off against equity reserves was out of step with that in the USA and most other European countries (Arnold et al., 1992).

From a theoretical point of view, immediately writing off goodwill against equity reserves is hard, if not impossible, to justify. It is simply a convenient way of disposing of an unwanted debit without reducing

reported profit. It breaks the relation between reported profits and investment decisions, which managers are supposed to be accountable for (Arnold et al., 1992). Another unsatisfactory aspect of writing off goodwill against reserves is that it creates a possible bias against real investment in the economy (Arnold et al., 1992). Much of research and development expenditure has to be immediately charged against profits and investments in tangible fixed assets have to be depreciated. Writing off goodwill against reserves can give the impression that companies that grow through mergers and acquisitions are more profitable than other businesses, thereby raising the "buy-or-make decision" (Arnold et al., 1992, p. 59). In addition, this approach is against the accounting matching convention, which suggests that goodwill should be carried forward as an asset and matched against revenues of the periods expected to benefit from its use. However, the main advantages associated with this approach are that it avoids the difficult task of estimating the useful economic life of goodwill and is consistent with the general approach of not recognizing internally generated goodwill in the accounts (Lewis and Pendrill, 2004).

A controversial solution, which became increasingly popular in the late 1980s was to capitalize a major portion of purchased goodwill as brands and similar intangibles. Brands, unlike goodwill, were not the subject of an accounting standard and so did not have to be written off (Arnold et al., 1992). Consequently, it has been argued that SSAP 22 provided managers with accounting choices with respect to the initial recognition and subsequent accounting treatment for goodwill (Grinyer et al., 1991; Gore et al., 1998). Grinyer et al. (1991) report that the proportion of purchase price assigned to separable net assets and consequently to acquired goodwill was affected by contractual motivations such as gearing (leverage) and the availability of merger relief reserves. Similarly, Gore et al. (1998) report that contractual motivations such as debt covenants and management compensation schemes affected managers' reporting choices with respect to the two alternatives permitted by SSAP 22.

In response to criticism of SSAP 22, the ASC issued ED 47 (ASC, 1990a), *Accounting for Goodwill,* which required all purchased goodwill to be capitalized and systematically amortized over a period not to exceed 40 years, and outlawed the immediate write off against reserves. The major criticism was that the immediate write-off option obscured the rate of return on capital. The ASC also issued ED 52 (ASC, 1990b), *Accounting for Intangible Fixed Assets*, which would require brands and other similar intangibles to be amortized on the same basis as it proposed for goodwill in ED 47. While SSAP 22 attempted to achieve consistency between the accounting treatments of purchased and internally generated goodwill, ED 47 attempted to achieve consistency between the treatments of purchased goodwill and that of other purchased intangible and tangible fixed assets. ED 47 provoked confusion since UK firms had become rather fond of the protection that SSAP 22 had given to their earnings during the 1980s, a decade of major acquisition activity (Paterson, 2002). Responses to ED 47 from the corporate sector were almost wholly negative, and the proposal was never converted into an accounting standard (Nobes, 1992, Peasnell, 1996).

When the Accounting Standards Board (ASB) replaced the ASC in August 1990, the task of dealing with the goodwill problem was indeed a daunting one. Existing and proposed UK treatments were severely opposed by many, and experience from other countries such as USA suggested that international treatments were no less problematic (Kirkham and Arnold, 1992). In December 1993, the Accounting Standards Board issued a Discussion Paper, *Goodwill and Intangible Assets* (ASB, 1993). In this proposal it was stated that ASB would allow goodwill not to be charged to the profit and loss account through the annual amortization charges, but a write down would be required only where the goodwill had suffered impairment in value. The idea of impairment reviews first surfaced in an ASB-sponsored study (Arnold et al., 1992). The ASB has since devoted considerable effort to devising and pilot testing means of carrying out such impairment tests (Peasnell, 1996).

In June 1995 the ASB issued a Working Paper (WP) *Goodwill and Intangible Assets* (ASB, 1995). This working paper supported capitalization and amortization for goodwill and intangibles, except for those

that are believed to have indefinitely long lives, in which case impairment tests only were to be used. The working paper also suggested that all balances for goodwill and intangibles, whether being amortized or not, would be subject to annual impairment tests and the balance sheet carrying value reduced via an immediate expense. After public hearings, this Working Paper was followed by a Financial Reporting Exposure Draft, FRED 12, *Goodwill and Intangible Assets*, in June 1996, and finally a new standard was issued in December 1997, FRS 10, *Goodwill and Intangible Assets*, both of which broadly followed the thinking of the 1995 working paper.

FRS 10 (ASB, 1997) was issued in December 1997 and seemed to have resolved most of the controversy surrounding goodwill at that time by addressing the issue of goodwill and other intangible assets in the same standard. FRS 10 required that purchased goodwill and intangible assets should be capitalized as assets and amortized under a rebuttable presumption that their useful economic lives do not exceed 20 years from the date of acquisition. However, there may be grounds for rebutting this presumption and regarding the useful economic life as greater than 20 years, or even indefinite, but only when the goodwill or intangible asset is expected to be capable of continued measurement. Where goodwill or intangibles are regarded as having indefinite useful economic lives, they should not be amortized. If goodwill is not amortized, or amortized over a period of more than 20 years, then an impairment review must be performed each year to ensure that the carrying value of the goodwill does not exceed its recoverable amount (the higher of net realizable value and value in use), in accordance with FRS 11 *Impairment of Fixed Assets and Goodwill* (ASB, 1998). In addition, an indication of impairment requires an impairment review without regard to the amortization period. FRS 10 permitted the reversal of a past goodwill impairment loss only if it can clearly be attributed to the unforeseen reversal of the external event that caused the recognition of the original impairment loss.

The way that UK firms applied the requirements of FRS 10 and FRS 11 was regarded as "slightly surprising, given their long-standing hostility to amortizing goodwill: most of them chose the amortization route in order to avoid the complexities of the full-blown impairment testing regime" (Paterson, 2002, p 102). Andrews (2006) reports that the majority of large UK firms in the 2004 financial year have selected 20 years as the finite useful economic life for goodwill and have amortized the asset over its finite life.

All European public companies have been required to use International Financial Reporting Standards (IFRS), including International Accounting Standards (IAS), to prepare their consolidated financial statements since 2005. Under the new international regulatory environment, UK public firms will have to prepare their financial statements in accordance with the International Standards and change the way they account for goodwill accordingly.

IFRS 3 *Business Combinations* and IAS 36 *Impairment of Assets*

In June 2001, the U.S FASB issued SFAS No.141, *Business Combinations* (FASB, 2001a), and SFAS No.142, *Goodwill and Other Intangible Assets* (FASB, 2001b), thereby replacing the existing requirements to amortize goodwill with an impairment testing approach. The IASB, seeking international convergence and global harmonization, followed the U.S FASB, and issued a new International Financial Reporting Standard (IFRS), namely IFRS No.3, *Business Combinations*, in 31 March 2004 (IASB, 2004a). The IASB revised IAS 36, *Impairment of Assets* (IASB, 2004b) on the same date. The requirements of these standards are quite similar to the U.S SFAS 141 and SFAS 142. IFRS 3 and IAS 36 (revised) replaced IAS 22, *Business Combinations* (IASC, 1983, 1998a) and IAS 36 (1998b), respectively.

Under IFRS 3, goodwill is no longer amortised but tested for impairment in accordance with IAS 36 (IASB, 2004b). According to IAS 36, goodwill acquired in a business combination should, from the

acquisition date, be allocated to each of the acquirers' cash-generating-units, or groups of cash-generating-units that are expected to benefit from the synergies of the business combination. Each unit or group of units to which goodwill is allocated should represent the lowest level within the entity at which goodwill is monitored for internal management purposes; and it should not be larger than a segment based on either the entity's primary or secondary reporting format according to IAS 14 *Segment Reporting* (replaced by IFRS 8 *Operating Segments* on 30 November 2006). A cash-generating unit to which goodwill has been allocated shall be tested for impairment both annually and whenever there is an indication that the unit may be impaired. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit are not impaired. If, instead, the carrying amount of the unit exceeds its recoverable amount, the entity must recognise an impairment loss. The *recoverable amount* of an asset or a cash-generating unit is the higher of its *fair value less costs to sell* and its *value in use*.

The impairment loss is allocated firstly to the goodwill of the cash-generating unit (group of units) and then on a pro rata basis to the other assets within the unit (group of units), as long as it does not reduce any asset below the highest of its fair value less costs to sell, its value in use, and zero. The impairment loss is recognised immediately above the line in income from continued operations. Once recognised, IAS 36 prohibits the recognition of reversals of impairment losses for goodwill in subsequent periods.
According to IFRS 3, negative goodwill must be recognized immediately in the income statement as a gain. However, before concluding that negative goodwill has arisen, IFRS 3 requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination (IASB, 2004a, para 56).

ADVANTAGES OF THE IMPAIRMENT APPROACH

The underlying logic for prohibiting the traditional amortization method is that straight-line amortization of goodwill over an arbitrary period does not reflect economic reality and thus does not provide useful information to the users of the accounts (Wines et al., 2007; IASB, 2004a; FASB, 2001b). It is usually possible for preparers to determine the economic life of depreciating assets, even if they cannot find a non-arbitrary way of allocating cost over that life; "with goodwill this is much more difficult, if not impossible" (Arnold et al., 1992, p. 60, Lewis and Pendrill, 2004).

In developing IFRS No. 3, the Board observed that the useful life of acquired goodwill and the pattern in which it diminishes generally are not possible to predict, yet its amortization depends on such predictions. As a result, the amount amortized in any given period can at best be described as an arbitrary estimate of the consumption of acquired goodwill during that period. Consequently, the Board argued that straight-line amortization of goodwill over an arbitrary period fails to provide useful information and concluded that a rigorous and operational impairment test would provide more useful information to the users of the financial statements (IASB, 2004a, BC 140, 142).

The amortization charge to goodwill has always been difficult to interpret. Many financial analysts used to ignore the goodwill amortization expense in their analysis of earnings per share (FASB, 2001b, B 77). Furthermore, many firms used to ignore the goodwill amortization expense in measuring operating performance for internal reporting purposes (FASB 2001b, B 90). Prior empirical studies examining the impact of the amortization expense on share prices provide little evidence that it is of significant value to users (Jennings et al., 2001; Moehrle et al., 2001). For example, Jennings et al. (2001) examine whether total earnings with goodwill amortization is more informative than total earnings before amortization. They find that earnings before goodwill amortization explain significantly more of the observed distribution of share prices than earnings after goodwill amortization, and that goodwill amortization adds "noise" making it harder for investors to use the earnings measure to predict future profitability. Similarly, Moehrle et al. (2001) find little evidence that goodwill amortization contains value relevant

information and suggest that the amortization disclosures were not decision-useful, thereby, supporting the FASB's choice of impairment tests for goodwill instead of amortization.

Another argument against the amortization of goodwill provided by the FASB, is that amortization of goodwill is based on the assumption that goodwill is a wasting asset, and thus ignores the fact that part of what is recognized as goodwill may have an indefinite useful life that could last as long as the business is considered a going concern (FASB, 2001b, B 82).

Although testing goodwill for impairment was required in certain circumstances under the provisions of the superseded accounting standards, the impairment-only approach to goodwill requires an annual impairment test irrespective of whether there is any indication that goodwill may be impaired, and thus imposes a more stringent impairment requirement. One of the criticisms of the pre-impairment approach is that an absence of a specific impairment trigger gave firms too much discretion in timing the write-offs, which could be used by managers opportunistically to meet certain reporting objectives, resulting in impairments that do not adequately reflect the underlying economics of the firm (Henning et al., 2004).

For example, Hayn and Hughes (2006) report that a large number of pre-SFAS 142 goodwill write-offs appear to be taken only after a considerable period of time (three to four years) has elapsed after the economic deterioration of the firm, suggesting that managers were exercising their reporting discretion to delay goodwill write-offs before the implementation of SFAS 142 presumably to meet certain reporting objectives. Similarly, Henning et al. (2004) find that U.S firms delayed goodwill write-offs before the adoption of SFAS 142 since a disproportionately high percentage of firms with weak performance have recognized impairments upon adopting SFAS 142 and the transition period write-offs significantly exceeded predicted write-offs. In addition, prior U.S and UK studies examining goodwill write-offs (as a subset of asset-write-offs) prior to the adoption of the impairment-only standards report that these write-offs are void of economic substance and more likely to be associated with managers' reporting incentives than other classes of fixed assets (Francis et al., 1996, Kvaal, 2005). The requirement to test goodwill for impairment annually is likely to eliminate the discretion available to managers in deciding when to test goodwill for impairment which may in turn result in the recognition of more timely impairments that better reflect the true underlying economics of the firm.

Furthermore, a number of studies examining the information content of goodwill impairments recorded subsequent to the adoption SFAS 142 report negative correlations between these impairments and stock returns and suggest that the impairment-only approach to goodwill has improved the quality of reported information on goodwill by allowing managers to reliably convey their private future-cash-flow information to markets (e.g., Hirschey and Richardson, 2003; Bens and Heltzer, 2004; Chen et al., 2004; Li et al., 2006; Zang, 2008; Lapointe-Antunes et al., 2009). These studies conclude that SFAS 142 is "net beneficial" consistent with the standard setters' objectives in developing the new impairment standards. Similarly, a number of studies examining manager's use of discretion in determining goodwill impairments following the adoption of the impairment-only approach in USA, Canada and the UK fail to find evidence that managers are opportunistically using their accounting discretion to distort the underlying economics of the firms (Lapointe-Antunes et al., 2008; Godfrey and Koh, 2009; Jarva, 2009; AbuGhazaleh et al., 2011).

ARGUMENTS AGAINST THE IMPAIRMENT-ONLY APPROACH

Although the impairment-only approach was issued to improve the subsequent accounting for goodwill and provide users of the accounts with value relevant information that more closely reflects the underlying economics of goodwill, this approach has been largely criticized and opposed by academics, practitioners and dissenting IASB members. The issues raised focus primarily on the managerial discretion inherent in the process of testing goodwill for impairment, and on the resulting blending of

acquired goodwill and internally generated goodwill. For example, Watts (2003) criticized the impairment approach based on the subjective and unverifiable fair value estimates used in testing goodwill for impairment. Watts (2003, p. 217) argues that "SFAS 142 may be an error in judgment by the FASB…Assessing impairment requires valuation of future cash flows. Because those future cash flows are unlikely to be verifiable and contractible, they, and valuation based on them, are likely to be manipulated". Similarly, Massoud and Raiborn (2003, p. 30) note that the managerial discretion and judgement afforded by the impairment approach may lower the quality of earnings figures.

Based on the implications of the contracting theory of accounting (Watts and Zimmerman, 1986), there is a large possibility that managers may exploit the discretion afforded by the impairment standard opportunistically to transfer wealth and make themselves better off at the expense of other contracting parties, resulting in goodwill impairments that do not adequately reflect the true underlying economics of the firm. Massoud and Raiborn (2003, p. 30) argue that managers may selectively "opt to manage earnings through a cursory, rather than intensive review of goodwill asset impairment". For example managers may decide to record large goodwill impairments when operations are at downturn following the "big bath" behavior. Alternatively, they may take goodwill impairment losses during periods in which actual earnings are higher than expected following the income smoothing behavior.

The respondents to Exposure Draft 3, *Business Combinations* (the exposure draft that preceded IFRS 3) who expressed a clear view on the issue of accounting for goodwill generally opposed the impairment-only approach and supported the amortization approach with impairment tests only when there is an indication that the goodwill might be impaired. They supported this approach by arguing that acquired goodwill is a wasting asset that is consumed over time and replaced, to a greater or lesser extent, with internally generated goodwill and that the acquired goodwill therefore must be amortized to ensure that no internally generated goodwill is capitalized as an asset in its place, consistently with the general requirements of not recognizing internally generated goodwill in the accounts (IASB, 2004a, BC 139).

Another argument raised by the respondents for amortizing goodwill consistent with the matching convention was that goodwill should be allocated to achieve a proper allocation of its cost to future operations, consistent with the approach taken to other intangible and tangible fixed assets that do not have indefinite useful lives. A final argument was that the useful life of acquired goodwill cannot be predicted with a satisfactory level of reliability, nor can the pattern in which goodwill diminishes be known. However, systematic amortization over an albeit arbitrary period provides an appropriate balance between conceptual soundness and operationality at an acceptable cost; the respondents concluded that amortization is the only practical solution to an intractable problem (IASB, 2004a, BC 139).

However, the IASB makes no reference in its basis for conclusions to whether this was the view taken by the preparer or non-preparer group. Preparers and non- preparers are expected to differ in their lobbying positions regarding how to account for goodwill based on their own self interest (Watts and Zimmerman, 1978). Preparers (managers) are more likely to lobby for the impairment-only approach since it allows them greater scope and discretion in deciding when to recognize an impairment loss. Ramanna (2008) provides evidence consistent with the idea that the FASB issued SFAS 142 in response to political pressure by firms (preparers) over its proposal to abolish the pooling of interests method with potential for opportunism. Ramanna suggests that firms' (preparers') lobbying positions for SFAS 142 depend on their ability to opportunistically manipulate goodwill accounting discretion Prior UK evidence also reveals that preparers have generally opposed goodwill standards that required systematic income reductions (Nobes, 1992).

On the other hand, non-prepares (e.g., auditing firms and standard setters) are more likely to oppose the impairment-only approach and support amortization because it is less complex, more objective, and can easily be audited. For example, two IASB members who dissented from the issue of IFRS 3 argued that

"IFRS 3 is putting its faith in a potentially unreliable impairment test that inevitably cannot separate out subsequent internally generated goodwill and has other weaknesses that require attention" (IASB, 2004a, DO 12). The dissenting members concluded that the costs of goodwill impairment tests are likely to be high and the benefits of such tests may be diminished by their potential unreliability (IASB, 2004a, DO 12). Similarly, Paterson (2002) argues that the impairment approach may have the trappings of science, but it is of doubtful reliability, as well as being onerous and difficult to perform.

Finally, in a US study examining managers' use of discretion in determining goodwill impairments, Ramanna and Watts (2009) report that non-impairment of goodwill is increasing in firm characteristics predicted to be associated with greater managerial discretion and provide evidence that this discretion is being used by managers opportunistically to distort the underlying economics of the firm.

SOURCES OF MANAGERIAL DISCRETION IN TESTING GOODWILL FOR IMPAIRMENT

Goodwill impairment is a result of the deteriorating economic performance of the acquired business. The acquired business is rarely operated as a distinct subsidiary within the firm, making its performance difficult to track (Hayn and Hughes, 2006). The acquired business is usually integrated into the operations of the acquiring firm; carried as part of an existing operating segment; or split among several internal units, making the process of evaluating goodwill for impairment more difficult and subjective (Hayn and Hughes, 2006). Furthermore, neither IFRS 3 nor IAS 36 provides measurable indicators of goodwill impairment. However, IAS 36 provides external and internal signs that may reduce the recoverable amount of a cash-generating unit or asset below its carrying amount. Examples of external indications include negative changes in technology, markets, economy, or laws, increases in market interest rates, and book value of equity more than its market capitalization. Examples of internal indications include plans to discontinue or restructure the operations to which an asset or cash-generating unit belongs and worse economic performance than expected (IASB, 2004b, para. 12). The U.S SFAS 142 adds that unanticipated competition and a loss of key personnel may also be possible indications of goodwill impairment (FASB, 2001b, para. 28).

Despite the standard setters' contention that the impairment-only approach will improve the quality of accounting for goodwill by forcing managers to test it for impairment annually, the impairment criteria provided by the standards are drafted in such a way that leave significant room for managerial discretion, interpretation, judgement and bias (Massoud and Raiborn, 2003, p. 28).

The first instance of managerial discretion is the managerial flexibility with respect to the definition of cash- generating units. Goodwill is tested for impairment at the cash-generating unit level. A cash-generating unit is defined by IAS 36 as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets. According to IAS 36, cash-generating units to which goodwill is allocated shall represent the lowest level within the firm at which goodwill is monitored for internal purposes; and not be larger than a segment based on either the firm's primary or secondary reporting format, thus implying that it does not have to be a specific subsidiary, division, branch or component. The lack of specificity in the definition of a cash-generating unit provides managers with significant flexibility in the identification of cash-generating units for impairment purposes. Thus, provided they have incentives to maximize or minimize future impairment losses, managers could "pick-and-choose" units in a way that best serves their own incentives (Massoud and Raiborn, 2003, p. 28). The larger and more numerous the cash-generating units, the greater is management's flexibility in allocating goodwill and hence determining future goodwill impairment losses as will be discussed shortly.

The second instance of managerial discretion is related to the allocation of goodwill to cash-generating units. For the purpose of impairment testing, goodwill acquired in a business combination shall, from the

acquisition date, be allocated to each of the acquirer's cash generating units, or groups of cash generating units, that are expected to benefit from the synergies of the business combination. Absent a specific joint cost allocation model, allocating goodwill to cash-generating units can be arbitrary and difficult to implement (Watts, 2003). In addition, goodwill is frequently the result of synergies between distinct operating units, and precisely identifying the source of such synergies and allocating them across cash-generating-units is "non-trivial" (Bens and Heltzer, 2004). The process of allocating goodwill to cash-generating units is expected to have an impact on the likelihood of an impairment loss being recognized (Beatty and Weber, 2006).

On the one hand, firms that have their goodwill allocated to more than one cash-generating unit are expected to carry out more impairment tests and thus may report higher amounts of goodwill impairment losses because an existing loss in one unit cannot be netted against an increase in another unit (Schneider, 2001). This may motivate managers to cut down the number of cash-generating units to minimize the impairment outcome (Schneider, 2001). On the other hand, firms with numerous cash-generating units may have greater flexibility in determining future impairment losses (either overstating or understating impairments). For example, managers willing to write-off a large amount of goodwill -"take a bath"- may have incentives to allocate the greater part of goodwill to cash-generating units that are expected to decrease in value (units with low growth options). In contrast, managers willing to delay or have little goodwill impairments may have incentives to allocate the greater part of goodwill to cash generating units that are expected to increase in value (units with high growth options) and hence lower the probability of recognizing goodwill impairment losses.

The third instance of managerial discretion is the assessment of the recoverable amounts of cash-generating units that contain goodwill. The recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. If no deep and liquid market exists for an asset or cash-generating unit to determine its fair value less costs to sell, the IASB considered that value in use may be used as its recoverable amount. However, because cash-generating units to which goodwill relates typically do not have active markets and hence no readily available fair values, managers primarily use the value in use technique to assess their recoverable amounts. In order to determine the value in use of a cash-generating unit, managers must use their judgement to forecast future cash flows and choose an appropriate discount rate that is appropriate to the risks of those particular units. Assessing the value in use has always been "as much an art as a science" and different experts can arrive at different valuations depending on the underlying assumptions employed about discount rates and future cash flows (Wayman, 2002). Therefore, it has been argued that managers might be able to calculate both impairment and non-impairment of goodwill in the same period, depending on their selection of underlying assumptions (Massoud and Raiborn, 2003, p. 29). In the case of goodwill impairment testing, the use of managerial discretion is further facilitated by the fact that no financial information is publicly available at the cash-generating unit level unless each unit is a public firm itself, which is rarely the case (Hayn and Hughes, 2006; Lapointe-Antunes et al., 2008). Therefore, it is difficult for outsiders to make an external assessment of the recoverable values of cash-generating units, to which goodwill has been allocated, providing managers with more flexibility and discretion in testing goodwill for impairment.

CONCLUSION

This paper critically examines the change in accounting treatment for goodwill pursuant to international financial reporting standards (IFRSs) by reference to the UK accounting standards. It discusses and compares the former UK and new IFRS policies for goodwill, demonstrating the advantages of and the arguments against the new impairment-only approach to goodwill.

The accounting treatment for goodwill has been the source of much debate amongst standard setters and financial report preparers. There have been great difficulties in the definition, measurement and the

subsequent accounting treatment for goodwill. Goodwill is a unique intangible asset in that it does not generate cash flows independently of other assets and is not separable from the company as a whole. It is measured as a residual amount, being the excess of the purchase price over the acquirer's interest in the fair value of the identifiable net assets acquired.

Accounting for goodwill has always been a controversial issue in the UK. The first attempt by the accounting standard setter in UK, SSAP 22, raised more problems than it resolved. The two different accounting treatments it permitted were "conceptually inconsistent" (Hussey and Ong, 2000, p. 37). The debate in the late 1990's in UK resulted in the amortization of goodwill instead of the immediate write-off to reserves. With the transition to international reporting standards in UK from 2005, all UK public firms listed in the main market had to change the way they account for purchased goodwill and account for it using IFRS No. 3, *Business Combinations.* IFRS 3 prohibits the amortization of acquired goodwill and instead requires goodwill to be tested 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*.

The impairment-only approach was issued with the intent of improving the information content of goodwill and reducing the managerial flexibility afforded by the former trigger-based standards. However, this approach has been criticized by academics, practitioners, and dissenting IASB members on the grounds of the managerial discretion inherent in the process of testing goodwill for impairment. While IFRS 3 forces managers to perform annual goodwill impairment tests, it also provides the opportunity for accounting discretion by requiring managers to make several important accounting choices, of which the determination of the cash-generating units, the subsequent allocation of goodwill to these units, and the recoverable amount estimates of the units are the most important. These accounting choices provide managers with significant discretion and flexibility in determining the existence, timing, and amount of goodwill impairment losses.

Thus, if managers have incentives to overstate, understate, or simply not recognize an impairment loss, they can be selective with respect to the underlying choices they make when testing goodwill for impairment. On the one hand, as predicted by the standard setters, managers may use this accounting discretion efficiently to convey their private information and expectations regarding the true value of the firm, resulting in impairments that better reflect the firm's underlying economics; alternatively, managers may opportunistically exploit this unverifiable accounting discretion to extract rents from other contracting parties, resulting in impairments that are less reflective of the firm's underlying economics. Therefore, ex-ante, it is unclear how the impairment-only approach has affected the reporting of goodwill impairment losses, including the related managerial flexibility exercised in determining them.

Prior empirical studies examining managers' use of discretion in determining goodwill impairment losses following the adoption of SFAS 142, Section 3062 and IFRS 3 in USA, Canada and the UK respectively, provide inconclusive evidence as to whether managers are using the discretion afforded by the impairment approach opportunistically or to convey their private information on future cash flows. As time passes and more data become available future research will be able to examine the long-term effects of the impairment-only approach to goodwill and determine whether the conclusions of these studies hold over time. The paper has implications for financial report prepares and users in highlighting conceptual issues of relevance that will arise in the application of the impairment-only approach to goodwill that may be useful for any regime reporting under IFRSs. It also provides a thorough review of the literature published on the accounting treatment for goodwill in the UK.

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BIOGRAPHY

Amer Qasim: Al Ain University of Science and Technology, Abu Dhabi- United Arab Emirates. He received his PhD in Accounting from Aberdeen University, UK. His research interests are in the areas of Internet Financial Reporting, Voluntary Disclosure, Investor Relations and Value Relevance of Accounting Information. Email: qasemamer@hotmail.com

Ayman E. Haddad: The American University of Kuwait- Kuwait. He received his PhD in Accounting from the University of East Anglia, UK. His research interests are in the areas of Disclosure of Accounting Information, Corporate Governance, Value Relevance, Stock Market Liquidity, Dividend Policy, Cost of Capital and International Financial Reporting Standards. Email: Ahaddad@auk.edu.kw

Naser M. AbuGhazaleh, corresponding author: Gulf University for Science and Technology (GUST)-Kuwait. He received his PhD in Accounting from Aberdeen University, UK. His research interests are in the area of Financial Reporting, Corporate Governance, Earnings management, Goodwill Accounting and Internet Financial Reporting. Email: Abughazaleh.N@gust.edu.kw