

BAD SYNERGY: CRITICAL ANALYSIS OF A COMBINED APPROACH
TO SUBSEQUENT GOODWILL IMPAIRMENT
(AMORTIZATION AND IMPAIRMENT TESTING)

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Abstract

The study deals with the viability of replacement of the impairment only approach in goodwill accounting with the combination of amortization and testing for impairment, the idea of which is being proposed in recent years. It is hypothesized that the method of writing off goodwill acquired affects insignificantly the most studied indicators of company performance. A logical analysis of the strengths and weaknesses of each of these methods was carried out. The amounts of write-downs of the recognized goodwill of TNCs are recalculated based on the assumption that, instead of actually recognized impairment, the company has amortized the acquired goodwill. A data correlation analysis of the net profit margin, capital and assets prior and after the recalculation has been made. The possible consequences of the implementation of a combination of such methods of the acquired goodwill writing down may appear as a failure to achieve the advantages inherent to each of the integrated methods, also the complicacy, cost increase and additional subjectivity of the accounts.

Keywords: goodwill, amortization, impairment.

JEL code: G32, G34, M41

Introduction

The 21st century is characterized by an increase in the role of intangible assets (which often remain unrecognized in the financial statements) in calculating the company value. This is inevitably confirmed by the results of numerous studies. For instance, regular value assessments of major global venture companies by experts from "The Wall Street Journal" demonstrate that the co-efficient of the market value of most of such companies to the amount of owned capital fluctuate within the range of 3-17 (The Wall Street Journal, 2017). Acquisition of companies which have internally created value exceeding the fair value of their identifiable assets, allows for goodwill recognition in the financial statements of the acquirers. IFRS 3 Business Combinations determines goodwill as an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identifiable or separately recognized. A salient

feature of goodwill which distinguishes it from other assets is that goodwill is inseparable from the company. In the view of the majority of contemporary scientists, the amount of goodwill is the assessment of the company resource pool which motivates the consumer to purchase the product produced by the company and bring at this account some additional return (see Ivanov, 2016; Kovalev & Kovalev, 2016). There is a widely circulating opinion among accountants that the purchased goodwill generates excess profit only for a certain limited period of time following the expiration of which it ceases to bring financial gains and shall be written off. It is important to emphasize that the acquirer can receive the excess profit also after the acquired goodwill is written off; yet, such excess profit can be often gained by the internally created acquirer's goodwill which has replaced the acquired one. In this present study we did our best to step back from the discussion of the accuracy of such understanding of the essence of the acquired goodwill and focused on the methods of its written-down value under the existing national and international accounting standards which are based on the paradigm of the definite useful life of goodwill.

In the existing national accounting standards which regulate goodwill accounting in various countries there exist two alternative methods of writing-down the amount of the acquired goodwill (Ivanov & Salomatina, 2014), i.e.

- 1) amortization on a regular basis during a definite period of the goodwill useful life;
- 2) regular testing for impairment.

The first approach originated in the beginning of the 20th century. Its most outstanding advocates were L.R. Dicksee and H.R. Hatfield who in their publications (Dicksee & Tillyard, 1906; Hatfield, 1909) insisted on goodwill having a definite period of useful life within which this asset should be written off. The said approach prevailed in accounting standards of various countries for quite a long while, beginning from the 1930s-1940s.

The other approach was also the result of scientific discussions at the beginning of the 20th century. J. Charpentier (Charpentier, 1906) was the first to propose that goodwill shall be accounted in the amount of its acquisition costs net of impairment losses. However, testing goodwill for impairment entered into the accounting standards only in 2001, when the US adopted US GAAP No. 141 «Business Combinations» and US GAAP No. 142 «Goodwill and Other Intangible Assets». For more detailed information referring to the history of the approach revision in terms of the goodwill writing down in accounting standards and the background factors for the said changes, please, see our earlier paper (Ivanov et al., 2015; Ivanov, 2016).

Despite the fact that development planners of national accounting standards have not yet agreed as to the methods of goodwill writing-down, since 2004 International Accounting Standards prescribe that following recognition of the amount of acquired goodwill in the accounts annual testing for impairment shall be performed. However, the issue of reliability of the financial reporting based on goodwill testing for impairment remains open. Discussion of what might be better: goodwill amortization or its testing for impairment is becoming wider in these recent years. Such renowned authors in accounting science as A. Beatty and J. Weber (Beatty & Weber, 2006), F. Gu and B. Lev (Gu & Lev, 2011), M. Hirschey and V.J. Richardson (Hirschey & Richardson, 2003), R. Watts (Ramanna & Watts, 2012.), S.L. Henning (Henning et al., 2000), K.G. Chalmers (Chalmers et al., 2011) have contributed considerably on the subject. Russian authors joined in with a number of publications, i.e. P.P. Baranov, V.P. Kozlova and Yu.S. Klimashina (Baranov et al., 2014), N.V. Generalova, N.A. Sokolova and E.Yu. Popova (Generalova et al., 2016), V.V. Kovalev and Vit.V. Kovalev (Kovalev & Kovalev, 2016), V.S. Plotnikov and O.V. Plotnikova (Plotnikov & Plotnikova, 2015).

Among the most widely discussed studies of the recent years is a joint work undertaken by accounting scientists from Accounting Standard Board of Japan (ASBJ), European Financial

Reporting Advisory Group (EFRAG) and the Italian Standard Setter, the Organismo Italiano di Contabilita (OIC) «Should Goodwill Still not be Amortized?» which was published on the official site of IAS Fund in September 2014 (Fabi et al., 2014). Professional accountants who acted as respondents were asked questions about the cost and complexity of testing for impairment. As a result of the survey it was found out that the costs of testing for impairment under IAS 36 ‘Impairment of Assets’ were considerable. These costs were primarily connected with the complexity to comply with the requirements of the standard’s testing technique. On the one hand, application of the testing technique simplified the accountants’ mission, for they did not have to define the goodwill useful life. On the other hand, though, it made their work still more difficult because the standards did not provide for the testing approach (this particular issue was handed over to accountants for their professional consideration). More than that, the majority of respondents agreed that non-recognition of any loss in the value of the acquired goodwill, save its impairment losses, results in the acquired ‘utilized’ goodwill being replaced over time with the internally created one. Such line of reasoning against goodwill testing for impairment without the regular amortization can be also traced in many publications (see, Kovalev & Kovalev, 2016). In practical reality it formed the basis for the November 2013 decision to allow goodwill amortization as an alternative technique for its subsequent accounting for private companies. The decision was taken by Financial Accounting Standards Board (FASB), an institution which in former days was the first to adopt the transition to the technique of goodwill testing for impairment. Also in 2015-2016 FASB were considering the issues of simplifying the technique of goodwill testing for impairment and the possibilities for public and not-for-profit entities to apply goodwill amortization (FASB project, 2016).

Based on the propositions made by the respondents of the survey and the study of publications, the research group considered four alternative ways of writing down the acquired goodwill amount, i.e.

- 1) splitting up goodwill into separate parts and application to each of them a separate method of subsequent accounting;
- 2) immediate writing down of the goodwill amount against the decrease/(increase) in the profit (loss) of the acquirer after M&A;
- 3) immediate redemption of the goodwill amount against the decrease of the acquirer’s capital after M&A;
- 4) combination of the goodwill systematic amortization and the regular testing for its impairment.

The major argument against the first approach was its complexity, costliness and a high level of assessment subjectivity. The second and third approaches ignore the substance of goodwill which is actually an asset able to generate a profit (such approaches prevailed at the end of the 19th and the beginning of the 20th centuries in the period when goodwill accounting was developing as an accounting item). The most reliable method in the opinion of the researchers is its amortization in combination with testing subsequently for impairment. Amortization makes it possible to avoid the replacement of the acquired goodwill with the internally created one without the redemption of the amount of the former, while testing for impairment allows avoiding insufficient writing down of the acquired goodwill amount when the financial gains from its utilization cease.

One would think that the compromise has been reached. More than that, national standards of some countries (for instance, Norway and South Korea) provide for this very type of goodwill accounting after it is recognized. However, in our opinion, the combination of goodwill amortization and its testing for impairment does not settle the existing problems of the subsequent goodwill accounting. In this study we presume that there is a low rate of dependency of the value

of the most frequently studied indices of the entity efficiency from the applied technique of writing down of recognized goodwill. Also the combination of goodwill amortization and its testing for impairment will result in the synergies of the negative sides of each of the methods and undervaluation of goodwill in the consolidated financial statements

Methods

We have recalculated the values of the recognized goodwill writing down, assuming that in the course of 10 years the companies amortized the purchased goodwill instead of the impairment actually recognized. The consolidated financial statements of sampled European and Russian companies in accordance with IFRS for 2005-2013 are the basis of empirical research. The sample has been built on the basis of two ratings: The Most Valuable European Brands-2016 and Forbes Global 2000-2016. The main criteria for companies' selection are: brand awareness, long-term operation of the company in the market and relative stable improvement of the main financial performance indicators of the company, significant amount of goodwill acquired (more than 10 % of total assets). As a result, the sample consists of 62 observations (consolidated financial statements). A more detailed description of the methods referring to this phase of the study was presented earlier (see, Generalova et al., 2016).

Following that, we carried out a correlation analysis of the data for net profit margin, return on equity (ROE) and return on assets (ROA) before and after the yearly recalculations in order to reveal the influence of the writing down method of the recognized goodwill on the most frequently studied indices of the company performance ratios.

A logical analysis of the reasons in favour of each of the existing methods to redeem the value of the purchased goodwill and the consequences of the combination of these methods (see, Ivanov & Timoshenko, 2017) was the final phase of the study. This allowed forecasting of the consequences of introduction into IFRS of the combination of goodwill amortization and its testing for impairment for company financial reporting.

Results

We have analyzed arguments in favour of each of the existing methods of writing down the amount of the purchased goodwill.

1. Assessment subjectivity

One of the most frequently named arguments against goodwill testing for impairment is a high level of subjectivity of assessments on which this method is based. In fact, subjective assessment does exist at the time when goodwill is being attributed to this or that cash generating unit (CGU), as well as in the course of calculating the recoverable amount of CGU. Determination of the 'value in use', i.e. determination of the present value of the future cash flows which the company expects to receive from CGU, appears to be a requisite parameter in testing for impairment. This value is impossible to assess with a high degree of exactness due to the forward-looking estimations of such cash flows. However, amortization is also exposed to subjective estimates: the goodwill useful life is per se an estimate value, and it is likewise impossible to truly define it for the same reason as in case of testing for impairment – i.e. we cannot predict the future. Neither the value of the future financial profits generated by goodwill, nor the period of time in which the company will gain these profits can be reliably estimated. It is true that useful life can be preset and that it is even possible to draw a theoretical foundation for this midrange numeric character. For instance, in the publication by H. Nurnberg an opinion was expressed that a goodwill forty-year amortization period which was specified in the USA APB 17 'Intangible Assets' (in operation in 1970-2001), was connected with the Biblical understanding of 40 years as a single-

generation lifetime, or a maximum operation period for a company with the same generation of employees and customers (Nurnberg, 2000). In such case, we will have to forget about the Matching Principle in accounting to suit expediency.

2. Feasibility to go on recognizing an asset in case it continues to generate financial benefit.

Testing for impairment makes it possible to go on recognizing the purchased goodwill in financial reporting for an unlimited time until indicators of its impairment appear. Hence, the company financial situation does not become worse as opposed to in the case of amortization, which on a regular basis decreases the balance value of the goodwill, even if this asset continues to generate excess profits. This is a strong argument against amortization.

3. Potential to recognize an asset which may not be recognized.

In testing the acquired goodwill for impairment there is a possibility that it is not an acquired but an internally created goodwill that replaced the acquired one that influences the expected CGU cash flows in time when the acquired goodwill has already ceased to generate profits. This actually brings to recognition the internally created goodwill, which is in some way or another prohibited by current accounting standards (see Ivanov & Salomatina, 2014). And such situation can last for an indefinite period of time. Goodwill amortization excludes such possibility, i.e. by the end of its useful life the value of the acquired goodwill (it and it alone) will be redeemed. Yet, there is the other side of the coin. The carrying value of the purchased goodwill remains recognized in financial statements to the end of its useful life, even if this goodwill is actually impaired in the very first year of its recognition.

4. Method complexity and costliness

The procedure of testing goodwill for impairment is a most complicated one in contemporary accounting. Approximately one third of IAS 36 'Assets Impairment' is dedicated to it. Viewed from the point of view of an accountant's labour effort it is undoubtedly easier to amortize the acquired goodwill, and this is one of the undisputable advantages of amortization.

Therefore, direct comparison of the existing methods of the purchased goodwill value redemption reveals that both methods have their own strong and weak sides.

Table 1 shows data on the calculated values of average deviation of the profitability indices before and after recalculation of the data from the financial statements of the test group companies.

Table 1. Data on the average deviation of the profitability when an impairment of goodwill and amortization of 10 years, based on a sample of companies, 2005-2013

The average deviation	Net Profit Margin	Return on equity (ROE)	Return on assets (ROA)
	0,10%	-1,28%	-0,53%
2013	0,27%	-1,47%	-0,63%
2012	0,05%	-1,61%	-0,69%
2011	0,01%	-1,63%	-0,69%
2010	-0,04%	-0,70%	-0,70%
2009	0,13%	-1,57%	-0,66%
2008	0,14%	-1,56%	-0,65%
2007	0,44%	-1,42%	-0,56%
2006	0,16%	-1,54%	-0,63%
2005	-1,32%	-2,10%	-0,97%

Table 2 shows the results of the correlation analysis of the data before and after recalculation of net profit margin (NPM), return on equity (ROE) and return on assets (ROA), from 2005 to 2013.

Table 2. Correlation coefficient data of profitability and impairment of goodwill amortization in 10 years, based on a sample of companies, 2005-2013.

Correlation coefficient <i>(for the whole period)</i>	Net Profit Margin	Return on equity (ROE)	Return on assets (ROA)
	0,847566294	0,954148847	0,928573282
2013	0,807688299	0,949775209	0,923641437
2012	0,811788862	0,951750241	0,926979954
2011	0,813927119	0,951724933	0,927481519
2010	0,814831605	0,952012296	0,928540426
2009	0,823543738	0,956176110	0,931045581
2008	0,824064223	0,956438302	0,931613558
2007	0,839090352	0,958525705	0,935430791
2006	0,840668704	0,958885067	0,937158280
2005	0,992062268	0,977914859	0,984784298

Based on the results of calculations, it can be seen that the values of profitability before recalculation (impairment; the actual reporting data) and after recalculation (amortization during a 10-year useful life) have a low degree of deviation and correlation coefficient is positive and high (coef: 0,8 - 0,9). Consequently, the returning to amortization of goodwill during 10 years will not be substantially worse for the status of the companies.

Therefore, we observed that the method of writing down the purchased goodwill has but slight impact on the most frequently studied indices of the company performance ratios; thus, in case of the combination of amortization and testing of the acquired goodwill for impairment a sufficient quality improvement in the financial statements is unlikely. In our opinion, such combination of methods, on the contrary, is a setback which shoves accounting one hundred years back into history when goodwill was treated neither by accountants nor by those who used financial statements as a 'real' asset. This super-conservative opinion is similar to bringing conservatism principle squared into operation, i.e. under otherwise equal conditions goodwill will be written down as expenses in a short time. The obvious advantage of goodwill testing for impairment without its amortization, i.e. the possibility to recognize goodwill as long as it brings profits to the company, will disappear. This will not be implemented the main advantage of the amortization of goodwill without impairment testing – the simplicity and low cost. And there will no longer be any complicated and costly testing for impairment. Subjectivity of the assessment, present both in goodwill testing for impairment and in amortization, will naturally increase. These 'bad synergies' resulting from the combination of goodwill amortization and its testing for impairment will lead to further complexity and costliness of accounting. And the net assets balance value *ceteris paribus* will be lower (or equal, at maximum) than in case of application of any of the conjoining methods separately, whilst the issue of the proper use of a professional opinion in defining the imputations will not be less acute. The only positive thing about the combination of these two methods is, in our opinion, that there will be no inflated goodwill values in financial statements as of any reporting date whatsoever. However, this is the case when the baby is thrown out of the bath with the bath water.

Discussion

Methodology of subsequent accounting of a purchased goodwill is experiencing a deep crisis. Neither goodwill amortization, nor its testing for impairment, let alone their combination,

makes it possible to get rid of conceptual imperfections inherent to each of the methods. More than that, our study revealed that introduction of goodwill implementation instead of its testing for impairment would not materially impact the most frequently studied indices of the company performance ratios. In our opinion, a review of the alternative turned down in the commented study ASBJ, EFRAG and OIC for its super-complexity, costliness and subjectivity of the assessment and which implies goodwill disintegration into separate components and application to each of them an accounting method corresponding to their economic substance might serve a way out of the existing situation. Even the authors of the commented study emphasize that, despite difficulties in its practical implementation, this approach does have ‘conceptual merits’ (Fabi et al., 2014, p. 30). Methodology of accounting has never been static, it develops and becomes more complex following the development and further sophistication of business. Therefore, in our opinion, it would be unreasonable to narrow down the discussion of subsequent methods of goodwill accounting to selecting one of the two already applied methods or their combination.

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