GOODWILL IMPAIRMENT: THE CASE OF HONG KONG

DUNG MANH TRAN

(BEs, MBA – NEU, VIETNAM)

A thesis submitted in fulfilment of the requirement for the degree of

Doctor of Philosophy in Management

Macquarie Graduate School of Management
Macquarie University
SYDNEY, AUSTRALIA

2011
TABLE OF CONTENTS

List of Tables vi
List of Figures viii
Certification ix
Acknowledgements x
Abstract xi

Chapter 1: Introduction 1

1.1. Rationale of the Study 1
1.2. Research Objectives and Questions 6
1.3. Structure of the Thesis 9

Chapter 2: Literature Review and Background of Goodwill 12

2.1. Introduction 12
2.2. Historical Review of Legal Goodwill Conceptualisation 14
2.3. Historical Review of Accounting Goodwill Conceptualisation 18
2.4. A Brief Review of Accounting Goodwill Conceptualisation 34
2.5. Is Goodwill an Asset? 37
   2.5.1. Generally Accepted Definition of Assets 37
   2.5.2. Does Goodwill Match the Definition? 38
2.6. Practice of Avoiding and Altering Goodwill Recognition 41
   2.6.1. Pooling-of-Interests Accounting – Avoidance of Goodwill Recognition 43
   2.6.2. In-Process Research and Development – Altering the Recorded Value of Goodwill 46
2.7. Measurement of Purchased Goodwill 50
2.8. Goodwill Adjustment Subsequent to Recognition 51
   2.8.1. Lump Sum Write-Off 51
   2.8.2. Ad-hoc Write-Off 52
   2.8.3. Systematic Write-Off 53
Chapter 3: Technical Requirements of Goodwill Impairment in Hong Kong

3.1. Introduction

3.2. Goodwill Reporting Arrangements and Practices in Hong Kong
   3.2.1. Pre-Regulation of Goodwill Arrangements and Practices
   3.2.2. Post-Regulation of Goodwill Arrangements and Practices (from March 1984 to December 2000)
   3.2.3. Post-Regulation of Goodwill Arrangements and Practices (from January 2001 to December 2004)
   3.2.4. Adoption of IFRS Impairment Testing

3.3. Technical Requirements of Goodwill Impairment in Hong Kong
   3.3.1. Identifying the Cash Generating Unit
   3.3.2. Allocating Goodwill to Cash Generating Unit
   3.3.3. Measuring Recoverable Amount of Cash Generating Unit
   3.3.4. Determining Impairment Loss for Goodwill
   3.3.5. Timing of Impairment Test for Goodwill
   3.3.6. Reversal of Impairment Loss for Goodwill
   3.3.7. Disclosures

3.4. Conclusion

Chapter 4: Data and Research Methodology

4.1. Introduction

4.2. Data Description

4.3. Measures of Compliance Levels and Disclosure Quality

4.4. Measures of Discount Rates
   4.4.1. The Capital Asset Pricing Model
   4.4.2. Goodwill Intensity

4.5. Measures of Audit Quality

4.6. Conclusion
Chapter 5: Compliance Levels and Disclosure Quality of Goodwill Impairment of First-time Adopters

5.1. Introduction 132
5.2. Relevant Literature Review 135
5.3. Assessment of Compliance Levels and Disclosure Quality of Goodwill Impairment
   5.3.1. Cash Generating Unit Allocation 144
   5.3.2. Business Segments and Cash Generating Units 148
   5.3.3. Cash Generating Unit to Segment Ratio 151
   5.3.4. Method Employed 153
   5.3.5. Discount Rate 157
   5.3.6. Growth Rate 163
   5.3.7. Forecast Period 167
5.4. Conclusion 171

Chapter 6: Compliance Levels and Disclosure Quality of Goodwill Impairment of Hong Kong-Listed Firms

6.1. Introduction 173
6.2. Issue of the Study 175
6.3. Assessment of Compliance Levels and Disclosure Quality of Goodwill Impairment
   6.3.1. Cash Generating Unit Allocation 176
   6.3.2. Business Segments and Cash Generating Units 180
   6.3.3. Cash Generating Unit to Segment Ratio 183
   6.3.4. Method Employed 185
   6.3.5. Discount Rate 188
   6.3.6. Growth Rate 193
   6.3.7. Forecast Period 197
6.4. Conclusion 201
# LIST OF TABLES

Table 2.1: Aspect of Understanding Goodwill Theories 35
Table 4.1: Overview of Unmatched Sample 104
Table 4.2: Overview of Matched Sample 106
Table 4.3: Summary of Final Sample Selection of Discount Rate 109
Table 4.4: Overview of Research Sample of Discount Rate 110
Table 4.5: Overview of Research Sample of Audit Quality 113
Table 4.6: Number of Firms Audited by Sector 114
Table 4.7: Descriptive Statistics of Firms by Auditor 115
Table 5.1: CGU Allocation Compliance by Sector 147
Table 5.2: Business Segments and CGU Aggregation by Sector 150
Table 5.3: Analysis of Controlled Entities, Business Segments and CGUs 152
Table 5.4: Method Employed to Determine Recoverable Amount of CGUs 156
Table 5.5: Discount Rate Methodology 161
Table 5.6: Discount Rate Disclosures 162
Table 5.7: Growth Rate Methodology 165
Table 5.8: Growth Rate Disclosures 166
Table 5.9: Disclosure of Forecast Period Method by Sector 169
Table 5.10: Disclosure of Forecast Period by Sector 170
Table 6.1: CGU Allocation Compliance by Sector 179
Table 6.2: Business Segments and CGU Aggregation by Sector 182
Table 6.3: Analysis of Controlled Entities, Business Segments and CGUs 184
Table 6.4: Method Employed to Determine Recoverable Amount of CGUs 187
Table 6.5: Discount Rate Methodology 191
Table 6.6: Discount Rate Disclosures 192
Table 6.7: Growth Rate Methodology 195
Table 6.8: Growth Rate Disclosures 196
Table 6.9: Disclosure of Forecast Period Method by Sector 199
Table 6.10: Disclosure of Forecast Period by Sector 200
Table 7.1: Number of Defined CGUs by Industry Sector 213
Table 7.2: Firm Goodwill Intensity by Industry Sector 216
Table 7.3: Analysis of Discount Rate Variance by Industry Sector 220
Table 7.4: Industry Sector Dollar of Goodwill by Discount Rate Variance 223
Table 7.5: Discount Rate Variance and Goodwill Intensity 226
Table 8.1: Method Employed to Determine Recoverable Amount of CGUs 241
Table 8.2: CGU Allocation Compliance by Auditor 244
Table 8.3: Business Segments and CGU Aggregation by Auditor 247
Table 8.4: Ratio of CGU to Business Segments 249
Table 8.5: Analysis of Discount Rates Used to Test Impairment 252
Table 8.6: Analysis of Growth Rates Used to Test Impairment 255
LIST OF FIGURES

Figure 1.1: Structure of the Thesis ......................................................... 8
Figure 3.1: The Impairment Test .............................................................. 77
Figure 3.2: Goodwill Impairment Testing Process ................................. 91
CERTIFICATION

This thesis is submitted in fulfilment of the degree of PhD at Macquarie Graduate School of Management, Macquarie University. It is wholly my own work, except when general and specific references are acknowledged. I hereby certify that this document has not been submitted for a higher degree to any other university or institution.

Signed

Dung Manh Tran

September, 2011
ACKNOWLEDGEMENTS

My gratitude goes to those who have supported me during my time at Macquarie Graduate School of Management (MGSM). Without their contribution, completing this thesis would not have been possible.

I would like to express my sincere thanks to Professor Tyrone M. Carlin, Acting Dean, Faculty of Economics and Business, The University of Sydney. His assistance, support and encouragement were crucial to the successful completion of this thesis and to my professional growth.

To Dr Nigel Finch, Senior Lecturer, The University of Sydney, many thanks for his valuable comments and assistance during the research process.

To Associate Professor Guy Ford, Deputy Dean of MGSM, I would like to express my thanks for his useful suggestions and support in completing this thesis.

Thanks also to other academic and administrative staff at MGSM for their support and for providing equipment during my study there.

I would like to thank the Vietnamese government for their funding of my research at MGSM.

Last but not least, my heartfelt thanks go to my wife, my children and my parents for their love, understanding and moral support while I undertook research at MGSM.
ABSTRACT

This thesis focuses on goodwill impairment implemented and practised in the first three years after Hong Kong’s adoption of the International Financial Reporting Standards (IFRS). Three issues – compliance, discount rate and audit quality with respect to goodwill impairment testing – are the focus of analytical and empirical attention.

Understandably, one of the most controversial issues that has been discussed in financial reporting is goodwill. Goodwill impairment is argued to be one of the most difficult issues in practice. This thesis commences with a review of literature relating to goodwill with regard to its conceptualisation, techniques to avoid or alter its recognition, ways to measure and adjust it, and a description of key technical requirements of goodwill impairment in the context of Hong Kong. These issues are demonstrably reviewed in this thesis.

This study focuses on filling the gap in knowledge of compliance, discount rate and audit quality in relation to goodwill impairment. To do so, detailed annual reports of listed firms collected from the Main Board of the Hong Kong Stock Exchange in the period from 2005 to 2007, were drawn upon. Employing analytical procedures and the Capital Asset Pricing Model (CAPM), the study provides persuasive evidence on the issues of compliance, discount rate and audit quality with respect to goodwill impairment.

The thesis concludes that the rates of non-compliance and poor quality of disclosure pertaining to goodwill impairment conducted by Hong Kong firms reduced in the first three years after Hong Kong’s adoption of IFRS. However, non-compliance levels and poor disclosure quality were still high. The sample firms had a tendency to
understate discount rates in comparison with independently estimated discount rates in all three years of the investigation. In addition, audit quality among the Big 4 auditors is proved to be heterogeneous rather than homogeneous.

The thesis concludes that a big gap exists between the standard requirements of goodwill impairment and practice. In the context of Hong Kong, this research demonstrates that the efficacy of this standard is low. It is therefore likely that the application of goodwill impairment in practice will continue to cause concern for policy makers and standard setters.