Issues on recognition, measurement and impairment of goodwill

Bunea-Bontaş, Cristina Aurora and Petre, Mihaela Cosmina

Tibiscus University from Timisoara

May 2009

ISSUES ON RECOGNITION, MEASUREMENT AND IMPAIRMENT OF GOODWILL

LECTURER CRISTINA BUNEA-BONTAS, PH.D.
ASSISTANT MIHAELA PETRE, PH.D. GRADUANT
"CONSTANTIN BRANCOVEANU" UNIVERSITY, PITESTI
THE FACULTY OF MANAGEMENT MARKETING OF ECONOMIC BUSINESS, BRAILA

Abstract:
Investors and their advisers have to asses how the activities of the acquirer and its acquired business develop following a business combination. Due to a complexity of business activities this is a challenging exercise. Certainly, one of the major challenge concerns the goodwill. Is it an asset? How can it be measured? Which are the implications on fair image of financial position and performances? Therefore, the accounting treatment of goodwill involves applying professional judgment in terms of meeting criteria for its recognition as an intangible asset, but also related to the initial measurement and its impairment. IFRS 3 (Revised) "Business Combinations" will create significant changes in accounting for goodwill, and further more, for business combinations.

Keywords: *goodwill, fair value, impairment loss, full goodwill, non-controlling interest*

JEL classification: *M410 Accounting*

Companies use their resources or assume debts in order to purchase or to generate internal items such as licenses, intellectual properties, trademarks, import quotas, franchises, devoted customers, knowledge about the market, contracts with distributors and other resources which are intangible as well.

Intangible assets are identifiable non-monetary assets, without physical substance, held for use for the production of goods or services, to be rented to third parties or be used for administrative purposes. Recognition of an element of intangible asset requires the company to demonstrate that the item meets the definition above: to have identifiable character, to be controlled, to obtain future economic benefits and can to be able to asses at a reliable cost.

Items such as goodwill, trademarks, licenses, customer lists, which are generated inside are not recognized as intangible assets. Even if, in order to generate such items, companies incurred such expenses to generate future economic benefits, these expenses do not lead to an intangible asset which meets the criteria for recognition.

Initial recognition and measurement of goodwill based on IFRS 3 (2004)

Internally generated goodwill is not recognized as an asset, because it's not a controlled identifiable resource, which may be valued at a reliable cost by the undertaking. Referring to International Accounting Standard IAS 38 "Intangible assets", it argues that differences between the market value of a company and the carrying amount of its net identifiable assets at a certain time, may take into account a whole range of factors affecting the company. Such differences can not be regarded as representing the cost of intangible assets controlled by the company.

Instead, the goodwill which results from business combinations must be recognized as an asset in the balance sheet of the purchaser. The concept of goodwill is approached through the International Financial Reporting Standard IFRS 3 "Business combination".

Goodwill represents the excess cost of business combination over the fair value of the net identifiable assets, liabilities and contingent liabilities.

The cost of business combination is the sum of fair values on the exchange, of assets transferred, of existing or contingent liabilities and the equity instruments issued by the acquirer and any costs directly attributable to the combination of enterprises.

Goodwill = Cost of business combination - Fair value of identifiable assets, liabilities and contingent liabilities acquired

Regarding the goodwill recognition and initial measurement, IFRS 3 requires that, at the acquisition date, the acquirer:

(a) should recognize goodwill acquired in business combination as an asset, and

(b) should assess goodwill at its cost, being the excess cost of the business combination over the acquirer interest in the fair value of net identifiable assets, debts and contingent liabilities.

The motivation underlying the recognition of goodwill acquired in a business combination as intangible asset is that it represents an advance payment by the purchaser to generate future economic benefits of assets that can not be individually identified and separately recognized.

Example 1: Initial measurement of goodwill based on IFRS 3 (2004)

At acquisition date ABC Company holds:

- Identifiable tangible assets (fair value)	\$310,000 mil
- Identifiable intangible assets (fair value)	\$60,000 mil
- Identifiable liabilities (fair value)	\$180,000 mil

XYZ Company acquires 80% of the shares of the subsidiary for \$200,000 mil.

Recognizing goodwill based on partial goodwill method:

	\$ Mil
▪ The fair value of the assets	370,000
(-) The fair value of the liabilities	(180,000)
= Identifiable net assets (fair value)	190,000
(-) Minority interest (20% × 190,000)	(38,000)
= Net Assets acquired	152,000

Goodwill on acquisition = 200.000 - 152,000 = \$48,000 mil

Initial recognition and measurement of goodwill based on IFRS 3 (Revised)

The above summarizes the current requirements of IFRS 3, concerning goodwill recognizing and initial measurement. But, a new standard – IFRS 3 (Revised) – has been published in January 2008 and comes into effect from July 2009. IFRS 3 was revised in a joint project between the IASB and FASB, aiming at taking a broader view at business combination accounting and at unifying the accounting treatment at a worldwide level. So, the IASB and the FASB agree to work together and to pool their resources as both Boards considered that it was the most effective method to eliminate as many as possible of the differences between IFRS and US GAAP.

One of the main changes regards "non-controlling interests" (NCI), term used in IFRS 3 (R) instead of "minority interests", this being the remaining equity interests which appears in a business combination when the acquirer achieves control without buying all of the equity of the acquiree.

The revised standard gives entities the option, on a transaction-by-transaction basis, to measure non-controlling interests either at the fair value of their proportion of identifiable assets and liabilities, or at full fair value. The first method will result in measurement of goodwill, which is basically the same as with the existing IFRS. The second method will record goodwill on the non-controlling interest as well as on the acquired controlling interest. No matter the applied method, goodwill continues to be a residual but it will be a different residual under IFRS 3 (R) if the full fair value method is used as compared to the previous standard. This is partly because all of the consideration, including any previously held interest in the acquired business, is measured at fair value but it is also because goodwill can be measured in two different ways.

The first approach is similar to the method under current IFRS. Goodwill is the difference between the consideration paid and the purchaser's share of identifiable net assets acquired. This is a "partial goodwill" method because the non-controlling interest is recognized at its share of identifiable net assets and does not include any goodwill.

The revised IFRS 3 uses the term "consideration transferred" (replacing "cost of the business combination") which is sum of the acquisition date fair values of assets transferred, liabilities incurred to seller and the equity interests issued, including contingent consideration. It does not include acquisition-related costs, which are recognized as expenses.

Goodwill can also be measured on a "full goodwill" basis, which means that goodwill is recognized for the non-controlling interest in a subsidiary as well as the controlling interest. Under the previous version of IFRS 3, NCI was recognized at their share of net assets and did not include any goodwill. Full goodwill means that non controlling interest and goodwill are both increased by the goodwill that relates to the non-controlling interest. The IASB assessed the effect of adding this option to IFRS 3 (R) as being neutral, mainly because it is an option: entities can choose not to change the measurement approach they use in present.

The question is when full or partial goodwill can be recognized. The standard gives a choice for each separate business combination. An acquirer may either recognize non-controlling interest in the subsidiary at fair value, which leads to 100% of goodwill being recognized (full goodwill), or the acquirer can recognize non-controlling interest measured at the non-controlling interest in net assets excluding goodwill. This leads to goodwill being recognized only for the parent's interest in the acquired entity, the same as under current IFRS 3 (partial goodwill).

This choice only makes a difference in an acquisition where less than 100% of the acquired business is purchased. Business combinations where the entire business is acquired will result in goodwill being calculated in much the same way as it is under IFRS 3.

Example 2: Initial measurement of goodwill based on IFRS 3 (Revised)

Considering the same example as previous, the minority interest was fair valued at $45,000 mil.

Recognizing goodwill based on full goodwill method:

	$ Mil
▪ The fair value of the assets	370,000
(-) The fair value of the liabilities	(180,000)
= Identifiable net assets (fair value)	190,000
(-) Non-controlling interest (fair value)	(45,000)
= Net Assets acquired	145,000

Goodwill on acquisition = 200.000 - 145,000 = $55,000 mil

It can be seen that goodwill is effectively adjusted for the change in the value of the non-controlling interest which represents the goodwill attributable to the NCI. (Note: As a reminding, the partial goodwill method may also be used based on IFRS 3 - Revised).

Treatment for goodwill measurement, subsequent to initial recognition

After recognizing the goodwill as an intangible asset, the questions how it will be depreciated along the time. The accounting practice and theory generally sustain four divergent solutions for the goodwill accounting treatment, as follows:

(a) Maintaining the goodwill as an asset, without any amortization or provisioning

Some experts sustain that the value of the goodwill does not decrease in time, but on the contrary it maintains its value or even grows along its economic life. So, goodwill is an investment and must be disclosure in the balance sheet without any amortization. Counterargument: goodwill represents a virtual asset that leads to the misrepresentation of the real financial position and performance.

(b) Subtracting the goodwill from the owner's equity

According to this solution, a company accepts to pay an extra-price for acquiring the assets belonging to another company, when it is estimated that it will obtain future economic benefits. These future extra-revenues will compensate the extra-payment made at the acquisition moment. Counterargument: a false image is created, that the company group has a higher profitability.

(c) Capitalization of the goodwill and making provisions for it, in case that the acquired assets have depreciated

This solution leads to a similar image like the first one.

(d) Capitalization of the goodwill and its amortization during a period equal to the useful life of the acquired assets

Some specialists plead for the necessity of depreciating the goodwill, due to its own elements' economic nature. Therefore, the goodwill may contain intangible assets that support depreciation, and which are not separately identifiable, because their cost cannot be reliable determined. Also, some components of the goodwill (i.e. "managerial team", "collective intelligence of the team") do not have a definite economic life. Consequently, not amortizing the goodwill does not allow the disclosure of a fair image of a company's financial position and performances. The amortization of the goodwill significantly influences the disclosed financial results of the company.

Consequently, most of the companies take advantage of all these ambiguities belonging to the various types and uncertainties of theoretical issues, in order to develop an opportunistic attitude that serves their own perspectives and targets.

Recognizing and measuring goodwill impairment loss based on IFRS 3 (2004)

IFRS 3 "Business combination" requires that goodwill acquired in a business combination should not be amortized. Based on IAS 36 "Impairment of Assets", it should be tested for impairment annually or more frequently, if certain events or changes in circumstances indicate the possibility of the depreciation.

IASB argues that goodwill is the only item of intangible assets for which depreciation is very difficult to identify. It does not generate cash flows independently of other assets or groups of assets and, therefore, its recoverable amount cannot be measured individually. Accordingly, if there is any indication that goodwill may be impaired, the recoverable amount is calculated for the cash-generating unit to which it belongs. This amount is compared with the value of the cash-generating unit and if there is an impairment loss, it is first allocated to goodwill and then to other assets of the cash-generating unit.

A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

The two-step impairment test involves the following:

Step 1: Compare the carrying amount of the cash generating 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, the goodwill allocated to that unit 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 recognize 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 recognized immediately, in profit or loss, as an impairment loss. If the cash generated unit is impaired, any impairment loss is allocated first to reduce the carrying amount of goodwill, and subsequently to the other assets of the cash generating unit on a pro-rata basis, based on the carrying amount of each asset in the unit.

IFRS 3 requires that goodwill related to a minority interest should not be recognized in the consolidated financial statements of the parent company. When a parent purchases a controlling, but not 100%, interest in a subsidiary, the goodwill recognized relates only to the parent's ownership interests and does not include amounts attributable to the minority.

Minority interest is defined in IAS 27 “Consolidated and Separate Financial Statements” as that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent.

When there is a minority interest in a cash-generating unit to which goodwill was allocated, the carrying amount of that unit comprises:

- interest of the parent company and minority interest in net identifiable assets of the unit;
- parent company interest in goodwill.

Some of the recoverable amount of the cash generating unit is attributable to minority interest in goodwill and, therefore, is not recognized in the consolidated financial statement. As a result, to test for impairment, the carrying amount must be adjusted before being compared with its recoverable amount.

Adjustment = Goodwill allocated to cash-generating unit + Unrecognized minority interest

New value is compared with the adjusted recoverable amount of the unit in order to establish whether the cash-generating unit is impaired.

Example 3: Goodwill impairment based on IFRS 3 (2004)

Following on example 1, XYZ Company acquired 80% of ABC Company, cost of combination \$200,000 mil. Goodwill has been initially assessed at \$48,000 mil. ABC’s assets meet the cash-generating unit definition. Assume that, at year-end, XYZ determines that the recoverable amount of cash-generating unit ABC is \$160,000 mil. XYZ use linear amortization for a period of 10 years to identifiable assets and anticipates no residual value. At the acquisition date, goodwill has been recognized, so it must be tested annually for impairment.

Testing for impairment at year-end

A part of \$160,000 mil recoverable amount is attributed to unrecognized minority interest in goodwill. Based on IAS 36, the carrying amount of ABC should be adjusted in order to include goodwill attributable to minority interest, and then compared to the recoverable amount. Therefore, it is necessary to assess the goodwill attributable to minority interest.

If XYZ acquired identifiable net assets of $152,000 mil, it means that the goodwill attributable to the parent company ($48,000 mil) represents 31.579%. Using the same reasoning, the goodwill attributable to the minority interest (which is $38,000 mil) is $12,000 mil.

So, the goodwill attributable to the cash-generating unit is $60,000 mil, respectively the sum of the goodwill attributable to the parent company ($48,000 mil) and the unrecognized goodwill attributable to the minority interest ($12,000 mil).

$ Mil

Items	Goodwill	Net Assets	Total
Carrying amount of net assets acquired	48,000	190,000	238,000
(-) Amortization	-	(19,000)	(19,000)
= Net carrying amount	48,000	171,000	219,000
(+) Unrecognized minority interest	12,000	-	12,000
= Adjusted carrying amount	60,000	171,000	231,000
(-) Recoverable amount	-	(160,000)	(160,000)
= Impairment loss	60,000	11,000	71,000

The results presented in the table above indicate that the cash-generating unit ABC is impaired, the impairment loss being $60,000 mil.

But XYZ recognizes only the part of the goodwill which corresponds with its parent interest (80%), therefore XYZ should recognize only 80% of the loss from depreciation of goodwill, respectively $48,000 mil (60,000 × 80%). So the goodwill has to be eliminated completely. Remaining impairment loss of $11,000 mil is recognized by reducing the values of identifiable assets of ABC, as it can be seen in the table below.

$ Mil

Items	Goodwill	Net Assets	Total
Carrying amount of net assets acquired	48,000	190,000	238,000
(-) Amortization	-	(19,000)	(19,000)
= Net carrying amount	48,000	171,000	219,000
(-) Impairment loss	(48,000)	(11,000)	(59,000)
= Recoverable amount	-	160,000	160,000

Because the goodwill is not considered likely to be recovered entirely through profitable operations of the acquired company, it should be reduced or eliminated completely. Any elimination of goodwill should be recognized as an expense.

Once reduced, goodwill can not be passed as an asset, reflecting once again that independent measurements are not possible and the acquired goodwill might be replaced by those generated internally, which is not recognized.

Recognizing and measuring goodwill impairment loss based on IFRS 3 (Revised)

To take into account the option to apply the "full goodwill method", the principles regarding the measurement of goodwill impairment based on IFRS 3 (2004) have now been expanded on as follows:

(a) In the case of a partially-held subsidiary, which is in itself a cash-generating unit, the impairment loss is allocated between the parent and the non-controlling interest on the same basis as that on which profits or losses are allocated.

(b) In the case of a partially-held subsidiary that is part of a larger cash-generating unit, impairment losses are allocated to the parts of the cash generating unit that have non-controlling interest and those that do not, as follows:

- to the extent that the impairment relates to goodwill in the cash generating unit, the relative carrying amounts of the goodwill of the parts before the impairment;

- to the extent that the impairment loss relates to identifiable assets within the cash-generating unit, the relative carrying amounts of the net identifiable assets of the parts before the impairment. The allocation to each asset is done on a pro-rata basis of the carrying amount of each asset (as outlined above).

For those parts of the cash generating unit that do not have a non-controlling interest, the impairment loss is allocated in full to the parent.

The choice regarding the measurement of the non-controlling interest in a subsidiary not only has implications for measuring goodwill at the acquisition date. Where the goodwill is impaired subsequently, the effect on the profits attributed to the shareholders of the parent and, consequently, the earnings per share figures will also differ.

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