Advance Australia Fair: The quality of AASB 136 fair value disclosures down under

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ABSTRACT

The introduction of an impairment test for goodwill under IFRS is seen as another step toward moving financial accounting and reporting from its traditional historical cost paradigm to one of fair value. This regulatory change has been the subject of a growing body of literature which has often criticised many of the technical aspects of the new standard and highlighted the increased discretion it has afforded managers in the determination of periodic profit. One example of this increased discretion is the opportunity to undertake an impairment test using a methodology based on “value in use” or “fair value less cost to sell”. While previous empirical studies examining the contemporary practice of goodwill impairment testing in Australian have focused on the large number of firms that have elected a “value in use” methodology, this paper examines the less popular practice of impairment testing using “fair value less cost to sell” by drawing from a sample of 200 of the largest Australian firms. One average, these firms tended to have greater levels of goodwill suggesting a higher potential sensitivity to impairment losses, yet they recorded a lower incidence of impairment recognition compared to those firms using a “value in use” methodology. Our analysis also identifies a systematic failure among these firms to comply with the basic disclosure requirements required under the standard which increases the likelihood of unverifiable estimates polluting financial statements. Our results assist in understanding the impact the introduction of IFRS brings to the reliability of financial reporting in Australia, and identifies issues that may assist regulators and standard setters in shaping future policy.

Keywords: Fair value, impairment, goodwill, IFRS
1. INTRODUCTION

The adoption of IFRS has resulted in the introduction of fundamental changes to the accounting and reporting regime for goodwill employed in Australia. The impairment testing led approach to goodwill reporting required under IFRS results in a materially different approach to goodwill valuation for balance sheet purposes and to the nature and timing of the influence of goodwill as an asset class on the determination of periodic profit. In principal goodwill is considered impaired when an entity is not able to recover the asset’s balance sheet carrying value.

The new impairment testing requirements for goodwill under AASB 136 – *Impairment of Assets* were introduced for reporting periods commencing 1 January 2005 and now require the determination of a “recoverable amount” for goodwill on at least an annual basis. The recoverable amount of goodwill is compared to the carrying value of goodwill to assess the quantum, if any, of the impairment expense. Recoverable amount is calculated as the higher of an asset’s fair value less cost to sell and its value in use1.

Arguably, the transition to IFRS goodwill accounting and reporting also results in substantially increased complexity – both in terms of the techniques required of reporting entities in accounting for goodwill, and in the nature of disclosures required in relation to goodwill and its impairment. This heightens the risk of inconsistent compliance and varying levels of disclosure quality by firms making their first reports under this new and complex regime.

Prior empirical studies examining goodwill impairment disclosure in the Australian context identified such inconsistencies in compliance and disclosure quality particularly by focusing on information pertaining to settings in which value in use, the dominant approach used in Australia as a basis for the estimation of recoverable amount (Carlin and Finch, 2007; Carlin et al., 2007) was used as a key benchmark in the goodwill impairment testing process. However, AASB 136 – *Impairment of Assets* makes it clear that reference to fair value (as opposed to value in use) is also an acceptable benchmark against which to test for instances of value impairment.

Given that impairment testing procedures represent an essential element of in the International Financial Accounting Standards Board’s strategy of moving financial reporting from a predominantly historical cost to a fair value basis (Reason, 2003; Benston, 2006) it is arguable that coming to a detailed understanding of the application of mechanisms such as the impairment testing regime represents an important element of developing clear understandings of the overall effect and implications of the transformations of reporting practice mandated under IFRS.

Arguably, reaching an understanding of the nuances of practice is most important in those spaces beset by the highest levels of technical challenge. Arguably, that space in the financial reporting rubric defined by the confluence of fair value principles and the unruly character of goodwill represents such a space. At present, that space has not been the subject of scholarly scrutiny. Thus, this paper adds to the literature by providing insights into the potentially vexed world of goodwill impairment testing by reference to fair value benchmarks, complementing similarly themed earlier work in which the difficulties associated with the use of value in use based value benchmarks in the context of goodwill impairment testing were explored.

The remainder of the paper takes the following form. Section 2 sets out some relevant theoretical and technical material necessary to anchoring the key themes developed later in the paper. Section 3 describes the data and analytical methods employed for the purposes of the research. Section 4 sets out the empirical results and offers commentary on key aspects of the results, while Section 5 sets out some conclusions, policy relevant ruminations and suggestions for future research.

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2. THEORETICAL AND TECHNICAL BACKGROUND

In practice, historical cost based accounting and reporting frameworks have represented the dominant framework for recognition and measurement. Increasingly however, this foundation is being replaced by a fair value oriented accounting paradigm. This move reflects the needs of users of financial accounting and the efforts of accounting standards setting bodies to reverse the pattern of declining relevance of financial information (Francis and Schipper, 1999; Lev and Zarowin, 1999) by attempting to make accounting information more relevant such that it accurately reflects the underlying condition of the firm (Choy, 2006). The incorporation of fair value accounting into the inventory of generally accepted accounting principles (GAAP) has deep consequences for the field of accounting and potentially, to management philosophy (Barlev and Haddad, 2003).

Prior to 1938 the application of a fair value approach had often been applied to banks and other financial institutions as a basis upon which to report their financial holdings. During the Great Depression this resulted in a systematic need for financial institutions to mark down their holdings and report losses, and to maintain their capital adequacy ratio, curtail loans. It subsequently became the received wisdom in key regulatory and legislative circles that this requirement served only to intensify and reinforce the economic crisis experienced throughout the world, with the result that the market value experiment was abandoned in favour of a historical cost approach (Barlev and Haddad, 2003, p. 388).

However, some re-emergence of fair values based ideas in accounting had re-emerged by 1947 by which time inventory was required to be valued at “the lower of cost or market”, where the market price was defined as the current replacement cost by purchase or production\(^2\). This early impetus was further propelled by the influential work of a number of thought leaders, amongst whom Professor Chambers was particularly notable (Edwards and Bell, 1961; Chambers, 1966; Sterling, 1970).

The work of these thinkers provided much of the foundation for the development of fair value accounting and highlighted that “there are many prices which may be assigned to any non-monetary object…but at any present time all past prices are simply a matter of history. Only present prices have any bearing on the choice of an action” (Chambers, 1966, p. 91). But it was Moonitz (1961) who is largely credited with the development of “market value” as the basis for financial measurement and reporting, and Sprouse and Moonitz (1962) for (re)introducing the concept of “market price” as the basis of valuation for marketable securities.

Today, measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks\(^3\) including for:

(a) marketable securities or liabilities to settle an obligation under a financial instrument;
(b) components of equity such as hybrid securities\(^4\);
(c) assets or liabilities acquired in a business combination and the initial determination of goodwill;
(d) assets or liabilities adjusted on a one-time basis, for example impairment testing of goodwill;
(e) aggregations of assets or liabilities, for example the measurement of a diversified loan portfolio;
(f) transactions involving the exchange of assets between independent parties without monetary consideration; and

\(2\) Accounting Research Bulletin No. 29 – Inventory Pricing, Committee on Accounting Procedure, July 1947.
\(3\) ASA 545 – Auditing Fair Value Measurements and Disclosures, paragraph 7.
\(4\) For a comprehensive assessment of hybrid securities in Australia see (Carlin et al., 2006).
(g) note-form disclosures provided as supplementary information but not disclosed in the financial report.

The focus of this paper lies on the current practice of impairment testing where fair value (less costs to sell) has been used as a basis for the estimation of recoverable amount in accordance with AASB 136 – *Impairment of Assets*.

Accounting for goodwill changed in Australia from 1 January 2005 through the combined effects of the new internationalised Australian financial reporting standards AASB 3 - *Business Combinations* and AASB 136 - *Impairment of Assets*. Currently, goodwill is initially recognised under AASB 3 - *Business Combinations* as the balancing item between the cost of the acquisition and the fair value of the identifiable assets acquired less the fair value of the liabilities and contingent liabilities assumed.

The value of goodwill acquired in a business combination is no longer amortised, but under AASB 136 - *Impairment of Assets*, it is tested for impairment annually or whenever events or circumstances indicate its value may have been impaired, that is, if carrying amount exceeds recoverable amount. The recoverable amount is calculated as the higher of an asset's fair value less cost to sell and its value in use.

A vexing issue in determining the recoverable amount of goodwill stems from the fact that goodwill does not produce profit in isolation. Rather, the profit is produced from a parcel or package of net assets of which goodwill is the residual and not capable of separate identification (Wines et al., 2007, p. 866). Where it is not possible for the recoverable amount of an individual asset to be estimated, this being the case with goodwill, the standard requires the “cash-generating unit” (CGU) to which that asset relates to be identified, and the recoverable amount of each CGU to be assessed. A cash-generating unit is:

(i) the smallest identifiable group of assets that generates cash inflows that are largely independent from other assets or groups of assets⁵, and,

(ii) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes⁶, and,

(iii) shall not be larger than a primary or secondary segment determined in accordance with AASB 114 - *Segment Reporting⁷*.

The recoverable amount of goodwill is determined by a deductive process that starts with subtracting the recoverable amount of the whole CGU (including the unidentifiable goodwill asset) from the recoverable amount of the CGUs identifiable net assets to reveal the recoverable amount of goodwill. If the recoverable amount of goodwill is less than the carrying value of goodwill, an impairment loss representing the difference in value is recognised against current period profit. If no impairment loss is to be recognised, the goodwill balance remains unaltered on the balance sheet from year to year.

The realisation of any impairment loss is therefore dependant on the two critical choices: the discretion concerning the identification and composition of unique CGUs, and the discretion in estimating their recoverable amounts. It is the exercise of discretion in these areas that has driven many commentators to see the new goodwill impairment testing regime as yet another tool for managing earnings (Cearns, 1999; Reason, 2003; Beatty and Weber, 2006; Bens et al., 2007; Ramanna, 2007; Ramanna and Watts, 2007; Skinner, 2007).

In understanding the application of the IFRS impairment regime in the context studied for the purposes of this paper, it is useful to review a number of key technical provisions of the key standards which set reporting and disclosure requirements in this area.

Paragraph 6 of AASB 136 – *Impairment of Assets* defines “fair value less costs to sell” as the amount obtainable from the sale of an asset or cash-generating unit in an arm’s length transaction between knowledgeable,

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⁷ AASB 136 – *Impairment of Assets*, paragraph 80(b).
willing parties, less the costs of disposal. The standard provides a structured flow to the determination of the amount obtainable as being:

(i) The best evidence is a price in a binding sale agreement in an arm’s length transaction, adjusted for incremental costs directly attributable to the disposal. 
(ii) If there is no binding sale agreement but an asset is traded in an active market, fair value less costs to sell is the asset’s market price less the costs of disposal. The appropriate market price is usually the current bid price. When current bid prices are unavailable, the price of the most recent transaction may provide a basis from which to estimate.
(iii) If there is no binding sale agreement or active market for an asset, fair value less costs to sell is based on the best information available to reflect the amount that an entity could obtain, at the reporting date, from the disposal of the asset in an arm’s length transaction between knowledgeable, willing parties, after deducting the costs of disposal. In determining this amount, an entity considers the outcome of recent transactions for similar assets within the same industry.

In the absence of a binding sale agreement (i.e. the best evidence as described (i) above), the fair value of asset or cash-generating unit is to be determined by an “active market” as described in (ii) above. An active market is defined in the Standard as a market in which all of the following conditions exist:

(a) the items traded within the market are homogeneous, and;
(b) willing buyers and sellers can normally be found at any time, and;
(c) prices are available to the public.

Given that CGU assets are unique to each organisation and vary in structure and composition, it is highly unlikely that they are homogeneous. Because of the specialised nature of the assets, it is also unlikely that willing buyers and sellers for a CGU could be found at any time, rather it is more likely that these assets are not fungible at all (Zimmermann and Werner, 2006, p. 130).

While prices for many homogenous items (such as listed securities and managed funds) are available to the public, we are yet to discover the CGU bourse, so it is unlikely that any of the three conditions above will be met concurrently. As such, it is highly improbable that an active market price will even be obtained in a fair value estimate, with the sole exception of a CGU asset that is listed on an exchange.

As such, the most probable fair value method is one that relies on the “best information available” (to management) to reflect the amount that an entity could obtain in a hypothetical sale. In other contexts in which fair value approaches to valuation are common, the determination of fair value is often undertaken within the context of what may be described as a “fair value hierarchy”. This is the case, for example, in the context of valuing financial instruments for financial reporting purposes.

It is generally accepted that a fair valuation methodology (especially for valuing financial assets or liabilities) will rely upon a range of inputs with varying reliability to support a valuation. This range of inputs is referred to as the “fair value hierarchy” and groups into three broad categories (levels) the inputs that should be used to estimate fair value. The hierarchy gives the highest priority (level 1) to market inputs that reflect quoted prices

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8 ASB 136 – Impairment of Assets, paragraph 6 defines “costs of disposal” as incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.
9 AASB 136 – Impairment of Assets, paragraph 25.
11 AASB 136 – Impairment of Assets, paragraph 27.
in active markets for identical assets and liabilities, and the lowest priority (level 3) to entity inputs developed based on an entity’s own internal estimates and assumptions (FASB, 2004, p. 5).

Level 1 inputs are unadjusted quoted prices in active markets for identical assets and liabilities. Level 2 inputs represent inputs derived from the following four sources:

(a) quoted prices for similar assets or liabilities in active markets;
(b) quoted prices for identical assets or liabilities in markets that are not active;
(c) inputs other than quoted prices that are observable for the asset or liability (such as yield curves, default rates, credit spreads);
(d) market-corroborated inputs being inputs that are derived from or corroborated by observable market data, by correlation or other means.

Finally, Level 3 inputs are unobservable inputs based on the reporting entity’s own assumptions about the assumptions that market participants would use, based on the best information available in the circumstances (Esquivel and Gornik-Tomaszewski, 2007, p. 21). Importantly, Level 3 inputs are those based on present value and other internally generated estimates produced by company managers and are not taken from market prices.

Enron extensively used Level 3 estimates for its external and internal reporting and while it used the term “mark-to-market” accounting, it rarely based the valuations on actual market prices (McLean and Elkind, 2003). Accountants and external auditors have had less experience with Level 3 estimates (at least for external reporting) and this has proven a challenge in both the measurement and verification of values in financial statements (Benston, 2006).

Importantly, for the purposes of the determination of recoverable amount by fair value less costs to sell, AASB 136 – *Impairment of Assets* does not allow the use of Level 3 estimates, rather these inputs are only permissible where the recoverable amount is being assessed by the value in use method\(^\text{13}\).

In summary, for the purpose of goodwill impairment testing where the recoverable amount is determined by fair value less cost to sell, the valuation of the CGU net assets ought be derived from either: a binding sales agreement; the bid price of a traded asset in an active market; or an estimate by reference to a recent transaction for a similar asset in a similar market. That is, fair value estimates much be referable to market based events, not merely to the results of assumption based financial simulations and models, a fact which is of some significance in interpreting the results of this study.

3. **DATA AND METHODOLOGY**

The research sample focuses on data drawn from 200 of the largest Australian listed corporations (by market capitalisation) which reported goodwill as comprising an element of their asset base in their 2006 consolidated financial statements. In constructing the sample of 200, firms were excluded if they reported under a framework other than IFRS, in a currency other than Australian dollars, or where listed asset holding vehicles or managed investments rather than trading enterprises. Successively smaller firms (by market capitalisation) which did not trigger these exclusionary rules were then added to the sample until it comprised 200 firms.

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\(^{13}\) Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit (AASB 136 – *Impairment of Assets*, paragraph 6).
The research sample had a combined market capitalisation of $882.1 billion and represented 63.5% of the total market capitalisation of the ASX as at the conclusion of December 2006. In compiling this sample, the audited financial statements for 412 listed firms were screened. These firms had a combined market capitalisation of $1.350 trillion which represented 97.12% of the total market capitalisation of the ASX at the relevant time.

In order to facilitate analysis of the final research sample, the 200 constituent firms were arranged by their GICS industry group classification and subsequently divided into 15 groups comprising organisations with related principal lines of business. At the date of sampling, the 200 firms included in the final sample controlled assets valued at $2,341,892 million, which included goodwill of $77,874 million. An overview of the research sample broken down by assigned sector, the dollar value of firm assets within the sector, and the dollar value of goodwill for each sector is shown in Table 1, below.

### Table 1 – Overview of Research Sample

<table>
<thead>
<tr>
<th>Sector</th>
<th>Total Assets ($ million)</th>
<th>Total Goodwill ($ million)</th>
<th>Goodwill as % of Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks &amp; Insurance (n=12)</td>
<td>1,927,443</td>
<td>22,868</td>
<td>1.19%</td>
</tr>
<tr>
<td>Capital Goods (n=18)</td>
<td>15,599</td>
<td>1,646</td>
<td>10.55%</td>
</tr>
<tr>
<td>Commercial Services &amp; Supplies (n=20)</td>
<td>10,894</td>
<td>2,090</td>
<td>19.19%</td>
</tr>
<tr>
<td>Consumer Services (n=8)</td>
<td>12,420</td>
<td>4,223</td>
<td>34.00%</td>
</tr>
<tr>
<td>Diversified Financials (n=20)</td>
<td>36,468</td>
<td>2,431</td>
<td>6.67%</td>
</tr>
<tr>
<td>Energy (n=4)</td>
<td>15,308</td>
<td>1,624</td>
<td>10.61%</td>
</tr>
<tr>
<td>Food, Beverage &amp; Staples (n=15)</td>
<td>62,163</td>
<td>10,983</td>
<td>17.67%</td>
</tr>
<tr>
<td>Health Care (n=14)</td>
<td>20,119</td>
<td>6,291</td>
<td>31.27%</td>
</tr>
<tr>
<td>Materials (n=17)</td>
<td>50,738</td>
<td>5,874</td>
<td>11.58%</td>
</tr>
<tr>
<td>Media (n=13)</td>
<td>24,566</td>
<td>1,855</td>
<td>7.55%</td>
</tr>
<tr>
<td>Real Estate (n=11)</td>
<td>40,219</td>
<td>2,409</td>
<td>5.99%</td>
</tr>
<tr>
<td>Retailing (n=18)</td>
<td>11,138</td>
<td>1,607</td>
<td>14.43%</td>
</tr>
<tr>
<td>Software &amp; Services (n=13)</td>
<td>3,519</td>
<td>1,957</td>
<td>55.60%</td>
</tr>
<tr>
<td>Technology &amp; Telecommunication (n=8)</td>
<td>38,276</td>
<td>2,767</td>
<td>7.23%</td>
</tr>
<tr>
<td>Utilities &amp; Transportation (n=9)</td>
<td>73,022</td>
<td>9,250</td>
<td>12.67%</td>
</tr>
<tr>
<td><strong>TOTAL (n=200)</strong></td>
<td><strong>2,341,892</strong></td>
<td><strong>77,874</strong></td>
<td><strong>3.33%</strong></td>
</tr>
</tbody>
</table>
After assigning firms in the total research sample to relevant industry groupings, sample firms were also sub-classified according to their disclosed method of testing for goodwill impairment. This process revealed that a majority (157 of 200) exclusively relied on the value in use approach to testing for goodwill impairment. These firms were not of direct interest for the purposes of this study.

A further 19 firms with material goodwill did not provide any details of the methods they had employed for the purpose of goodwill impairment testing, and thus do not factor in the analysis. However, a total of 24 firms (17 exclusively and 7 in combination with other methods) reported that they used fair value as the benchmark against which they tested goodwill for impairment. This data is set out in Table 2, below.

Table 2 – Method Employed to Determine Recoverable Amount by Sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Fair Value Method</th>
<th>Value-in-use Method</th>
<th>Mixed Method</th>
<th>Method not Disclosed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks &amp; Insurance (n=12)</td>
<td>4</td>
<td>6</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Capital Goods (n=18)</td>
<td>-</td>
<td>17</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Commercial Services &amp; Supplies (n=20)</td>
<td>-</td>
<td>18</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Consumer Services (n=8)</td>
<td>-</td>
<td>8</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Diversified Financials (n=20)</td>
<td>2</td>
<td>12</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Energy (n=4)</td>
<td>-</td>
<td>3</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Food, Beverage &amp; Staples (n=15)</td>
<td>1</td>
<td>13</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Health Care (n=14)</td>
<td>1</td>
<td>13</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Materials (n=17)</td>
<td>-</td>
<td>15</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Media (n=13)</td>
<td>2</td>
<td>9</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Real Estate (n=11)</td>
<td>2</td>
<td>6</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Retailing (n=18)</td>
<td>2</td>
<td>13</td>
<td>-</td>
<td>3</td>
</tr>
<tr>
<td>Software &amp; Services (n=13)</td>
<td>1</td>
<td>11</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>Technology &amp; Telecommunication (n=8)</td>
<td>1</td>
<td>6</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Utilities &amp; Transportation (n=9)</td>
<td>1</td>
<td>7</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>TOTAL (n=200)</td>
<td>17</td>
<td>157(^{14})</td>
<td>7</td>
<td>19</td>
</tr>
</tbody>
</table>

\(^{14}\) A total of 157 firms of the 200 sample (78.5% by number) assess the recoverable amount exclusively by the value-in-use method. These firms account for a total of $58,047.047 million in goodwill (74.5% of the total sample by value).
The financial statements of all firms which used fair value as a value benchmark for goodwill impairment testing (whether solely or in combination with another technique) were analysed, with particular attention to the form and content of disclosures pertaining to the manner in which fair value had been determined. This data was then coded into nine categories as a basis for further analysis. It was necessary to undertake this coding process at the CGU level rather than at the whole of firm level, because impairment testing takes place on a CGU by CGU basis, with the result that within a single firm a “mixed method” may be applied where goodwill attached to some CGUs might be tested for impairment by reference to value in use methods, while simultaneously, others could be tested with recourse to fair values.

Further, since the characteristics of each CGU differ from those exhibited by other CGUs, AASB 136 – *Impairment of Assets* calls for particular disclosures at the CGU level of granularity, in order to facilitate greater transparency and more meaningful disclosure. The key results of the study are set out in section 4, below.

### 4. RESULTS

Although only a small proportion of the total commencing sample of 200 firms employed a fair value approach to the determination of recoverable amount, the firms that did employ this technique tended to be larger, on average, than firms which used the value in use approach or made no useful disclosures. The firms which used fair value as their basis for impairment testing benchmarking also tended to have greater levels of goodwill, on average, than firms employing the dominant value in use benchmark approach.

By way of contrast, the incidence of impairment recognition was less frequent in the case of firms which used the fair value approach to recoverable amount determination than firms adopting the value in use technique or a hybridised “mixed method” technique. Further, the value of individual impairment events was materially lower for firms relying on the fair value approach than in the case of impairment events recognised by firms employing either the value in use or mixed methods impairment testing approaches.

This is set out in Table 3, below.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Fair Value Method</th>
<th>Value-in-use Method</th>
<th>Mixed Method</th>
<th>Method not Disclosed</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets ($ million)</td>
<td>911,737</td>
<td>1,283,416</td>
<td>23,974</td>
<td>122,764</td>
<td>2,341,892</td>
</tr>
<tr>
<td>Total Goodwill ($ million)</td>
<td>15,818</td>
<td>58,047</td>
<td>1,321</td>
<td>2,688</td>
<td>77,874</td>
</tr>
<tr>
<td>NPBT ($ million)</td>
<td>18,151</td>
<td>42,383</td>
<td>426</td>
<td>2,661</td>
<td>63,622</td>
</tr>
<tr>
<td>Impairment Expense ($ million)</td>
<td>0.500</td>
<td>74.649</td>
<td>10.595</td>
<td></td>
<td>85.744</td>
</tr>
<tr>
<td>Market Capitalisation ($ million)</td>
<td>211,397</td>
<td>708,879</td>
<td>12,655</td>
<td>49,213</td>
<td>882,144</td>
</tr>
<tr>
<td>Number of Firms</td>
<td>17</td>
<td>157</td>
<td>7</td>
<td>19</td>
<td>200</td>
</tr>
</tbody>
</table>
Our data suggests that there are some industry settings where the recourse to fair value approaches to goodwill impairment testing is substantially more prevalent than the whole of sample norm. Three examples which clearly stand out from the data include banks and insurers, where more than 40% of firms used a fair value approach\(^\text{15}\), media firms – where some 23% used fair value approaches and Real Estate firms, where some 27% of firms used fair value. The data pertaining to banks & insurers as well as media firms is particularly striking, since 52.25% and 60.13% of the total goodwill for all firms in these industry sectors was impairment tested with reference to fair value. This data is set out in Table 4, below.

Table 4 – Fair Value & Mixed Method Election by Sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Fair Value &amp; Mixed method (number of firms)</th>
<th>Number as % of all Firms</th>
<th>Goodwill ($ million)</th>
<th>Goodwill % of all Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks &amp; Insurance (n=12)</td>
<td>5</td>
<td>41.66%</td>
<td>11,949.00</td>
<td>52.25%</td>
</tr>
<tr>
<td>Capital Goods (n=18)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Commercial Services &amp; Supplies (n=20)</td>
<td>1</td>
<td>5.00%</td>
<td>38.81</td>
<td>1.86%</td>
</tr>
<tr>
<td>Consumer Services (n=8)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Diversified Financials (n=20)</td>
<td>3</td>
<td>15.00%</td>
<td>153.67</td>
<td>6.32%</td>
</tr>
<tr>
<td>Energy (n=4)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Food, Beverage &amp; Staples (n=15)</td>
<td>1</td>
<td>6.66%</td>
<td>374.50</td>
<td>3.41%</td>
</tr>
<tr>
<td>Health Care (n=14)</td>
<td>1</td>
<td>7.14%</td>
<td>880.37</td>
<td>13.99%</td>
</tr>
<tr>
<td>Materials (n=17)</td>
<td>1</td>
<td>5.88%</td>
<td>1,004.90</td>
<td>17.11%</td>
</tr>
<tr>
<td>Media (n=13)</td>
<td>3</td>
<td>23.07%</td>
<td>1,115.60</td>
<td>60.13%</td>
</tr>
<tr>
<td>Real Estate (n=11)</td>
<td>3</td>
<td>27.27%</td>
<td>307.92</td>
<td>12.78%</td>
</tr>
<tr>
<td>Retailing (n=18)</td>
<td>2</td>
<td>11.11%</td>
<td>37.55</td>
<td>2.34%</td>
</tr>
<tr>
<td>Software &amp; Services (n=13)</td>
<td>2</td>
<td>15.38%</td>
<td>121.50</td>
<td>6.21%</td>
</tr>
<tr>
<td>Technology &amp; Telecommunication (n=8)</td>
<td>1</td>
<td>12.50%</td>
<td>32.22</td>
<td>1.16%</td>
</tr>
<tr>
<td>Utilities &amp; Transportation (n=9)</td>
<td>1</td>
<td>11.11%</td>
<td>1,122.99</td>
<td>12.14%</td>
</tr>
<tr>
<td><strong>TOTAL (n=200)</strong></td>
<td><strong>24</strong></td>
<td><strong>12.00%</strong></td>
<td><strong>17,193.04</strong></td>
<td><strong>22.01%</strong></td>
</tr>
</tbody>
</table>

\(^\text{15}\) This compares to the overall rate of 24 (in some form) from 200 – or 12%.
As described in section 3, above, a key element of our methodology was to undertake a process of impairment testing disclosure coding, whereby CGUs were assigned to groups in relation to which consistent approaches had been used as the basis for estimating fair value. In the process of undertaking this coding, nine treatment categories emerged, ranging from the determination of fair value by reference to an active market for the assets the subject of the CGU in question, through to situations in which no more was disclosed in relation to a particular CGU than that fair value had been adopted as the basis for testing for the potential impairment of goodwill associated with that CGU. The results of this coding process are set out in Table 5, below.

### Table 5 – Analysis of Fair Value Valuation Methodologies by Type

<table>
<thead>
<tr>
<th>Code</th>
<th>Valuation Method</th>
<th>CGU Frequency</th>
<th>% of all frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Active market</td>
<td>3</td>
<td>5.77%</td>
</tr>
<tr>
<td>B</td>
<td>Agreed sale</td>
<td>1</td>
<td>1.92%</td>
</tr>
<tr>
<td>C</td>
<td>Current year acquisition</td>
<td>3</td>
<td>5.77%</td>
</tr>
<tr>
<td>D</td>
<td>Independent valuation</td>
<td>5</td>
<td>9.62%</td>
</tr>
<tr>
<td>E</td>
<td>Discounted cash flow</td>
<td>12</td>
<td>23.08%</td>
</tr>
<tr>
<td>F</td>
<td>Cash flow multiple</td>
<td>6</td>
<td>11.54%</td>
</tr>
<tr>
<td>G</td>
<td>Earnings multiple</td>
<td>12</td>
<td>23.08%</td>
</tr>
<tr>
<td>H</td>
<td>Other multiple</td>
<td>2</td>
<td>3.85%</td>
</tr>
<tr>
<td>I</td>
<td>No disclosure</td>
<td>8</td>
<td>15.38%</td>
</tr>
<tr>
<td></td>
<td><strong>TOTAL</strong></td>
<td><strong>52</strong></td>
<td><strong>100.00%</strong></td>
</tr>
</tbody>
</table>

Several features of this data are worthy of particular note. In only a very small number of instances was fair value determined either with reference to existing active market prices for the particular assets in question, prices recently paid for those assets in a current period acquisition or a firm contract for the disposal of the assets in question (that is, coding categories A through C, above). These coding categories arguably relate to the instances where the fair values used for the purposes of impairment testing are at their most robust and are clearly directly referable to the particular parcel of assets the value of which is being appraised (as opposed to some similar parcel of assets embedded in some similar organisation), yet these categories represented only some 13.5% of total instances where a fair value benchmark was used.

At the other end of the coding spectrum, it seems noteworthy that in relation to more than 15% of CGUs where the fair value benchmark for impairment testing was adopted, no meaningful disclosure which would assist the reader to determine how this amount had been appraised was available (coding category I).
The most common means of assessing fair value appeared to be by reference to relative value approaches, including earnings multiples, sales multiples and asset multiples (categories F, G and H). In a total of 20 CGUs, it was this approach which was used. Unfortunately, as discussed further below, very little information was typically forthcoming about why the particular multiples used as a basis for determining fair value had been adopted, what sample of reference transactions had been used as a basis for setting a range of relevant multiples, and what point in that range had been adopted as the basis point for fair value estimation in a particular impairment testing process.

It was also unusual to note that in 12 CGUs, the stated approach to determining fair value was by reference to discounted cashflow models (coding category E), whereas this approach would appear to be more consistent with the adoption of a value in use benchmark for impairment testing. Further, there were 5 instances where the fair value of a CGU was assessed by means of an independent expert review (coding category D), but closer inspection of these instances also suggests that the independent valuers also predominantly relied on discounted cashflow based approaches in estimating fair value.

The most striking feature of the disclosure data provided by firms which adopted the fair value benchmark for the purposes of goodwill impairment testing was the general lack of information they provided, beyond the bare minimum that they had used a fair value approach and, excluding coding category I firms – where nothing more was said, some very rudimentary description of the approach used to determine fair value. Typically this was no more, for example, than that fair value had been determined with reference to, for example, an appropriate earnings multiple. There was substantial variety in the disclosures offered by the sample firms; however, the common traits were overwhelmingly an absence of useful or relevant information, and a clear departure from requirements of the Standard, as the following examples highlight:

- The recoverable amount has been determined based on a fair value calculation using the projected cash flows for 2005/06 and applying a multiple of 12 (2005:12). Management believe this multiple is appropriate for this business\textsuperscript{16}.

- Fair value is established using valuation techniques including the use of recent arm’s length transactions and valuations based on earning multiples\textsuperscript{17}.

- Fair value less costs to sell is calculated using a discounted cash flow methodology covering a specified period, with an appropriate residual value at the end of that period\textsuperscript{18}.

- This assessment is conducted by the directors based on their extensive knowledge of the motor industry including the current market conditions prevailing in the industry\textsuperscript{19}.

- The recoverable amount of the cash-generating unit within IP Ventures Group is determined on a fair value less costs to sell calculation, whereby fair value has been determined with reference to the estimated market value of the technology being developed in that cash-generating unit\textsuperscript{20}.

More forensically, it is instructive to evaluate the lack of detail in disclosures pertaining to fair value based goodwill impairment testing by reference to the technical requirements of AASB 136 – \textit{Impairment of Assets}. Paragraph 134 of that standard prescribes various note-form disclosures to be included in financial statements to support the estimates used in determining the recoverable amount of each CGU which has been tested for goodwill impairment.

\textsuperscript{17} AMP Limited, Annual Report, 2006, p. 65.
\textsuperscript{19} AP Eagers Limited, Annual Report, 2006, p. 23.
\textsuperscript{20} UXC Limited, Annual Report, 2006, p. 53.
The level of disclosure for each CGU varies based on the method used to determine recoverable amount. These disclosures can be grouped as information common to fair value and value in use approaches, additional information required specifically in cases where a fair value benchmark is adopted, and additional information required in settings where a value in use approach is taken.

Common to both methods the following information is required:

(a) the carrying amount of goodwill allocated to each CGU\(^\text{21}\);

(b) the carrying amount of intangible assets with indefinite useful lives allocated to each CGU\(^\text{22}\); and

(c) the basis on which the CGUs recoverable amount has been determined (i.e. value in use or fair value less costs to sell)\(^\text{23}\).

The additional information required where fair value less costs to sell has been used to determine the recoverable amount is:

(a) disclosure regarding the methodology used to determine fair value less costs to sell\(^\text{24}\). If fair value less costs to sell is not determined using an observable market price for the CGU, the following additional information is also required;

(b) a description of each key assumption (those to which the CGUs recoverable amount is most sensitive) on which management has based its determination\(^\text{25}\); and

(c) a description of management’s approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information\(^\text{26}\).

The additional information required where value in use has been used to determine the recoverable amount is:

(a) a description of each key assumption (those to which the CGUs recoverable amount is most sensitive) on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts\(^\text{27}\);

(b) a description of management’s approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information\(^\text{28}\);

(c) the period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a CGU, an explanation of why that longer period is justified\(^\text{29}\); and

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\(^{21}\) AASB 136 – *Impairment of Assets* paragraph 134(a).

\(^{22}\) AASB 136 – *Impairment of Assets* paragraph 134(b).

\(^{23}\) AASB 136 – *Impairment of Assets* paragraph 134(c).

\(^{24}\) AASB 136 – *Impairment of Assets* paragraph 134(e).


\(^{26}\) AASB 136 – *Impairment of Assets* paragraph 134(e)(ii).

\(^{27}\) AASB 136 – *Impairment of Assets* paragraph 134(d)(i).

\(^{28}\) AASB 136 – *Impairment of Assets* paragraph 134(d)(ii).

\(^{29}\) AASB 136 – *Impairment of Assets* paragraph 134(d)(iii).
(d) the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the CGU is dedicated\(^{30} \).  

When set against these requirements, two matters become clear. First, reporting entities are failing on a systematic basis to comply with the basic explanatory disclosures required of them in cases where they adopt a fair value benchmark for goodwill impairment testing purposes. The relevant provisions of AASB 136 – *Impairment of Assets* make it clear that it is insufficient to merely note the reference to some form of earnings multiple (as an example) by way of discharging accountability around the robustness of the impairment testing process. Far more explanation is required, allowing financial statement users to better familiarise themselves with the dimensions of the businesses in question, and the robustness of the assumptions brought to bear by management in reaching a determination as to the appropriate value for goodwill in corporate balance sheets.  

Further, setting the disclosure requirements which apply in contexts where fair value is adopted as the relevant benchmark next to those which apply where value in use is the benchmark brings into relief the relatively relaxed disclosure requirements which apply to the former, in comparison to those applicable upon application of the latter approach. This gap in required disclosure intensity represents an opportunity for regulatory arbitrage within the context of the IFRS framework. Put simply, rather than fulfilling the detailed disclosure requirements attached to the decision to test for the impairment of goodwill on the basis of a value in use benchmark, some reporting entities may prefer the more relaxed disclosure rules which obtain where fair value is the benchmark.  

Recall from Table 3, above, that though comparatively few firms adopted fair value benchmarks as a basis for goodwill impairment testing, those which did tended on average to have higher levels of goodwill, suggesting higher potential sensitivity in the event of a need to recognise impairment losses. Further, Table 4 demonstrates that on an industry by industry setting, the decision by a firm to adopt a fair value approach to impairment testing places that firm in a distinct minority amongst its peers. This gives rise to questions about the extent to which the character of the asset portfolios (as assigned to CGUs) in the fair value adopters could reasonably be expected to differ materially in their character from the asset portfolios (as assigned to CGUs) of same industry firms which had adopted the value in use approach.  

Table 5 suggests that in a limited number of instances (categories A through C), the circumstances faced by reporting entities rather than the actual character of the underlying asset portfolios might explain why an otherwise highly similar asset portfolio would be impairment tested by reference to fair values in one firm, while in another similar organisation, a value in use approach was adopted. But these situational explanations (listed subsidiary, agreed sale transaction in effect, current year acquisition) are in a clear minority, giving rise to strong questions as to the motivation of testing method choice – particularly among those firms which either provided no meaningful disclosures (category I firms) and those who stated that a discounted cashflow technique had been used as a value estimation technique (category E).  

Further, irrespective of the coding category into which the firms in our final sample fell, the level of technical compliance with the disclosure requirements we have set out above was systematically poor, suggesting a failure on the part of both preparers and auditors to adequately fulfil their obligations. While elsewhere we have documented concerns with the level of information provided in disclosures pertaining to goodwill impairment by firms using a value in use approach (Carlin and Finch, 2007; Carlin et al., 2007), our considered impression of the quality of disclosures made by fair value adopters is that they are profoundly poor, again raising questions as to the motivation impelling the use of this method by firms captured in our sample.

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\(^{30}\) AASB 136 – *Impairment of Assets* paragraph 134(d)(iv).
5. CONCLUSION

Shakespeare commences his 30th Sonnet thus.

“When to the sessions of sweet silent thought I summon up remembrance of things past, I sigh the lack of many a thing I sought, and with old woes new wail my dear times’ waste.”

We will impute a far loftier motive to the great bard in penning these words, but he may as well have been describing his experiences over time with accounting and reporting for goodwill, and in particular the virtual absence of any real meaning in disclosures pertaining to impairment testing for goodwill where fair value has been used as the relevant benchmark. Things, it seems, can only get better.

One concrete change which would in our view engender such a result would be the amendment of AASB 136 – Impairment of Assets to require that in addition to the other information already required as part of the impairment testing disclosure, firms be required to reveal their estimate of CGU fair value, in addition to the carrying value of assets assigned to each CGU. That at least would permit financial statement readers to readily understand the level of “head room” between carrying value and recoverable amount, and thus develop more useful insights into the likelihood that some impairment event might be imminent.

We confess not to being the first authors to promote this idea. It would seem indeed that early draft versions of the IFRS impairment standard embedded such a rule. However, at the October 2003 meeting of The International Accounting Standards Board (IASB) in Toronto, Canada the decision was made to amend the then draft of the IAS 36 – Impairment of Assets and delete the proposed requirement that would have required an entity to disclose the amount by which the recoverable amount of a cash-generating unit exceeds its carrying amount (IASB, 2003, p.2).

Instead, the standard was amended to require an entity to disclose this information only if a reasonably possible change in a key assumption would trigger impairment. In practice, this has meant that this vital piece of information is well and truly shielded from shareholders’ eyes. There are certain things modern day shareholders seem to have well and truly in common with children raised according to the finer Victorian tradition.

Ultimately, our research suggests that the rules as presently configured and enforced are increasing the likelihood that unverifiable estimates are polluting financial statements and related disclosures, increasing managerial discretion in managing and timing impairment events (Ramanna and Watts, 2007). Further, though only evident in a small number of instances in our final research sample, we cannot help but note reports from the United States pertaining to the rise in the number of instances where value estimates are purchased by management responsible for financial statement preparation from “independent” experts, further complicating the process of audit interrogation.

So prevalent is this trend that valuation firms in the USA have also commented on the upsurge in demand for their services, noting that the adoption of SFAS 142 – Goodwill and Other Intangible Assets in the USA has been good for the valuation business and that his trend will continue because ongoing (annual) impairment testing is required (Reason, 2003; Wiese, 2005, p. 113).

It remains to be seen whether the patterns we have detected in our dataset are transient and can be explained as evidence not so much of a systematic problem with the impairment testing regime, its architecture and operation, but rather of teething difficulties with implementation, bound to diminish with the accumulation of experience. While a conveniently optimistic assessment of affairs, it is not one about which our data suggests we ought be sanguine. We believe that there is very good cause for auditors, regulators and rule makers to be very concerned about this corner of the reporting fabric, and to pay close heed to reform possibilities such as those we have flagged above.
REFERENCES


Wise, A. (2005), Accounting for goodwill: The transition from amortization to impairment - an impact assessment, Meditari Accountancy Research, Vol. 13, Iss. 1, 105-120.
