The goodwill game

The accounting profession and accounting rules are under pressure following recent high-profile corporate collapses. At the invitation of the Institute, KEITH ALFREDSON and ADRIAN MURRAY flag some of the issues that can result from the new US accounting rules.

When analysts are asked about goodwill amortisation expense, a common response is that they add it back to profit. Accordingly, some may be glad to learn of the recent issue of Statement of Financial Accounting Standards FAS 141 “Business Combinations” and FAS 142 “Goodwill and Other Intangible Assets” by the US Financial Accounting Standard Board (FASB). These Standards, which have spelt the end to goodwill amortisation in the US, have numerous significant implications which are of interest to Australian reporting entities.

FAS 141 addresses the initial accounting for assets acquired in a business combination. A key feature of FAS 141 is the removal of the “pooling-of-interests” method of accounting for business combinations, which entitled combining entities to basically sum their balance sheets under certain circumstances. FAS 141 also introduces a new criteria requiring identifiable intangible assets to be recognised apart from goodwill when those assets arise from contractual/legal rights, or if those assets are separable (including if the intangible is separable in combination with another asset or liability). The Standard even includes a list of assets that satisfy this recognition criteria, such as order and production backlog, customer lists and customer relations, items that are not normally capitalised in Australia.

FAS 142 covers the subsequent accounting for goodwill and other intangible assets. Most significantly it prohibits the amortisation of all goodwill and “indefinite life” intangible assets, instead requiring detailed impairment testing procedures, based on fair value measurements, to be applied at least annually. While FAS 141 and 142 are quite detailed, there are likely to be several implementation issues involved with the application of these Standards. Already the FASB staff have issued tentative guidance reading down the transitional provisions in FAS 141 requiring entities to reclassify pre-existing goodwill and intangible assets to conform with the new recognition criteria. The FASB has also established a working group to deal with issues that may arise if the new rules are applied to not-for-profit entities.

Given these developments, the current FASB project revising purchase method procedures, and the FASB proposal for a project to increase disclosures of internally generated intangibles, accounting for business combinations and intangible assets should still be considered to be in a state of flux.

An obvious appeal of the new rules, particularly to those entities carrying large amounts of goodwill, is the end to regular amortisation charges. The early adoption of FAS 142 by US based gas distributor Airgas reflects this, with the company's diluted earnings per share being raised from US$0.15 to US$0.20 for the three months ending 30 June 2001, due to the adoption of FAS 142. However, FAS 142 has a mixed effect. For acquisitions completed after the introduction of the new Standard, many entities will be forced to attribute greater value to identifiable intangibles, reducing the goodwill number substantially. And while goodwill was previously entitled to be amortised over a maximum of 40 years in the US, many of these new identifiable intangibles will be required to be amortised over much shorter periods, say two or three years.

The new rules are also likely to hit hard when business valuations are down. Billions of dollars of goodwill and other intangible assets have already been written off the balance sheets of US companies in recently issued quarterly reports.

A key reason given by the FASB for issuing FAS 142 was the view that goodwill amortisation expense was not a useful number for analysing investments. While this view is supported by recent academic work, this begs the question as to whether impairment reviews will be any better—especially given the likely cost of the new impairment testing procedures.

How will the market react to an impairment write-down? Most likely on a case by case basis. The delay in issuing financial reports may mean that in many cases an impairment write-down only confirms expectations already held by analysts. But even so, an impairment write-down may still reveal the magnitude of the problem, and management’s awareness of the issue. In other cases, an impairment write-down may provide fresh evidence of a bad acquisition, or an unexpected deterioration in the fundamentals of the business acquired. Accordingly, while an impairment write-down is still a non-cash charge, there is every chance the US approach will convey more information than amortisation.

In issuing the new rules, the FASB also noted that users of financial statements are becoming aware that intangible assets are an increasingly important economic resource for many entities. FAS 141 goes part way to...
addressing the associated need for better information concerning intangibles, placing pressure on entities to increase recognition of identifiable intangibles separately from goodwill, and through detailed disclosure requirements such as the requirement to disclose the factors contributing to a purchase price resulting in goodwill.

MERGERS, RATIOS AND DIVIDENDS

Some defendants of the “pooling-of-interests” method outlawed by FAS 141 argued that the new rules would prove a disincentive to merger activity in the US, because the purchase method replacing pooling would require entities to restate the assets of the acquired entity to fair value when preparing consolidated accounts.

This will increase the asset base of the combined entity, placing pressure on key performance ratios such as return on assets and return on equity. Whether removing pooling will really have such an effect on merger activity is yet to be seen. In any event, as pooling of interests has been outlawed in Australia for some years the same implications are unlikely to exist directly for Australian entities.

An argument raised in an Australian context for removing goodwill amortisation is that amortisation expense may impact on the ability of an entity to take advantage of available franking credits, given the fact that goodwill amortisation is non-deductible for income tax purposes and that dividends are generally paid out of accounting profit. However, the same problem will exist for any write-off of goodwill or intangibles even if amortisation were no longer required.

The International Accounting Standards Board (IASB), the pronouncements of which will be required to be followed by all entities listed in the European Union by 2005, is moving quickly to finalise an exposure draft of proposals that are likely to closely harmonise with the US rules, at least to the extent of the increased recognition of intangibles, and the non-amortisation of goodwill and certain indefinite life intangibles.

While there are several inconsistencies between current IASB proposals and the US rules, the elimination of pooling in the US represents a major step forward in the global investment market.

The Australian Accounting Standards Board is already under considerable pressure to adopt a US approach in its project on Intangible Assets. However, rather than taking this approach without fully considering the consequences, the AASB is participating closely with the IASB as part of the AASB’s role as an IASB liaison standard-setter.

The AASB has recently invited Australian entities to participate in field testing the US impairment approach through the assistance of the Group of 100. This field testing is intended to inform the AASB of the feasibility of the US approach for Australian entities, and to provide significant input into the IASB’s deliberations. Undoubtedly the stage is being set for Australian entities to be applying radically new rules for goodwill and intangible assets, within the next two years.

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March 2002