AIFRS – A Practitioner’s Viewpoint

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This paper addresses a range of contemporary financial reporting issues from a practitioner’s viewpoint. Rules relating to the accounting and reporting for goodwill and its impairment are subjected to a forensic review, and found wanting. In particular, the concern is expressed that the implementation of AIFRS rules for accounting for goodwill and identifiable intangibles will yield potentially misleading results, at odds with any discernable thread of logic or principle. Alternative treatments to those embedded in the accounting standards reviewed are contemplated as part of an argument for an alternative future reporting regime.
1. Introduction

That there are inadequacies and inconsistencies in Australia’s and the International Accounting Standard framework is well known. Most of these inadequacies arise out of the mixed model of accounting which, in many places, mandates the simultaneous application of two fundamentally inconsistent conceptual approaches, that is historic cost and market value accounting.

Despite this, there is a conspicuous scarcity of professional published articles referring, even tangentially, to the more glaring inadequacies and deficiencies in the AIFRS regime, nor suggestions as to how to fix at least the worst of these deficiencies. Arguably, a number of factors contribute to this professional silence. One of these is the apparently widespread belief that mandatory compliance with AIFRS has been forced upon the community by the Financial Reporting Council (FRC) and that nothing can be done about this.

Another relates to the belief that international accounting standard setting objections from “down under” will go unheeded - coupled with a mentality which might be described as comprising a reluctance to bite the hand that feeds us. The vacuum has been reinforced by the apparent decision of one major accounting body not to publish articles which are critical of AIFRS as and always, the pressure of other work priorities also operates to limit the volume and ambit of public critique.

Sadly, the lack of professional comment or criticism of AIFRS inevitably results in the problems inherent in the framework not being appropriately highlighted or resolved. The conceptual and practical problems in AIFRS stem from three basic failures. These are the failure to fix the gaping hole in accounting standards to fix what can only be termed obviously silly errors in AIFRS and finally the failure to properly integrate market value concepts into financial statements. To a significant degree, resolving the second of these issues would represent a significant step towards the resolution of the third and most critical of the problems.

This paper contributes to the literature by discussing a range of conceptual and practical difficulties with elements of the AIFRS regime and entertaining alternative solutions. Particular attention is paid to the difficulties associated with the present regime’s treatment of intangibles, with specific focus on goodwill accounting as well as the operation of the asset impairment regime.

2. The gaping hole

The obvious and gaping hole in accounting standards is the lack of comprehensive standards concerning identifiable intangible assets (ie brands, licences, patents, mastheads, etc). This is self evidently unacceptable in a world where a high proportion of listed public company values are represented by intangible assets of one sort or another. In practical terms, the gaze of existing accounting standards often falls on line items which represent a minority portion of financial statement values.

Those standards that do focus on goodwill and acquisition accounting are either incomplete, flawed in concept, or so widely misunderstood in practice, that a significant rewrite is needed.

Contemplation of a means of resolving this problem commences with the recognition that readers of financial statements require information that is useful for decision making purposes. Yet this basic function, clearly set out in the Statements of Accounting Concepts, has been overlooked or overridden at IASB level by other considerations, including:

a. the doctrine of conservatism. (Notwithstanding claims of representational neutrality)

b. subservience to conservative European and USA views about valuing identifiable intangible assets and their lack of experience with revaluations

c. (well founded) concerns about the lack of familiarity of market value concepts by preparers and auditors.

At the most fundamental level, there is still no agreement about whether financial reports and the very concepts of capital and profit should be based on:

a. paid up capital, ie an historic cost and custodianship focus

b. real capital, ie inflation adjusted capital; or

c. economic capital, ie maintenance of productive capacity; or

d. market value of capital.

In the absence of agreement about what the fundamental underlying accounting concept is (which will still be argued after all readers of this article are long gone), it is clear, at the very least, that:

a. forbidding the recognition of the market value of identifiable intangible assets is so contrary to the concept of information utility that the prohibition on identifiable intangible assets revaluation should (but certainly won’t) be immediately reversed

b. maintenance of capital is important, and if it is returned to shareholders it shouldn’t be disguised as “profit”

c. hedge accounting, which is full of silly and complex rules, should be replaced with market value rules

d. if there is significant debate about whether historic cost, or market value, is the most relevant information, then disclose both.

In essence, market value information about asset and liability values, even if it is not the fundamental basis of financial reporting, should at least be disclosed. Space does not permit an evaluation of all the deficiencies in AIFRS. However, putting aside Financial Instruments (a subject in its own right), the two most glaring problem areas arise under Impairment Testing and Goodwill.

3. Impairment of assets

Those who study the glacial evolution of market value concepts into accounting standards will have noted that AASB 136 mandates the application of some fundamental valuation concepts into impairment testing.

These include mandatory use of present values for cashflows (albeit at the wrong rate in the case of value in use approaches, as discussed below), consistent matching of discount rates and cashflows (i.e. nominal with nominal) and significantly improved disclosure requirements compared to those that existed in previous regimes. The AIFRS regime also tends to be associated with extrapolations of steady state or declining
growth rates into the future as a feature of value modelling, rather than the use of high growth rates set to perpetuity and valuations of offshore investments are also handled comparatively well.

Given the technical sophistication of some of the things AASB 136 did get right, it is appropriate to examine two basic concepts that the standard got completely wrong. These are:

a. the mandated use of pre-tax discount rates in assessing value in use, and

b. the permitted application of a warped version of value in use as one of the “higher of” reference point for impairment testing.

When discounting pre tax cash flows it is widely assumed by practicing accountants that discounting pre tax cash flows at pre tax discount rates will give the same answer as if after tax cash flows and after tax discount rates are used. However, generally, this is not the case and material errors can arise, unless both the cash flows and the discount rate are after tax. The preferred (and technically correct) method to assess market value is to discount cash flows after tax using an after tax discount rate.

To ensure consistency between the cash flows and the discount rate used, the cash flows and the discount rate should be expressed on a consistent basis. That is, after tax cash flows must be discounted at after tax discount rates. There are a number of fundamental reasons why this is so. First, the rate of return on equity investments is only observable on an after company tax basis. Second, the capital asset pricing model, from which discount rates are derived, is based on stock market returns on equity securities, which are calculated after tax. Finally and perhaps most fundamentally, as a matter of logic, like should be compared with like.

Undeterred by such practical considerations, AASB 136 requires the disclosure of the pre-tax discount rate used to discount future pre-tax cash flows in assessing value in use. Obviously, the simple way around AASB 136’s requirement to discount future cash flows at a before-tax discount rate is to calculate the correct present value using after-tax cash flows and an after tax discount rate and then back solve the pre-tax discount rate. Back solving, however, isn’t just a matter of grossing up at the standard rate of tax.

Indeed this “back solving” solution is even suggested in the Basis for Conclusions appended to IAS 36 (BCZ85), but, until recently, not published with the Australian Standard. Such important information was always contained in the basis for conclusions and attached to the IAS standards. However, it was originally not contained in the Australian Standards “for copyright reasons”.

More philosophical readers may wonder why the IASB chose to impose in the standard the requirement to discount future cash flows at a before-tax discount rate and then suggest in the Basis for Conclusion the use of an after-tax discount rate to back solve the pre-tax discount rate that the IASB should never have specified in the standard in the first place.

Implicit in the approach based on discounting pre-tax cash flow at pre-tax discount rate is the proposition that pre-tax cash flow can be obtained by grossing up post-tax cash flow at a rate equal to one less the marginal corporate tax rate, or conversely, post-tax cash flow is simply pre-tax cash flow multiplied by a factor equal to one less the marginal corporate tax rate.

This proposition is not generally correct because it ignores the divergence between pre-tax income, which is used for tax assessment, and pre-tax cash flow. This divergence arises:

a. because cash flows may differ significantly from profits due, for example, to working capital movements and the timing of capital equipment purchases, etc

b. due to the difference between the timing of revenue and expense recognition for accounting purposes and the time when cash receipts and cash outgoings actually occur.

The accrual basis of accounting which is adopted in most businesses (other than small, cash-based businesses), focuses on the acquisition and use of economic resources in operations, not on their associated cash flows. For example, although council rates may be paid once a year, under accrual accounting one twelfth of the amount is expensed each month.

The divergence between pre-tax income and cash flows and its consequence on the pre-tax approach is exacerbated by:

a. depreciation and capital equipment purchases and disposals, which are not coterminous

b. permanent tax differences (PTD) and temporary timing differences (TTD)

The flaw of the pre-tax approach is best understood if debt is assumed to be zero, and PTD and TTD are put aside, for the sake of simplicity and illustration. In which case, the difference between pre-tax income and pre-tax cash flow is mainly attributable to:

a. movements in working capital

b. tax depreciation

c. tax losses (if any)
d. capital expenditure.

By definition, post-tax cash flow is equal to pre-tax cash flow less tax. Pre-tax income is not always equal to pre-tax cash flow due to the foregoing factors. Therefore, tax payable, which is determined by multiplying the corporate tax rate (eg 30%) by pre-tax income, is generally different from pre-tax cash flow multiplied by the corporate tax rate. It mathematically follows that multiplying pre-tax cash flow by a factor equal to one less the marginal corporate tax rate is generally not equal to post-tax cash flow.

This proposition can be further reinforced by deriving a mathematical relationship between pre-tax cash flow and post-tax cash flow. The derivation is presented below.
Equation (7) sets out a theoretical relationship between pre-tax cash flows (CFBT) and post-tax cash flows (CFAT). It is clear that CFAT is equal to CFBT \((1-T)\) only if the second term of Equation (7), \((\Delta WC – Capex + TD + TL) \times T\), is zero. This is generally not the case because there is no consistent relationship between working capital, capital expenditure, tax depreciation and tax losses.

A limited (but relatively rare) circumstance under which the second term of Equation (7) might be zero is mature profitable businesses where there is no change in working capital requirement and depreciation is equal to capital expenditure. This is consistent with examples of no-growth or constant-growth perpetual cash flow scenarios.

Pre tax discount rates are often calculated by grossing up the after tax discount rate by one less the marginal corporate tax rate. On this basis, an after tax discount rate of 14% per annum, assuming a tax rate of 30%, is assumed to equal a pre tax discount rate of 20% per annum. However, there are various difficulties in undertaking a pre tax discounted cash flow (DCF) analysis. In summary, the grossing up formula used to derive pre tax discount rates is an over-simplification and only holds under limited circumstances.

Firstly, there is no practical reliable method to calculate a pre tax discount rate, and they can not (in most situations) simply be calculated by grossing up the after tax discount rate.

Secondly, investors are generally interested in after tax rather than pre tax returns. Furthermore, the variables used to calculate the cost of equity (including beta and the market risk premium) are based on movements in company stock prices which are based on companies after tax (not pre tax) results. The CAPM variables of the cost of equity and the pricing of company shares are therefore measured on an after tax basis. Thus it is simply not possible to empirically verify pre tax rates of return.

In summary, adjusting an after tax discount rate to calculate a pre-tax discount rate using the above gross up formula will only lead to the same values being determined on a before and after tax basis when the cash flows are in perpetuity with no growth.

### 4. Cash flow forecasts and Their Duration

The duration of cash flow forecasts also has important implications for the reliability, or otherwise, of the NPV result. In an ideal world, cash flow forecasts would be prepared for the life of the investment. At a practical level, the inherent unreliability of forecasts beyond say year 10 and the effect of discounting\(^9\), means that valuers generally include a terminal value at the end of a 10 year forecast period. In the current relatively low interest rate environment the proportion of terminal value at the end of year 10, to total value, is relatively high (upwards of 50%). As a result, much greater care needs to be taken in assessing terminal value than, for example, in high interest rate environments, for example the 1980s, when terminal values were generally 20% or less of total value.

This is because a, say, 20% error in assessing terminal value in a high interest rate environment has an immaterial impact on total value (ie a 20% error on a terminal value equal to 20% of total value is only a 4% valuation error\(^9\)). It is not widely appreciated, although it is a matter of obvious mathematics, that the reverse applies during low interest rate periods when terminal values are high. That is, a 20% error in the assess-
5. Conceptual Issues with Value in Use

Testing for impairment, assuming the test is triggered, is now based on a comparison of carrying value with the higher of fair value (in essence, market value) and value in use. Testing against fair value is correct in principle, and no further comment is made.

The term “value in use” is frequently used in property, plant and equipment valuations. That such valuations frequently capitalise the value of internally generated goodwill does not appear to overly concern the accounting standard setters (although this was discussed in the Basis for Conclusions). This lack of concern is to be contrasted with the long standing pre and post AIFRS prohibition on the recognition of the value of internally generated goodwill. It is also to be contrasted with the post AIFRS prohibition on revaluing identifiable intangible assets.

The accounting standard concept of value in use, and the way it has to be calculated under AASB 136, is different to even the conventional measurement of value in use. Value in use under AASB 136 is subject to a number of specific and idiosyncratic rules. The AASB 136 rules include the use of pre-tax discount rates (refer above) and the excluding of:

a. taxation effects
b. financing
c. future restructuring costs and benefits.

The other reference point for impairment testing is “fair value” which from a valuation perspective should be based on after tax discount rates applied to all after tax cash flows. In simple terms, fair value is basically market value as conventionally defined.

That the IASB chose two reference points for impairment testing says a lot about the politicisation of the standard setting process. What is even more remarkable is that the two reference points should be so different in concept (market value is based on discounting at an after tax discount rate all after tax cash flows, based on market evidence, value in use is discounting at a before tax discount rate some pre-tax cash flows based on management views).

Value in use is therefore significantly different from market value in the way it is calculated. The nature and extent of the differences are, however, both complex and idiosyncratic by entity and by time period.

6. Tax and its importance to Value

Anyone who has ever prepared or reviewed anything but the simplest DCF model will know that the tax deductibility of interest and other outgoings, entity specific tax benefits and tax timing differences are very important factors, if not critical factors, in assessing value.

The exclusion of tax effects (not to mention the other exclusions) under the AASB 136 calculation of value in use is clearly incorrect in principle, and in its practical application.

The fundamental problems created by excluding key factors from value in use cash flows are exacerbated by the fundamental inconsistency between:

a. maintaining the traditional accounting concept of asset and liability classes, with individual accounting standards specifying detailed, and often inconsistent, measurement and disclosure rules for those asset and liabilities classes
b. the standard setters’ use of cash-generating units (CGUs) as a key measurement point for impairment testing, and
c. allowing, as an alternative, for CGUs to be aggregated up to the level of AASB 114 Segment Reporting levels.

7. Problems With the Asset Base of CGUs

To the great relief of some directors one major audit firm (at least in Australia) believes that stock values should be excluded from the asset base when assessing the carrying value of assets and CGUs for impairment testing purposes.

If it wasn’t so self-evidently silly, one could almost understand why a literal interpretation of AASB 136 Scope paragraph [2(a)] would result in the value of stock, often the largest single asset, being excluded from the asset base of CGUs for impairment testing purposes.

Under a market value test\textsuperscript{11}, or even a “blind Freddy” test, it is obviously logically necessary to assess impairment by comparing like with like. That is:

a. cash flow from all assets with value of all assets employed, or
b. cash flow from all assets excluding stocks with value of all assets excluding stock.

Most often the second of these is too hard to do in practice, but it is at least logically consistent. Undeterred by the basic need to compare like with like, one major audit firm persists with the literal interpretation of the scope paragraph of the standard and compares asset values excluding stock with cash flow from all assets including stock. The natural consequence is that (wrongly) the impairment write down is not recognised when it should be.

8. Summarising AASB 136’s Flaws

It is important that after tax cash flows and after tax discount rates are applied to all cash flows when assessing value. At a very basic level this is not only correct technically, it is also normally done in valuation practice. At the simplest level it is a like with like comparison.
There are fundamental errors in calculating the present value of cash flows using pre-tax cash flows and pre-tax discount rates. The approach adopted in AASB 136 will only give the same answer as discounting after tax cash flows at after tax discount rate in special cases, such as cash flows in perpetuity with no growth.

Valuation errors multiply if not all cash flows are taken into account. Yet this is what occurs in value in use the allowable (and widely used) alternative valuation base for impairment testing purposes allowed under AASB 136.

Further valuation errors occur if forecast periods are too short (magnifying the impact of terminal value errors), or if impairment testing is not based on market value. Issues of after tax discounting and the flawed concept of value in use are not just matters of technical detail and lack of comparability. Many corporates, and their auditors, get the wrong value in use result because they do not understand that the before-tax discount rates required under AASB 136 are not simply the grossed up after-tax discount rate.

Value in use as a reference point for impairment testing is fatally flawed in the way AASB 136 requires it to be calculated excluding key cash flow and key value drivers such as tax, restructuring costs and benefits and financing. The combination of a flawed concept of value in use and the absence of any requirement for a reasonable cross-check to market value means that serious valuation overstatements are inevitable.

9. Goodwill

The AIFRS Business Combinations Standard (AASB 136) replaced the mandatory 20-year (maximum) amortisation period for goodwill with an annual impairment test. In the absence of impairment, no amortisation is required. The prohibition on the recognition of internally generated goodwill, in theory, remains (see AASB 138 Intangible Assets). In reality, however - and notwithstanding this stated prohibition - some, or even all the value of internally generated goodwill will be subsumed into the carrying value of acquired goodwill.

AASB 136 also introduces asymmetric accounting for goodwill. This is because where goodwill is subject to an impairment write down, that write down can never be reversed even if the conditions resulting in that write down cease to exist. The historic over-valuation of acquired goodwill is not just a matter of accounting and reporting arbitrage. The AIFRS goodwill accounting rules will actually change corporate behaviour.

Following the introduction of AAS 18 and ASRB 1018 Accounting for Goodwill, corporate Australia was obsessed for many decades with avoiding the annual goodwill amortisation charge. Historically, this obsession has manifested itself in a number of ways including, but not limited to, immediately writing off acquired goodwill, inverse sum of the years digits amortisation of goodwill, the undervaluation of offer consideration and the over-valuation of identifiable intangible asset values for brands, licences, mastheads, etc.

It should be noted that the corporate obsession with avoiding goodwill amortisation was, and still is, based on a fundamental misunderstanding of how equities are valued. Goodwill amortisation does not affect cash flow, and it naturally follows that it does not affect share values.

This fundamental valuation principle has been confirmed by a number of surveys of investment institutions by the Securities Institute of Australia (now Finsia) which surveys have consistently confirmed that 93 percent of investment institutions add back goodwill amortisation when assessing share values. The other seven percent are a bit of a worry, however. Why amortise something that almost everyone adds back? The real reasons for amortising acquired goodwill was that acquired goodwill does decline in value, and amortisation of goodwill (now a thing of the past) is a maintenance of capital concept.

| Table 1: Amortisation and maintenance of capital pre AIFRS - P&L simplified |
|-------------------|--------|--------|---------|--------|
| Profit            | $m    | Year 2 | $m      | Year 3 | $m      | Year 20 | $m     |
| Less amortisation of goodwill | (10) | (10)   | (10)    | ...    | (10)    |         |        |
| Net effect on reported profit\(^1\) |        | -      | -       | -      | -       |         | -      |

Note:
\(^1\) Ignores tax, PV and growth complications.

| Table 2: How capital was maintained - pre AIFRS |
|-----------------|--------|
| Initial Capital / cash | (Y\(_0\)) |
| Acquire goodwill asset | (200) |
| Net cash | - |
| Add back: |
| - 20 years cash flow from amortisation of goodwill | 200 |
| Year 20 Capital / cash | (Y\(_{20}\)) |

Note:
\(^1\) Ignores tax, PV and growth complications.
Expressed simply, the maintenance of capital principles that underpinned the former amortisation rules, but which were never clearly articulated, have been sacrificed on the altar of accounting standard setting expediency. This is best explained by way of a simple example. Assume that a company is acquired for $200 million whose sole asset is goodwill. Under the AGAAP goodwill standard acquired goodwill was amortised on a straight line basis over 20 years as set out in Table 1.

The object of the former AGAAP requirement to annually amortise acquired goodwill was to try and ensure that companies did not dissipate their capital by buying wasting assets and declaring profits, when in substance the so-called profit was really, in part or in whole, no more than a return of capital.

In balance sheet terms the principle underlying how capital was maintained under the previous annual amortisation rules is shown in Table 2.

Under the AIFRS accounting standard the value of acquired goodwill will no longer have to be amortised, but it will be subject to an annual impairment test. This is demonstrated in Table 3.

In balance sheet terms, capital will not be maintained, as demonstrated in Table 4:

The AASB 136 impairment test is based on cash generating units (CGU). In simple terms a CGU is the smallest unit that generates identifiable cash flows. However, completely inconsistently with requiring that goodwill be assessed at the CGU level, AASB 136 permits impairment to be assessed at a combined CGU level, the CGUs that can be combined being only constrained by the AASB 114 Segment Reporting requirements.

To minimise future impairment write downs many corporates will naturally seek to report on the basis of larger or combined CGUs rather than smaller CGUs. In this way what would otherwise be impairment losses on acquired goodwill can be offset against the unrecognised value of internally generated goodwill or other unrecognised identifiable intangible assets of the more profitable parts of the CGU or of different CGUs. Companies seeking, or willing to accept, a more conservative outcome will define smaller CGUs. Measurement of impairment at a CGU level will inevitably result in the blurring of the value of acquired goodwill, internally generated goodwill, recovery in the value of previous goodwill write downs, unrecognised identifiable intangible asset values and the value of synergistic benefits.

The reason for this is that the goodwill impairment assessment of a CGU is now based on the assessment of future cash flows of the CGU (or group of CGUs). In the assessment of goodwill impairment, five sources of cash flow and value will inevitably be combined:

a. from acquired goodwill, plus
b. from internally generated goodwill, plus
c. from synergy benefits, plus
d. from unrecognised increases in the value of identifiable intangibles assets, plus
e. previous goodwill write-downs which have subsequently recovered in value but whose recovery in value is prohibited from being recognised under AIFRS.

Offsetting the cash flows and values of these different intangible assets which naturally occurs under AASB 136 therefore effectively recognises, inter alia, the value of internally gen-

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**Table 3: What happens under AIFRS**

<table>
<thead>
<tr>
<th>Year</th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>10</td>
</tr>
<tr>
<td>Goodwill impairment write-down</td>
<td>10</td>
</tr>
<tr>
<td>Year</td>
<td>$m</td>
</tr>
<tr>
<td>Year X</td>
<td>(30)</td>
</tr>
<tr>
<td>Year 20</td>
<td>10</td>
</tr>
</tbody>
</table>

**Note:**
1. No profits in year X due to recession year.
2. Impairment write downs in other years sheltered by other unrecognised intangible asset values (refer below).

**Table 4: Capital won't be maintained post AIFRS**

<table>
<thead>
<tr>
<th></th>
<th>$m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Capital / cash</td>
<td>(Y_{t0}) 200</td>
</tr>
<tr>
<td>Acquire goodwill asset</td>
<td>(200)</td>
</tr>
<tr>
<td>Net cash</td>
<td>-</td>
</tr>
<tr>
<td>Limited impairment write down due to blurring of internally generated goodwill, acquired goodwill, unrecognised identifiable intangible assets and synergy benefits</td>
<td>30</td>
</tr>
<tr>
<td>Year 20 Capital / cash</td>
<td>(Y_{t0}) 30</td>
</tr>
</tbody>
</table>

**Note:**
1. The result is that the only capital maintained is that arising out of impairment write-downs (in this example, $30 million in whatever year the write down occurs). The remaining diminution in value of acquired goodwill being sheltered by the value of other unrecognised intangible assets.
gerated goodwill. This is a complete contradiction of the long established and universal accounting standards prohibition on the recognition of internally generated goodwill. It is also in complete contradiction to the other paragraphs in AASB 136 that state that internally generated goodwill should not be recognised (because of its inherent measurement uncertainty) and that goodwill impairment write downs cannot be reversed because any increase in the recoverable amount would be attributable to internally generated goodwill.

Corporate Australia is still delighted at the elimination of the annual goodwill amortisation charge. However, this same sector will be a lot less delighted in the next economic downturn or large interest rate increase when the inevitable profit declines will be exacerbated by impairment write downs on acquired goodwill. The elimination of annual goodwill amortisation has important implications for both financial reporting and investment decisions. In essence, instead of avoiding goodwill recognition and favouring the recognition of identifiable intangible assets as occurred in the past, in future years the reverse will occur. This is demonstrated in Table 5 and Table 6.

The over-valuation of acquired goodwill and the carrying forward of this over-valuation will occur, notwithstanding the more definitive approach contained in AASB 138 which requires that acquired identifiable intangible assets have to be valued at market value. The over-valuation of acquired goodwill is not just a matter of accounting and reporting arbitrage. The new goodwill accounting rules will actually change corporate behaviour.

This is because the disincentive effect of having to amortise goodwill each year previously discouraged some takeovers or at least capped the goodwill component bidders were prepared to pay. This disincentive effect has been substantially reduced under AIFRS.

Post the AIFRS standard companies seeking profit growth and EPS growth will actually have an incentive to acquire companies with substantial intangible asset values provided that the purchase price can be allocated (rightly or wrongly) to goodwill. Whereas the previous goodwill amortisation rules kept a cap on, or even reduced, post take over profits, in future this constraint will no longer apply.

Furthermore, such takeovers will, for a time at least, also be EPS positive. This is because the carrying value of acquired goodwill will not have to be amortised, will only be tested annually for impairment and diminution in value will be sheltered by the unrecognised value of other identifiable intangible assets.

Conversely, where a company acquired has identifiable intangible assets (such as customer lists, patents, etc.) the purchase consideration is required (under AASB 3 “Business Combinations”) to be – but in many cases won’t be – allocated to the individual underlying identifiable intangible assets. In the case of short life identifiable intangible assets the post acquisition profits will be reduced by the amortisation charge for these assets as this value has to be written off over their useful life.

Simply put, the AIFRS goodwill standard will actually encourage takeovers in those industries where the purchase cost can be allocated to goodwill but will be discouraged in those industries where the purchase cost has to be allocated to short life identifiable intangible assets. Those who bother to read the accounting standards might think that the intent of,

### Table 5: The economic reality of acquisitions

<table>
<thead>
<tr>
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<th>$m</th>
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<tbody>
<tr>
<td>Purchase cost of acquisition</td>
<td>100</td>
</tr>
<tr>
<td>Less net tangible assets</td>
<td>40</td>
</tr>
<tr>
<td>Total intangible assets</td>
<td>60</td>
</tr>
</tbody>
</table>

**Comprising:**
- identifiable intangibles (brands, licences, etc) |  45 |
- unidentifiable intangibles (goodwill)              |  15 |
| Total intangible assets          |  60 |

### Table 6: Reversal of the accounting arbitrage of goodwill

<table>
<thead>
<tr>
<th></th>
<th>Pre AIFRS</th>
<th>Post AIFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase cost of acquisition</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Less net tangible assets</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>Total intangible assets</td>
<td>60</td>
<td>60</td>
</tr>
</tbody>
</table>

**Valued allocated:**
- identifiable intangibles |  60 |
- goodwill                  |  -   |
| Total intangible assets          |  60 |  60 |

**Note:** Neither arbitrage position is promoted in the respective standards. However, it is what has happened in the past, and undoubtedly what will happen in the future.
and the effect of, the Business Combination standard will be to properly reflect the market value of acquired identifiable intangibles, reduce or eliminate acquisition provisioning and generally reduce post acquisition results due to, inter alia, faster amortisation of identifiable intangibles values and other acquired assets.

If corporate Australia’s long established history of arbitraging goodwill to generate the desired accounting result is taken as a guide, then we can confidently look forward to some very large values being (wrongly) attributed to acquired goodwill. Furthermore, these overstated values will be carried forward because value decline will be camouflaged by the value of other unrecognised intangible asset values. This situation will continue until a catastrophic event occurs eventually results in an impairment write down of acquired goodwill.

Those readers who think that goodwill arbitrage will not occur under AIFRS should consider some mining industry examples. It is self evident that a mining company’s main assets are its plant and equipment, ore reserves and resources and exploration potential. It is obvious that a miner of a homogenous, or nearly homogenous, commodity like gold, iron ore, etc is unlikely to have any material value of goodwill.

Yet a number of mining companies have (wrongly) attributed very large goodwill values to acquired mining companies. This problem was bad enough under AGAAP. There were also some technical offer date / acceptance date issues in scrip based offers which distorted financial reports. However, at least under AGAAP, companies had to write off either the ore reserves or the (wrongly valued) goodwill over the expected mine life, or in the case of goodwill, a maximum of 20 years.

The impact on the reported profit and financial position was that at least that capital had been paid for wasting asset was recognised (albeit, incorrectly named) and that at least the diminution in value was recognised over either the mine life, or 20 years, albeit, again wrongly described.

Now that the requirement for a 20 year write off of acquired goodwill has disappeared under AIFRS. The end result is that provided:

- companies can convince the auditors there is a large element of goodwill (and there is precedent for this), and
- commodity prices keep increasing or companies prove up enough new reserves to offset what is mined each year.

Under these circumstances, so-called acquired goodwill isn’t impaired (according to AIFRS) and acquisitive mining companies can continue to report for financial purposes that they are generating significant post acquisition profits and not recognise that they paid a large capital sum for a wasting asset (ore reserves and resources in the ground) and that a significant proportion of their so-called profit is really a return of capital.

The end consequences of the AIFRS goodwill standard are that:

- post AIFRS more value will be (often wrongly) attributed to acquired goodwill
- increases and decreases in the value of goodwill will be treated asymmetrically
- the carrying value of acquired goodwill will continue to be overstated due to the blurring of the values of acquired goodwill, internally generated goodwill, unrecognised identifiable intangible assets, goodwill from different CGUs, unrecognised recovery in the value of previous goodwill write downs and the value of synergy benefits
- these overstated values will be carried forward until a catastrophic event occurs
- in the first serious economic downturn following the introduction of AIFRS standards the accounting treatment of goodwill will inevitably be discredited.

This discrediting should occur, since the outcome of adopting IAS 38 in Australia will inevitably lead to the over-valuation of acquired goodwill and the unjustified retention of its carrying value when the reality in many, if not most situations, is that the real value of acquired goodwill has fallen and that a material proportion of reported profit is really a return of capital.

10. Some other issues

Under the first time adoption provisions of AIFRS, the catch up effects of a change in accounting policies (ie AGAAP to AIFRS) has to be booked to reserves. In fairness to the IASB, this is consistent with the first time adoption provisions generally applied to other accounting standard changes. However, the accounting result is that the same income, and in some cases (likely to be rarer in practice) the same expense, can be booked to the profit and loss account twice.

The AIFRS standard requirements applicable to property developers demonstrates the point. Under AGAAP, property developers with long term development projects spanning many years, recognised profits on the percentage of completion method. In simple terms, that meant that a developer with a 33% completed project at year end recognised 33% of profits in that year.

However, AIFRS now requires that no profit be recognised on long term projects until project completion. This principle (or more accurately put, lack thereof) is shown in Table 7.

<table>
<thead>
<tr>
<th>Table 7</th>
<th>Example of AIFRS and AGAAP Profit Distortion</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>AIFRS profit distortion is better (more accurately put, lack thereof) is shown in Table 7.</td>
</tr>
</tbody>
</table>
| B | Not only is profit recognition distorted under AIFRS (eg bad luck, if completion is on 1 July, not 30 June) but, worse still, as a result of the first time adoption requirements, the same profits will be offset by the non-recognition of profits on partly completed projects in future years.

Table 9 demonstrates why this is not so even in a “steady state” business. The profit distortion is even worse in either an expanding or contracting business (especially the latter).

Such double counting and reversal problems are not just confined to profits on long term construction contracts. The same double counting can issue arise under other standards (eg capitalised interest under SGARAs).

In addition to the problems identified above in relation to the potential double counting of profits, issues also arise in relation to the revaluation of certain classes of assets. AIFRS prohibits the revaluation of identifiable intangible assets16. This denies useful information to users of financial statements. It is also yet another manifestation of the victory (albeit pyrrhic) of conservatism over market value accounting in accounting standard setting.
Table 7 - Comparison of profit recognition on long term projects

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of project completed</th>
<th>AGAAP profit recognised</th>
<th>AIFRS profit recognised</th>
<th>Difference AIFRS to AGAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>33.3%</td>
<td>$33.3</td>
<td>-</td>
<td>(33.3%)</td>
</tr>
<tr>
<td>2</td>
<td>33.3%</td>
<td>$33.3</td>
<td>-</td>
<td>(33.3%)</td>
</tr>
<tr>
<td>3</td>
<td>33.4%</td>
<td>$33.4</td>
<td>$100.0</td>
<td>66.6%</td>
</tr>
</tbody>
</table>

Table 8 - Impact of transitional provisions

<table>
<thead>
<tr>
<th>Year</th>
<th>AGAAP profit recognised</th>
<th>Profit previously recognised but reversed to reserves and not recognised in P&amp;L account</th>
<th>AIFRS profit recognised</th>
<th>Total profit recognised</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$33.3</td>
<td>(66.6)</td>
<td>$100.0</td>
<td>166.6</td>
</tr>
<tr>
<td>2</td>
<td>$33.3</td>
<td>(66.6)</td>
<td>$100.0</td>
<td>166.6</td>
</tr>
<tr>
<td>3</td>
<td>33.3</td>
<td>(66.6)</td>
<td>100.0</td>
<td>166.6</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 9 - Profit recognition - steady state business

<table>
<thead>
<tr>
<th>Year</th>
<th>AGAAP profit recognition</th>
<th>First time adoption to reserves</th>
<th>AIFRS profit recognition</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>33</td>
<td>(66)</td>
<td>100</td>
<td>67</td>
</tr>
<tr>
<td>2</td>
<td>33</td>
<td>(66)</td>
<td>-</td>
<td>(33)</td>
</tr>
<tr>
<td>3</td>
<td>33</td>
<td>(66)</td>
<td>-</td>
<td>(33)</td>
</tr>
<tr>
<td>4</td>
<td>33</td>
<td>(66)</td>
<td>-</td>
<td>(33)</td>
</tr>
<tr>
<td>5</td>
<td>33</td>
<td>(66)</td>
<td>-</td>
<td>(33)</td>
</tr>
<tr>
<td>6</td>
<td>33</td>
<td>(66)</td>
<td>-</td>
<td>(33)</td>
</tr>
</tbody>
</table>

Note: AGAAP profit years 3 to 6 shown for comparative purposes only.

The AIFRS prohibition on revaluing identifiable intangible assets is a very peculiar outcome given that:

a. the soundness of the conceptual and theoretical framework under which identifiable intangible assets, etc should be valued (market value based on CAPM, NPV, etc)\(^ {17}\)

b. that all sophisticated capital market participants apply the same framework for decision making purposes

c. that AIFRS mandates (yes mandates) that the very same identifiable intangible assets must be revalued to market value when an acquisition is made

d. that AASB 136 sets out in considerable and laudable detail most of the principles which should be applied in assessing market value

e. that property and plant and machinery valuers do not operate under the same conceptual framework and many do not recognise even the time value of money in their valuations.

Yet, under AIFRS, plant and machinery and property valuers revaluations are permitted without reservation and without any conceptual basis of valuation being specified, whilst other revaluations are banned.

11. Conclusions

Putting aside the issue of accounting for financial instruments, it is relatively easy to fix most of the bad bits of AIFRS. Unfortunately, there is no indication from the standard setting community that doing so is either laudable, or necessary, let alone that it should be done quickly.

If the deficiencies of AIFRS are not fixed before the next serious economic downturn it is inevitable that deficiencies in the international accounting standard process will be blamed for at least some corporate collapses. Unless the obviously bad bits of AIFRS are fixed, such blame will not be without justification. JARAF
Footnotes

1 Before allowing for the premium of control.
2 a.k.a. tell it like it is.
3 Neither came from a revaluation framework.
4 The USA only banned pooling of interests accounting in 2001.
5 Other than at the date of acquisition.
6 Academic research has confirmed that note disclosure does not adequately convey the importance of this information.
7 Read “to protect IASB revenue”.
8 Which reduces the present value.
9 Not trivial, but in standard setting terms not material.
11 a.k.a. the simple solution which IASB didn’t adopt.
13 Acquirors normally only pay away a proportion of the value of synergy benefits. The balance of the value of synergy benefits not paid away, plus the unwinding of the present value and risk discounts reflected in the total purchase consideration, remain unrecognised, and therefore available to hide losses on other acquired goodwill.
14 It is unnecessary to comment upon the logical inconsistency in valuing acquired assets at market value but permitting impairment not to be recognised when the market value falls if value in use can support carrying value.
15 The term “Statement of Financial Performance” is used in standard setting. In practice the old terminology is much preferred.
16 Except in the very rare cases where they are actively traded.
17 In fairness not well understood in practice.