Goodwill, how it should be accounted for, and whether it should be amortised, have long been subjects of controversy in Australia. Many arguments have been formulated and debated at length.

However, writes WAYNE LONERGAN, the debate has been clouded by some misconceptions and by outright misrepresentation by some opponents and proponents of the Australian goodwill standard.

Since 1990, compliance with Australian Accounting Standards as promulgated by the Australian Accounting Standards Board (AASB) has been mandatory by law for listed public companies. AASB 1013 (often referred to as the “goodwill standard”) is the accounting standard that deals with the accounting for goodwill in Australia.

AASB 1013 defines goodwill as “the future benefits from unidentifiable assets”. In monetary terms, it is the difference between the acquisition cost and the fair value of the identifiable net assets of the business entity or subsidiary acquired.

Goodwill should be distinguished from, but in practice is often confused with, identifiable intangible assets such as licences, trademarks and patents. Part of this confusion results from the deliberate policy of many companies of seeking to avoid the effect of AASB 1013 and its predecessor standard. AASB 1013 requires, inter alia, that acquisition goodwill is written off over its expected useful life and that the period should not exceed 20 years.

To avoid the impact of the goodwill write-off, many companies have attributed values to identifiable intangible assets. In some cases the values attributed have been excessive, the most dramatic example of this being the values attributed to many television licences during the 1980s.

PURCHASED AND INTERNALLY GENERATED GOODWILL

AASB 1013 distinguishes between, and imposes different requirements on, purchased goodwill and internally generated goodwill. Internally generated goodwill is not defined in AASB 1013; however, it is goodwill which the company has generated from its own resources rather than...
acquired directly or indirectly from another entity. Under the standard a company is not permitted to bring to account internally generated goodwill (paragraph 20). The standard states that internally generated goodwill is virtually impossible to identify and value accurately or reliably. By contrast, the value of goodwill which has been purchased can usually be determined objectively by reference to the price paid for the business.

For this reason, purchased goodwill is brought to account as a non-current asset (paragraph 34). It is then systematically amortised (depreciated) to the profit-and-loss account (as an expense) over the period (a maximum of 20 years) during which the benefits are expected to arise. The unamortised balance of goodwill should be reviewed at each balance date, and charged to the profit-and-loss account (as an expense) to the extent that future benefits from the purchase are no longer probable. Subject to this requirement, purchased goodwill cannot otherwise be revalued (paragraph 36).

INTERNATIONAL CONSISTENCY

The essential features of AASB 1013 are consistent with accounting requirements for acquisition in Canada, the United States, Japan and New Zealand, and with the standard recently adopted by the International Accounting Standards Committee. Each of the pronouncements:

- acknowledges that goodwill arising on a business acquisition is an asset;
- requires acquisition goodwill to be recognised as such in the financial statement;
- requires that acquisition goodwill be amortised over the period during which it will provide benefits to the entity; and
- places an arbitrary maximum limit on the benefit period, although the maximum amortisation periods differs between countries.

In the case of bona fide mergers (which, in reality, are not common) the pooling of interest method of accounting is permitted in the US and UK and under the IASC rules. Its use is prohibited in Australia.

Table 2 compares the goodwill accounting standards in a number of jurisdictions. It shows that only in the United States is the maximum permissible amortisation period greater than that in Australia.

The International Accounting Standards Committee states in IAS 22 (paragraph 42): “The amortisation period should not exceed five years unless a longer period, not exceeding twenty years from the date of acquisition, can be justified.” Therefore the presumption in the latest IAS standard is that, prima facie, acquisition goodwill does not normally have a useful life of more than five years.

Accounting standards in some other countries, including the UK, the Netherlands and Germany, permit entities to choose between capitalising acquisition goodwill as an asset and subsequently amortising it, and writing it off immediately (the recently released UK
exposure draft proposes somewhat different treatment). The effect of the alternative treatment provided in these countries is that the reported accounting earnings of a company adopting the "immediate write-off" treatment would be higher in the years subsequent to acquiring goodwill than if the "capitalise and amortise" approach were taken. At the same time, the company's total assets and total equity, and any key indicators based on asset measures, such as returns on net assets, would be recorded at lower amounts. Cash earnings remain unaffected in all cases.

In substance, the traditional UK view is that acquisition goodwill has no real value. It is effectively considered an incidental cost of purchase and therefore should be written off directly to the profit-and-loss account as an extraordinary item. Some opponents of AASB 1013 support the UK approach of immediate write-off. Interestingly, however, proponents of the UK approach do not generally concede that Australia's permitted 20-year write-off is, in fact, a much more lenient regime to the amortisation of goodwill than that of the UK.

US TREATMENT OF GOODWILL

The US accounting standard on the treatment of acquisition goodwill is much tougher than it looks at first glance. It is far from the ideal that opponents of AASB 1013 claim it to be. Despite the apparent appeal of its amortisation period of up to 40 years, the US standard has stringent rules about the amortisation of all intangibles including not only goodwill but also brand-names, trademarks, licences etc.

In Australia virtually all companies adopt the maximum 20-year amortisation period. By contrast, the actual US periods for amortising goodwill differ between industries, with the broad guideline of 40-year amortisation periods being the maximum but many companies using shorter periods. Each industry is monitored by the SEC and all amortisation rates are compared.

METHODS OF AMORTISATION

The Australian standard does not specify a particular method of amortisation, requiring only that it must be systematic. Most firms use the straight-line depreciation method, while a minority of firms (including a small number of "blue-chip" companies) have used a method known as "inverse sum-of-the-years'-digits" (ISOYD).

Unlike the straight-line method, the ISOYD method allows for a small goodwill write-off in the early years with compensating increased write-off provisions in later years. The Australian Securities Commission has stepped into the debate by issuing a practice note that rules out the use of the ISOYD method except in exceptional cases.

The ASC is aware of only eight listed companies who use this method and only three other companies which use the other deferral amortisation schemes. Given the recent "settlement" between the ASC and Pacific Dunlop, and the two-year prohibition on its use imposed by the Urgent Issues Group, it is likely that this method will disappear from use in Australia.

AMORTISATION IN THE HEADLINES

Pacific Dunlop issued a booklet, titled When Goodwill Creates Ill Will, outlining its justification for the ISOYD method and detailing the company's objections to AASB 1013. It has been estimated that Pacific Dunlop's use of ISOYD increased its reported profit by $18 million after tax in 1992/93 ($13 million actual goodwill amortisation expense versus $31 million straight-line) and $16 million in 1993/94 ($20 million versus $36 million).

Pacific Dunlop's booklet identified only the negatives associated with AASB 1013. It noted differences in treatment between the Australian and US standards but failed to note that in the US:
- all acquired identifiable intangible assets (including brands, licences etc)
- FRRP

WHAT OVERSEAS COMMENTATORs SAY ABOUT ISOYD

US (Walter Schuetze, chief accountant, Securities and Exchange Commission): The SEC staff cannot envision a circumstance under which the use of the inverse sum-of-the-years'-digits method could be justified under US GAAP for reasons that are consistent with the views expressed in paragraph 7 of the Practice Note (39).

UK (Professor David Tweedie, chairman, Accounting Standards Board): I have no knowledge of the 'Inverted Sum of the Digits' method being used though clearly the ASC [Accounting Standards Committee] was making sure that such a method did not appear. As 96% of our companies write-off goodwill to reserves we do not really have a problem with this issue here and consequently I have no knowledge of the FRRP investigating anything of the nature. On a personal basis I cannot help but agree with your action - the ASC clearly would have done so as well.

Canada (Michael Meagher, formerly acting chief accountant, Ontario Securities Commission): I agree that the inverted sum-of-the-years'-digits method of amortisation of goodwill is perverse and inappropriate. The whole thrust of accounting for goodwill worldwide is to cause shorter amortisation periods with a faster write-off, since with the substantial changes in technology today there is virtually no business that can argue for a long-term goodwill.
are amortised on the same basis as goodwill:

- identifiable intangibles are prohibited from being revalued (such revaluations are permitted, and frequently occur, in Australia);

- the different accounting standards should be viewed overall to get a balanced view of their impact. In this respect it is interesting that Pacific Dunlop reports significantly lower profits under US accounting standards than under Australian standards.

There is considerable concern that ISOYD has the capacity to overstate current profits. The method is also held in low regard by many overseas commentators (see box). At the time of writing, the issue of ISOYD is on the agenda of the Australian Accounting Standards Board. It is to be hoped that these discussions will lead to the banning of the method.

Table 3 and Figure 1 illustrate the difference in amortisation amounts under different goodwill accounting methods, using the following example.

The example assumes that $100 million of purchased goodwill is amortised over the 20-year maximum period allowed by AASB 1013.

The amortisation expense under the ISOYD method is calculated by dividing the relevant year (e.g., year five) by the sum of the years between one and 20 (210 in this case) which is then applied to the relevant goodwill amount.

Under the “discount” method, the inherent capitalisation rate in the transaction giving rise to the goodwill (say 8 per cent per annum) is used to determine an initial amortisation charge which, when compounded at 8 per cent per annum, will produce the required amount of $100 million over 20 years.

**INTERNATIONAL COMPETITIVENESS**

Claims that AASB 1013 affects the international competitiveness of Australian companies are focused on the comparison of Australian requirements with those in the UK and the US. Even at its most basic level, the argument is difficult to accept. This is because:

- the markets are well informed of the required accounting treatment of goodwill and therefore can accurately identify the effect it has on reported accounts; and

- goodwill amortisation has no effect on actual cashflow; thus, its effect on value should be nil.

An even more fundamental argument is that companies compete on the basis of the products and services they offer and how they are managed. Accounting is a means of reporting economic phenomena, and it cannot make a company’s products, services or management any more or less competitive than they are. In this context, the competitiveness argument could be considered from four perspectives:

- decision to invest in other businesses;
- share prices;
- existing contracting relationships; and
- dividend distribution policies.

**Investment Decisions**

Investment decisions are, in theory, and generally in practice, based on the assessment of expected cashflows. The present value of these cashflows represents the value of the investment. Where a DCF analysis is not conducted, investment decisions may be based on a surrogate measure of value such as capitalised earnings. The method of accounting for goodwill does not affect the cashflow or the fundamental economic performance of the investment.

While the accounting treatment of goodwill does not have any cashflow effect, a cashflow effect does result in countries where goodwill amortisation is deductible for taxation purposes. However this is a tax issue, not an accounting issue.

It is sometimes argued that if an investor uses a multiple of accounting earnings to establish the price or value of an investment, the method used to account for goodwill will affect that...
value. This is said to create a competitive disadvantage against companies allowed to write off goodwill direct to reserves or over longer periods.

Such arguments implicitly assume that the earnings multiple used to generate the valuation is fixed regardless of whether reported earnings are net of, or gross of, amortised goodwill. This is simply not so. The commercial reality is that share prices are basically determined by the buying and selling decisions of sophisticated investors and institutions who are more than capable of making any adjustments necessary to reflect the differences between countries or companies of the accounting treatment of goodwill.

Share prices
It is asserted that the share price of a company which adopts the immediate write-off approach, and in subsequent years reports higher earnings, will be higher than the one which adopts the capitalisation-and-amortisation approach. This argument should be dismissed for the same reason as the preceding one.

Existing contracting relationships
Data in the financial reports is often used to define contracting relationships between the companies and other parties (debt covenant policies). The company which adopts the capitalisation-and-amortisation approach would have the potential to breach the accounting-cost based covenants, while the company which adopted the immediate write-off approach will have the potential to breach the liability and negative-pledge based covenants. While these are economic in nature, they are not primarily the product of an accounting standard. Rather, they are attributable to the way in which the company has structured its contracting relations.

Dividend policy
Some companies have argued that the AASB 1013-imposed treatment of goodwill restricts their ability to pay dividends because their reported profits are lower than they would be if they were able to adopt the immediate write-off approach. The company in a country with an extended 40-year amortisation regime is similarly said to be able to distribute higher dividends to shareholders.

This argument fails to acknowledge two points. First, under Australian law companies’ dividends can be paid from profits or reserves. Second, and more important, for most companies it is liquidity that determines the ability to pay dividends. Amortising goodwill does not affect liquidity; it only affects reported profit cover.

ASSOCIATED COSTS OF ACQUISITION
Under AASB 1013 goodwill is calculated as the difference between the acquisition cost and the fair value of the identifiable net assets of an acquired business entity. As a result, acquisition costs such as stamp duty and advisory expenses are capitalised as an asset (which is hardly appropriate) and written off over 20 years.

ACTUAL LIFE OF ACQUIRED GOODWILL
The need to amortise purchased goodwill (and generally amortising it over much less than 20 years) is best demonstrated by analysing the components of purchased goodwill and the expected life of those components. As shown in Table 4, the components of acquired goodwill have an average life of three to seven years and only in rare cases a life of 10 years or more.

Given the nature of the components of goodwill, it is difficult to see how the majority of the benefits arising from those components would emerge towards the end of the 20-year write-off period. Unless that were the case, the use of ISYD cannot be justified.

Accordingly, companies which consider AASB 1013’s 20-year period is too short, or who are proponents of the ISOYD method of amortisation, probably need to reconsider their views.

ISSUES ARE MISUNDERSTOOD
The real issue in the goodwill debate is not whether acquired goodwill (ie, the goodwill arising in a takeover that AASB 1013 requires to be amortised) depreciates in value over time. Clearly, it does. And, because it does depreciate, it is also clear that it should be written off over its expected useful life. Indeed, for the reasons set out in Table 3 it is apparent that the maximum 20-year write-off period for acquired goodwill permitted in AASB 1013 is actually generous.

What is arguably unfair about the Australian accounting standard requirements is that the reported profits are reduced not only by the write-off of acquired goodwill but also by the write-off of internally generated goodwill (that is, replacement goodwill, being the annual expenditure by companies to maintain, replace or expand their goodwill).

In a successful business, goodwill is nurtured and grows. Yet accounting standards worldwide preclude the recognition of this internally generated goodwill. The reason for forbidding the recognition of internally generated goodwill is simple. If its recognition were permitted it would lead to widespread overstatement of reported results. Simply put, the value of internally generated goodwill is so difficult to measure that its recognition is forbidden in all major countries of the world.

Accounting standards throughout the world require that companies regularly assess the value of any remaining goodwill in the balance sheet and to make further write-downs (but not write-ups) of the amount if the inherent value is no longer present. AASB 1013 also requires the write-down of goodwill where the annual amortisation charge proves insufficient.

CONCLUSION
To summarise the above points:
• the controversy over the amortisation
of acquisition goodwill in Australia has been clouded by misconceptions;

- the essential features of AASB 1013 are in fact consistent with overseas accounting standard requirements;

- a distinction has to be made between acquisition goodwill and internally generated goodwill;

- acquisition goodwill clearly depreciates in value and should be amortised;

- the belief that AASB 1013 adversely affects Australian companies’ international competitiveness, stockmarket values and their ability to make takeovers does not sustain close analysis;

- in particular, the amortisation of acquisition goodwill is purely an accounting entry that does not affect cashflows. Accordingly, it should not affect competitiveness, market values or the ability to make takeovers;

- on balance, the US accounting standard requirements relevant to the treatment of goodwill are much tougher than AASB 1013;

- in particular, US companies are required to amortise all intangible assets (not just goodwill), and are not allowed to revalue identifiable intangible assets;

- furthermore, many US companies amortise acquisition goodwill over shorter periods;

- the use of the inverse sum-of-the-years’-digits method of amortising goodwill has the capacity to overstate current profits;

- if the actual components of acquisition goodwill are examined it is clear that most of them have an effective life of much less than 20 years.

Table 4: Actual Life of Acquired Goodwill

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<th>GOODWILL ELEMENT1</th>
<th>LIKELY DURATION2</th>
<th>COMMENTS</th>
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| Quality of management team, marketing expertise | Short/Medium | • Management retirement age.  
• Management may move to other companies.  
• Competition skills may be enhanced by new management.  
• Depth of management hard to retain.  |
| Synergies | Medium | • Highly dependent on ability of management to implement.  
• Technology changes, market changes or regulatory factors generally dissipate benefits over time.  
• Competitors may also make acquisitions (etc) thus eliminating or reducing synergy gains.  |
| Consumer preference loyalty | Medium/Long | • People age/die  
• Consumer preferences change with age.  
• Downturns occur in the economy.  
• Brand loyalty is often a result of an individual’s self-perception and psychological characteristics which change over the medium term.  
• Government policies change.  |
| Economies of scale | Medium/Long | • Benefits may be eliminated by technology changes, market changes or regulatory changes which dissipate the economies, enables competition or competitive products to achieve economies or favour competitors.  |
| Distribution network | Medium/Long | • Markets may change or move.  
• Competitors can build networks over time.  |
| Locational | Medium/Long | • Competition in short term cannot develop in immediate area but in medium/long term they can either develop or buy into the area.  
• Rental costs (on property values) are likely to rise if location is desirable. Thus locational advantages gravitate over time to the landowner. Thus the long-term locational value will be reflected in the property value.  |
| Individuality/unique-ness, monopoly | Short/Long | • If no barriers to entry competition will develop quickly.  
• If barriers exist may take longer but competition will develop over time.  |
| Know-how | Short/Medium | • Depends on length of stay of management and technical skills.  
• Likely to be learned, copied or licensed from overseas and/or superseded by competitors.  |
| Technical skills | Short/Medium | • Competitors may copy, improve on, or develop alternative technology on product.  |

NOTE:
1 The list excludes identifiable intangible assets such as licences, patents, trade-marks etc as these are not components of goodwill.
2 Definitions of duration: Short, 0–3 years (approx); Medium, 3–7 years; Long, 7–10 years; Very long, 10–20 years.

Responsible corporates should closely examine their carrying value of acquisition goodwill and its amortisation period. Given that write-downs of acquisition goodwill have no cashflow consequences, corporations should make any necessary write-downs before they become obliged to do so as a result of the likely tightening of accounting requirements by the