Impairment of Intangible Assets - An Effort to Convergence

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ABSTRACT
Over the last few years, we have witnessed an increasing convergence in accounting practices around the world to provide high quality financial information that is comparable, consistent and transparent in order to serve the needs of financial users. As companies now become more knowledge based, intangible assets will comprise an increasing percentage of the value of businesses acquired. The value derived from intangible assets has increased significantly in today's knowledge based economy. In today's business world, importance has shifted from tangible to intangible. This highlights the significance of intangible assets and their importance in acquisition. In this backdrop, this paper analyses the impact of transition from amortization to impairment of goodwill and the measures have taken by different accounting standard setting bodies with a view to promote convergence of accounting standard with a ultimate objective of developing a single set of high quality accounting standard that can be used by different countries throughout the world.

Keywords-- Intangible Assets, Amortization, Impairment, IFRS, Convergence

II. BACKGROUND OF THE STUDY:
An intangible asset is defined by the International Accounting Standard Board (IAS-38) as an identifiable non-monetary asset without physical substance. This asset is a resource that is controlled by an enterprise as a result of purchase or self-creation and from which future economic benefits, inflows of cash or other assets are expected. Intangible assets have an unusual measurement and recognition features, which have made it difficult to develop a comprehensive accounting standard. Accounting standard setters are aware of the potential information gap in the reporting of intangible assets. Earlier no country required recognition of acquired goodwill separately from intangible assets. The excess cost of an acquired entity over the net amount assigned to assets acquired and liabilities assumed shall be recognized as an asset and is referred to as goodwill. The amount recognized as goodwill measured through this is residual approach. The major financial Reporting change takes place due to adoption of
FASB Statements 141: Business Combinations
FASB 142: Goodwill and Intangible Assets.
FASB 141 provides recognition criteria for intangible assets other than goodwill:
- An asset arising from a contractual or legal right.
- An asset other than contractual that can be sold, transferred, licensed, rented or exchanged individually or in combination with a related contract, asset or liability.
IFRS-3 also recommended recognition of acquired intangible assets separately on the balance sheet to carry out as a part of purchase price allocation. Intangible assets resulting from a business combination, which either arises from contractual or legal rights or are being capable of transferred from acquired entity must be recognized as assets apart from goodwill.

III. IMPORTANCE OF INTANGIBLE ASSETS:

In today’s business world, importance has shifted from tangible to intangible. Instead of plant & equipment, companies today compete on ideas and relationships. These assets could come in the form of trademark, licenses, patent rights, company’s location or reputation. This highlights the significance of intangible assets and their importance in acquisition. The value derived from intangible assets has increased significantly in today’s knowledge based economy. The book value of many publicly quoted companies is significantly less than the market value. Stock market value is derived, to a large extent, from assets that do not appear in the balance sheet. During the last three decades, an increasing proportion of country’s gross domestic product is being accounted for by the knowledge-driven activities in which the role of intangible assets is paramount. As companies now become more knowledge based, intangible assets will comprise an increasing percentage of the value of businesses acquired. According to Price Waterhouse Cooper analysis in US market, intangible assets constituted seventy-four (74%) of average purchase price of acquired companies in 2012, and out of this 22% constitute intangible other than goodwill and 52% was goodwill. This finding is certainly in tune with the increasing attention now being paid to the management of intangible assets by the companies in US and around the world and growing demand for the investors, analysts and standard setters for the provision of accurate, properly communicated information on the value of intangible assets.

IV. OBJECTIVE OF THE STUDY

Since, the scope of the intangible assets is too wide, we here, single out goodwill for the purpose of our in-depth analysis. In this backdrop, this paper highlights on the
1. Prevailing system of amortization of goodwill and its limitations.
2. Potential impact of transition from amortization to impairment of goodwill.

Most controversial aspect of present treatment of goodwill is the amortization period. There is no explanation for the selection of magical maximum amortization period by the accounting standard setter bodies of different countries. The companies have competitive disadvantage in comparison with other companies, which follow longer amortization period. The accounting practice of amortization of goodwill is based on the assumption that it is a wasting asset and thus ignores the fact that some kind of goodwill can have an indefinite useful life. It is virtually impossible to predict accurately the useful life of goodwill; hence, the amount amortized in any given period can at the best be described as an arbitrary estimate of the consumption of goodwill. On the contrary value of goodwill can be maintained or even improved by the effort of management. If it is properly managed, goodwill is an appreciating asset, and if it is not properly managed, the impairment test will recognize any reduction in value. Without considering the usefulness of goodwill, management effort and the ongoing business value is just an imposition of arbitrary life on goodwill and systematic write down is quite a mechanistic approach. Therefore, amortization is not a reliable approach to judge the possible erosion of goodwill value. Financial statement users in the USA have indicated that they do not regard goodwill amortization as useful information in investment analyses (FASB 2001). For this reason, most analysts ignore amortization of goodwill when they calculate ratios for the purpose of analyzing financial position of any firm to take prudent investment decision. When FASB adopted an impairment test approach in 2001, rather than amortizations, the accounting for goodwill arising from an acquisition took a step in a new direction. FASB issued Statement No. 142 provides guidance on the accounting for acquired goodwill; that acquirer companies are no longer permitted to amortize goodwill and other intangible assets with indefinite lives. Instead, such intangible assets are now subject to annual impairment testing. Moving away from amortization towards an impairment test involves a radical change. Intangible assets cannot be valued once and for all; the annual impairment reviews will require the ongoing evaluation of intangible assets. At each reporting date a company is required to assess whether any asset is impaired or whether intangible assets have lost value. A good impairment test promotes transparency, because the trigger is a change in underlying economic or business conditions, not an arbitrary period. As a result, reporting is based on current events that affect the business.

“Intangible assets with an identifiable remaining useful life must be separated from those with an indefinite useful life” (FASB statement number 141).

Determination of expected useful life of an intangible asset is an important process and requires careful consideration of the circumstances as well as judgement. An indefinite life assertion needs to be backed by evidence and analysis supporting that no legal,
regulatory, contractual, competitive, economic or other factors limit the life of the asset.

Thus, goodwill and intangible assets with an indefinite useful life will no longer be allowed to be amortized but must be subject to a two-step test for impairment. Goodwill of the Reporting Unit shall be tested for impairment on an annual basis and if required under certain circumstances like, significant adverse change in legal factors or in business climate, Loss of key personnel and Unanticipated competition etc. between annual tests.

The annual goodwill impairment test may be performed at any time during the fiscal year provided the test is performed at the same time every year. Different Reporting Units may be tested for impairment at different times. Two-step impairment tests shall be used to identify potential goodwill impairment and all tests should be done at the reporting level. Where a reporting unit is defined as an operating segment or one level below an operating segment. A component of an operating segment is a reporting unit. if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component. However, two or more components of an operating segment shall be aggregated and dumped as a single reporting unit if the components have similar economic characteristics.

FASB 142 requires businesses to perform a Transitional Impairment Test on all goodwill within six months of acquisition. After the initial test, businesses must perform the goodwill impairment Test on an annual basis. To identify the potential value of impairment we have to compare the fair value of a reporting unit to its carrying amount. No impairment of goodwill is considered until the fair value of the unit is greater than its carrying value. The fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in orderly transaction between market participants at the measurement date. Quoted market price in active markets is the best evidence of fair value and shall be used as the basis for the measurement if available. The second step is only required if an impairment of goodwill is identified in step one.

The second step involves determination of the implied fair value of goodwill of the reporting unit by allocating the fair value of the reporting unit used in step-I to all the assets and liabilities of that reporting unit as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the price paid to acquire the reporting unit. Compare the implied fair market value of goodwill to its carrying amount. In case the carrying amount of goodwill exceeds its implied fair market value, an impairment loss is recognized. That loss is equal to the carrying amount of goodwill that is in excess of its implied fair market value, and it must be presented as a separate line item on financial statements.

Step-I: $CR<FV$ (No further testing of goodwill for impairment is necessary i.e. Step-II is not required, if $CR>FV$ then goes to
Step-II: If Implied Fair Value of Goodwill> Carrying amount of goodwill, then impairment loss arises. No impairment loss is recorded in the second step also If Implied Fair Value of Goodwill<= Carrying amount of goodwill. We can illustrate these steps with numerical figures for easy understanding.

Step-I: Carrying amount of reporting unit including goodwill (Rs. 60000) Say Rs. 520000 & Fair value of reporting unit Say Rs. 500000. Since, the Fair value<Carrying amount of reporting unit go to Step-II, here we have to calculate fair value of all assets and liabilities those are used in step-I excluding Goodwill.

Carrying amount of reporting unit (excluding goodwill): Rs. 460000 (Rs. 520000-60000)

Fair value of the reporting unit: Rs. 500000

Implied Fair Value of Goodwill: Rs. 40000

Carrying amount of Goodwill: Rs. 60000;

Impairment Loss is (impairment amount): Rs. 20000.
The IASB, seeking international convergence and global harmonization, also implemented this change when it issued IFRS 3 in 2004. A revised IAS 36 ‘Impairment of Assets’ was issued at the same time as IFRS 3, on 31 March 2004. Previously an impairment test was only required if a ‘triggering event’ indicated that impairment might have occurred. Under the revised rules, an annual impairment test is required for certain assets, namely:

• Goodwill
• Intangible assets with an indefinite useful economic life (e.g. strong brands) and Intangible assets not yet available for use. The recoverable amount of these assets must be measured annually (regardless of the existence or otherwise of an indicator of impairment) and at any other time when an indication of impairment exists.

The recoverable amount of an asset is defined as the greater of its ‘fair value less costs to sell’ and the ‘value in use’. To measure impairment, an asset’s carrying amount is compared with its recoverable amount. The recoverable amount is determined for individual assets. However, if an asset does not generate cash inflows that are largely independent of those from other assets, the recoverable amount is determined for the CGU to which the asset belongs. A CGU is the smallest identifiable group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Here, “Fair value less costs to sell’ means the amount obtainable from the sale of an asset in an arm’s length transaction between knowledgeable, willing parties, less the costs of disposal. Although the previous version of IAS 36 used the term ‘net selling price,’ it was changed to be consistent with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. However, the substance of the measurement remains the same.

“Value in use” is the present value of the future cash flows expected to be derived from an asset or CGU. It is an estimate of the future cash flows the entity expect to derive from the asset. IAS 36 requires that value in use should reflect the expected present value of the future cash flows, that is, the weighted average of all possible outcomes and the entities should compare their previous estimates of cash flows with actual figures as part of the assessment of the rationality of current assumptions.

An impairment loss is recognized to the extent carrying amount of an assets exceeds its recoverable amount and such impairment loss is recorded in profit or loss for assets carried at cost. In case of impaired assets carried at a revalued amount, as permitted by IAS 16 Property, Plant and Equipment, the impairment loss is directly recorded against the previously recognized revaluation gain in equity to the extent of any exiting gain in respect of that asset. Any additional loss is immediately recognized in profit and loss account.

Though IASB issued IFRS-3 (2004) in line with FASB 141 & 142 for the purpose of convergence, still there remain some major differences in the following items:

**Recognition of Impairment Loss**

Under IAS 36, an impairment loss is recognized if an impairment test indicates that the carrying amount of an asset or group of assets exceeds the recoverable amount. However, under US GAAP, only if the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, a detailed impairment analysis is performed. This difference may result in recognition of impairment losses for assets under IFRS at an earlier period for which impairment losses are not recognized under US GAAP.

**Measurement of Impairment Loss**

Under US GAAP, an impairment loss is measured as the amount by which the carrying amount of the asset exceeds its fair value. Under IAS 36, the carrying amount of an asset is compared with its recoverable amount, which is the higher of its fair value less costs to sell and value in use, to measure impairment loss. As a result, if value in use is greater than the fair value, the amount of impairment loss would be less under IFRS than under US GAAP.

**Goodwill Impairment**

Under IAS 36, goodwill is allocated to CGUs for the purpose of impairment testing. Under US GAAP, goodwill impairment is assessed at a higher level of the ‘reporting unit.’ This difference will lead to different computations of impairment losses when CGUs are
comprised of different assets than reporting units. US GAAP requires a two step-approach to identify potential impairment. In step two implied fair value of goodwill compares with carrying amount of goodwill. No such computation of implied fair value of goodwill is involved under IFRS as provided by FASB.

**Reversal of Impairment Losses**

Under US GAAP, the reversal of previously recognized impairment losses is always prohibited. IAS 36 provides for the reversal of impairment losses, other than for goodwill.

**V. CONCLUSION**

Though impairment of intangible asset provides a better treatment than the traditional amortization but in practice application of impairment test is going to be a tough task particularly for those entities that have complex assets structure. It is not only time consuming and problematic, in many cases recognition and measurement of asset impairment will depend on subjective judgment which will open the door for large scale manipulation of accounts. Accounting standard setting bodies throughout the world should promote appropriate measures for preventing such abuses, which will help greatly the general investors for taking their investment decisions. With the increasing attention to the management of goodwill and growing demand from all concerned, it is high time the standard setting bodies should think about a single, uniform globally accepted and enforced set of accounting standard for the treatment of intangibles to generate and communicate relevant, reliable and comparable financial information.

**REFERENCES**