

# Lax Compliance of Goodwill Impairment Accounting in the Early Year after IFRS Implementation

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## Abstract

After some decades of discussing in recognizing, measuring and reporting goodwill in the financial reports, Hong Kong finally has promulgated HKAS 36 - Impairment of Assets, for the convergence of IFRS including IAS 36. This is absolutely applicable to all transactions of business combinations beginning on or after 1<sup>st</sup> January, 2005. The adoption of HKAS 36 has resulted in significant changes and more complexity in terms of techniques and in the nature of disclosures relating to goodwill and its impairment to the reporting first-time adopters. The traditional method by adopting “capitalize and amortize” has been replaced by impairment testing regime based on subjective assumptions. Therefore, it is more likely to have inconsistent compliance by the first-time adopters in their transition period under the new reporting approach. Thus, this study has the purpose of examining the compliance levels under a variety of provisions of HKAS 36. By using the data of annual reports of Hong Kong listed firms, first-time adopters, the research found the material levels of non-compliance and substantial changes in the quality of note-form disclosures bearing on impairment testing process. Further study on post transition period is identified and discussed.

**Keywords:** Goodwill, Impairment, Financial Reporting Standard, Hong Kong

## 1. Introduction

Goodwill, its impairment and its disclosures set out in the accounting standard are regarded as the most controversial aspects of financial reporting both in techniques and practices. The adoption of HKAS 36 is conducted basing on many subjective and ambiguous assumptions so it is very difficult to determine which ones are proper and results in overflow of abundant disclosures of information relating to goodwill and its impairment. So goodwill impairment testing and disclosure are viewed as two of five most difficult issues in practice when IFRS implementation has been made (Hoogendoorn, 2006).

In the context of Hong Kong, issues of recognizing, measuring and reporting of goodwill have changed significantly. Before 2001, goodwill acquired from business combination was written off against reserve account in the balance sheet or amortized through the income statement (Moliterno, 1993). From 2001 up to 2005, goodwill was recorded at cost less both accumulated amortization and accumulated impairment loss. Goodwill was capitalized and amortized not higher than twenty years employed the straight-line method. Goodwill impairment testing was conducted in case of useful life of goodwill higher than twenty years.

For the convergence of International Financial Reporting Standards (IFRS), HKICPA<sup>1</sup> has set out fully legal framework in accounting, mainly the same to IFRSs, but some small differences to be applicable to Hong Kong. In consequence, Hong Kong Financial Reporting Standards (HKFRS) were fully converged with IFRS with effect from 1<sup>st</sup> January 2005 (E&Y, 2008).

Now implementation of the new standard, Hong Kong Accounting Standard No. 36 (HKAS 36), has substantial changes. HKAS 36 requires goodwill acquired in a business combination is no longer amortised but tested annually, cash generating units (CGUs) that goodwill should be allocated will not be larger than a segment and no reversal of impairment loss at any cost.

Clearly, implementation of HKAS 36 makes more difficult and complicated for reporting firms to apply in practice because the standard consists of many subjective and ambiguous assumptions when economic conditions and financial markets change very quickly with differently unexpected tendencies. As a result, different assumptions result in various outcomes, and it is not easy for financial statement users, policy makers

<sup>1</sup> HKICPA is Hong Kong Institute of Certified Public Accountants (HKICPA). The former name was Hong Kong Society of Accountant (HKSA) that was established on 1<sup>st</sup> January, 1973.

and very auditors to decide which outcome is the best. However, implementation of this standard provides much information for financial report users to assess the transparency of goodwill impairment disclosures in the note to financial statements.

From this point, this research has the purpose to look into compliance levels under the standard requirements. For satisfying the objective, compliance levels were evaluated by testing goodwill impairment regime from large listed firms in the first year adoption of HKFRS, including HKAS 36, first-time adopters.

This research is structured as follows. Section 2 presents an overview of goodwill accounting and reporting in Hong Kong. Section 3 gives the way of data collection and methodology adopted. Section 4 contains a discussion of results while Section 5 gives some key conclusions and implications of the study practice and potential further research.

## 2. Goodwill Reporting Arrangements in Hong Kong

Having been a British colony more than one hundred years before July 1997, Hong Kong Accounting Standards (HKAS) and Professional self regulation were heavily influenced by United Kingdom Standards and Practices (Ball *et al.*, 2003). The legal requirements of the company accounts and financial reporting were stated in the Companies Ordinance in 1932, based on the UK Companies Act in 1929, the later version of the Companies Ordinance incorporated provisions of UK Companies Act in 1948. However, legal requirements have since been simple and limited both in forms and contents of financial statements (Lee, 1997). There were no specific accounting standards presented in the compulsory law except for the main principle that financial statements of the entity should be presented with the view of “*true and fair*” expression (Lee, 1997).

The main accounting professional body is Hong Kong Society of Accountant (HKSA), founded in 1973. HKAS established the Accounting Standard Committee (ASC) in February 1982 with the responsibilities of preparing definitive standards of accounting and reporting for the accounting profession (Hui & Ng, 2006).

Before 1982, there was no formal standard setting in Hong Kong, the non-mandatory accounting standards issued in that period were essentially reissues of UK accounting standards and were generally compatible with International Accounting Standards (IAS). Formal standard setting framework was introduced in 1982, Hong Kong Statements Standard Accounting Practice (SSAP) were issued based on the UK Standards, almost identical to the UK SSAPs. From 1992, HKAS officially switched to IAS as a model of new HKSSAP and Accounting Guidelines (Ball *et al.*, 2003). With effect from 1<sup>st</sup> January 2005, all the existing HK SSAP and Interpretations have been renamed as HKAS and HKAS Interpretations (HKAS-Int).

In terms of goodwill, understood as an asset item or written off at once from the financial statements under the UK method as soon as it appeared due to business combination is a controversial issue and depends much on the regulations of each nation. In Hong Kong, no reporting standard bearing on goodwill existed in the legal accounting framework until the issue in March 1984 of the SSAP 1 “*Presentation of Financial Statements*” issued by HKSA.

From that time to 2001, according to SSAP 1<sup>1</sup>, Interpretation 13<sup>2</sup> and Guidance in the former Accounting Guideline 2.204 “Accounting for Goodwill” recommended some treatments when accounting for goodwill. More specifically, positive goodwill—an excess of the cost of the acquisition over the acquirer’s interest in the fair value of the identifiable assets and liabilities acquired - may be written off (eliminated) from the account of reserves or amortized on the straight-line basis to the profit and loss account over its economic life (Moliterno, 1993). In case of negative goodwill, an excess of the acquirer’s interest in the fair values of the identifiable assets and liabilities acquired over the cost of the acquisition, should be credited directly into reserve account. This regulation is absolutely the same with its approach of UK, rather different from the approaches of United States and Germany with “*capitalized and amortized*” goodwill in that period (Lee, 1997).

In 2001, Financial Accounting Standards Committee (FASC)<sup>3</sup> - member of HKAS - had issued more SSAPs that come into effect to periods beginning on or after 1<sup>st</sup> January, 2001, including SSAP 30<sup>4</sup> “Business Combination”, SSAP 31 “Impairment of Assets” and Interpretation 13 “Goodwill - continuing requirements for goodwill and negative previously eliminated against credited to reserves”.

In SSAP 30 “Business Combination”, goodwill was recorded differently from the past, it was carried at cost less any accumulated amortization and any accumulated impairment losses. SSAP 30 requires a firm to capitalize goodwill immediately after it appears because of business combination (if any) and amortize it under a straight-line basis over its estimated useful life, not exceeding twenty years from initial recognition. If not, explanations should be stated clearly in the circumstances.

<sup>1</sup> : SSAP 1 “Presentation of Financial Statements” had been issued in March 1984 and revised several times in May 1999, August 2001 and December 2001.

<sup>2</sup> : Interpretation 13 was issued in June 2001.

<sup>3</sup> : FASC was established in 1994, the former name was ASC.

<sup>4</sup> : SSAP 30, SSAP 31 was promulgated in January 2001.

In case of amortization period higher than twenty years, the entity should estimate the recoverable amount of goodwill for identifying any impairment losses even if there is no indication that it is impaired and be suitable with SSAP 31. Interestingly, almost all firms with goodwill have policies of amortization period of goodwill not higher than twenty years through checking notes to the accounts of the reporting firms. It means that goodwill balances were amortized based on estimated useful lives and not tested for impairment charges.

SSAP 31 states that if there is an indication that goodwill may be impaired, whether the indication belongs to internal or external source of information, recoverable amount is determined for the cash generating units (CGUs) to which goodwill belongs. Then this amount is compared to the carrying amount of CGUs and any impairment loss is recognized in the income statement.

In SSAP 31 "*Impairment of Assets*", based on the IAS 36 "*Impairment of Assets*", HKSA prescribed almost all the same with IAS 36 to be affective at that time, such as impairment testing method, recoverable amount calculation assumptions, goodwill allocated to cash generating units, disclosure and so on. However, in comparison with the prevailing HKAS 36, there were some changes in recognition, measurement and disclosures in relation to goodwill impairment.

In 2001, knowing the importance of convergence with IFRS, HKFRS should be set for providing the legal framework in accounting in Hong Kong. HKFRS can be understood to consist of HKFRS, HKAS and Interpretations. HKICPA has mandated the Financial Reporting Standards Committee (FRSC) to develop Financial Reporting Standards (FRSs) for achieving convergence with IFRS issued by International Federation of Accountants (IFAC) and required the Standard Setting Steering Board (SSSB) to review and advise on the HKICPA's overall strategy, policies and process for setting FRS. In December 2004, HKICPA officially announced the completion of full convergence of HKFRS into IFRS, and HKFRS came into effect from 1<sup>st</sup> January, 2005.

Ultimately, Hong Kong firms would apply an own version of accounting framework that came into effect from 1<sup>st</sup> January, 2005 to get progress of goodwill reporting. Under the new standards (HKFRS), almost the same with IFRS, Hong Kong firms are required to apply all HKFRS issued by HKICPA in the recognition, measurement and disclosures of all items in the financial statements. The setting of HKFRS assures that regulatory bodies in Hong Kong are very active in providing legal professional framework that is suitable with prevailing international standards.

HKAS 36 "*Impairment of Assets*", HKAS 38 "*Intangible Assets*" and HKFRS 3 "*Business Combinations*", outputs of goodwill accounting treatments, have also been adopted for the annual reports beginning on or after 1<sup>st</sup> January, 2005. From the period 2001 to 2004, all firms with goodwill amortised goodwill based on the estimated not higher than twenty years, so SSAP 31 seems to be neglected for goodwill impairment purpose. Therefore, these standards produce some significant and new procedures which have material impacts on treatments of goodwill in Hong Kong.

Now, the view of recognizing, measuring and disclosing of goodwill impairment is quite new from the past and makes preparers not easy to comply with. Some substantial changes include, the first, goodwill acquired in a business combination is no longer amortised but tested annually. Second, goodwill should be allocated to each cash-generating units (CGUs) or groups of CGUs and each unit represents the lowest level within the entity at which the goodwill is monitored for internal management purposes and not be larger than a segment based on primary or secondary reporting format. Third, recognition of reversal of impairment losses for goodwill is banned in all cases.

HKAS 36 is a version which is much more perfect than SSAP 31 and similar to IAS 36. With the purpose of converging with IFRS, providing much more transparency information to financial statement users, HKAS 36 states more procedures and assumptions related to goodwill and its impairment, from CGU aggregation, approaches, goodwill allocation to CGUs to assumptions of calculating CGU recoverable amount and disclosures.

Adoption of HKAS 36 is a main step for recognizing, measuring and reporting goodwill impairment and makes considerable changes not only to preparers but also auditors and policy makers. Under the HKAS 36, the highly prescriptive and technical requirements, to some extent, seem very subjective and substantial different from the previous years. This pushes the question need to be answered about the compliance levels of goodwill impairment conducted by large Hong Kong firms as the first-time adopters.

### **3. Data and Research Methodology**

Hong Kong Financial Reporting Standards (HKFRS) including HKFRS, HKAS and Interpretations form compulsory frameworks for all reporting firms to apply on or after 1<sup>st</sup> January 2005. Consequently, a subset of the listed Hong Kong firms reported to the sense of HKFRS in that year. However, financial year lasts twelve months, so only firms to do so were those which their financial statements contain explicit and unreserved statements of compliance with all HKFRS and have year end as at 31<sup>st</sup> December. Therefore, firms with year ends 31<sup>st</sup> December are considered to be the first-time adopters of HKFRS, including HKAS 36.

From this view, the research reported in this paper focused on the data selected from a sample of Hong Kong listed firms which reported goodwill as an asset base in the consolidated financial statements. The final sample of 267 listed firms as the first-time adopters of HKAS 36, including firms applying IFRS, having goodwill balances and year end of 31<sup>st</sup> December.

The final sample, 267 listed firms, was divided into eleven groups under the HSICS industry classification<sup>1</sup> for the purpose of analysis in this research. In the final research, total sample assets and goodwill closing balances valued at 19,326 billion HK\$ and 430 billion HK\$, respectively. An overview of the research sample consists of assigned sectors, Hong Kong dollar value of firm assets and dollar value of goodwill within each sector are illustrated in Table 1, below.

**Table 1: Overview of Research Sample**

Sectors	No. of firms	Total Assets (\$ million)	Total Goodwill (\$ million)	Goodwill as % of Total Assets
Conglomerates	15	1,186,459.05	23,598.04	1.99%
Consumer Goods	64	344,849.78	14,775.90	4.28%
Energy	5	644,086.64	15,151.79	2.35%
Financials	24	14,598,536.58	276,657.48	1.90%
Industrial Goods	18	138,292.48	5,893.60	4.26%
Information Technology	16	123,329.94	14,679.39	11.90%
Materials	13	147,494.38	1,945.38	1.32%
Properties & Construction	38	579,215.11	5,781.76	1.00%
Services	57	494,919.68	13,028.85	2.63%
Telecommunications	4	654,604.73	49,297.51	7.53%
Utilities	13	414,954.59	10,083.22	2.43%
<b>Total (n)</b>	<b>267</b>	<b>19,326,742.98</b>	<b>430,892.93</b>	<b>2.23%</b>

The data in Table 1 show that distribution of assets, goodwill and ratios of goodwill/assets in each sector is uneven. Financials have biggest value of assets, but low percentage of goodwill per assets, whereas Information Technology has lowest value of asset but highest percentage of goodwill/assets. The range of assets and goodwill are 11,647 billion and 226 billion HK\$, respectively. Average of goodwill per assets in the whole sample is 2.23%.

In order to answer research questions, a two tiered comparative methodology is employed. The first tier requires a comparison to be conducted between contents of goodwill impairment disclosures and requirement checklist of HKAS 36. As a result, disclosures are classified under categories of compliance and non-compliance of HKAS 36. The second tier is to instruct multi-category disclosure quality for understanding thoroughly goodwill impairment disclosure rather than classification of compliance and non-compliance.

The first potential interest that should be inspected thoroughly pertaining to goodwill impairment regime is to investigate CGU aggregation under requirements of the standard. A CGU, under HKAS 36, is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. The role of CGUs considers to be very important within the process of goodwill impairment testing, because it reflects whether impairment loss being recognized (Carlin & Finch, 2008).

In the Paragraph 80 of HKAS 36, for the purpose of impairment testing, goodwill acquired in a business combination is to be allocated to each CGU (or groups of CGUs) that is expected to have benefit from the synergies of the combination. CGU is defined to be the lowest level within the entity at which the goodwill is monitored for internal management purpose.

In order to avoid inappropriate aggregation of CGU/CGUs, the standard states that each CGU or group of CGUs to which goodwill is so allocated should not be larger than a segment based on either primary or secondary reporting defined for the purpose of segment reporting (HKAS 14)<sup>2</sup>. It means that each CGU cannot relate to more than one segment, even though each segment is more likely to have at least one CGU, except some special cases.

In order to have insights in CGU aggregation of the listed firms, it is very important to compare the number of CGUs and the number of business segments. One point plays very importance in knowing appropriate CGU

<sup>1</sup>: HSICS: the Hang Seng Industry Classification System (previously named as the Hang Seng Stock Classification System). This system covers 11 industries and 28 sectors that meet the need for a detailed industry classification and reflects stock performance in different sectors.

<sup>2</sup>: HKAS 14 "Segment Reporting" is applicable for annual periods beginning on or after 1 January 2005, but before 1 January 2009. HKFRS 8 "Operating Segments" will supersede HKAS 14 and be effective on or after 1 January 2009.

aggregation is to know the number of the controlled entities in the firm. The reason is that goodwill acquired in a business combination as a result the parent firm buying subsidiary entities.

The fact is that the more number of controlled entities is, the more likely number of CGU exists if each CGU creates cash inflows independently from other assets or groups of assets. Maybe one exception is that the parent firm has many subsidiaries and some subsidiaries produce goods or services for other subsidiaries in a closed cycle and those subsidiaries make cash inflows that are related to among them and independent from other assets or group of assets. In order to have insights of CGU aggregation, comparison between number of controlled entities and business segments and CGUs should be made.

For evaluating the completeness and disclosure quality pertaining to goodwill at CGU level, comparison between goodwill balances and total of CGU goodwill allocation is necessary. If the total of disclosed goodwill does not reconcile to the total of goodwill allocated to CGUs (if no proper explanations), the quality and disclosure completeness are judged to be low.

The second potential interest is to look into the methods used to calculate CGU recoverable amount. Paragraph 6 of HKAS 36 states that recoverable amount of an asset or a CGU is higher of its fair value less cost to sell (hereafter call *fair value*) and value in use. This is related to a selection of fair value or value in use and a firm is required to disclose the method used in the note-form of the financial reports.

Fair value is defined as the amount obtainable from the sale of an asset or a CGU in an arm's length transaction between knowledgeable and willing parties, less costs of disposal. For some actively traded assets, it may be not too difficult to get fair value to sell from the public information (Hui & Ng, 2006). So determining CGU recoverable amount based on fair value is feasible and reliable. Active market is defined as a market when the items traded within the homogeneous market, willing buyers and sellers can normally be found at anytime and prices are available to the public (Paragraph 6 of HKAS 36).

In case of CGUs is not traded in an active market, fair value can be applied to measure CGU recoverable amount, but the firm proves that there is proper basis for making a reliable estimation of the amount obtainable from the sale of the assets or CGU in an arm's length transaction between knowledgeable and willing parties (Paragraph 20), such as using the recent transactions for similar assets within the same industry with adjustments for different in condition, age, etc.

However, one question raises is that the reliability of recoverable amount based on fair value where there is no active and liquid markets. Also in Paragraph 20, in case of not calculating CGU recoverable amount under fair value, the firm should use the value in use for measuring CGU recoverable amount.

Value in use is defined as the present value of the estimated future cash flows expected to be derived from an asset or CGU (Paragraph 6). The same as the method of fair value, some specific and detailed disclosures are required to disclose in the note-form when value in use applied for determining CGU recoverable amount. Apparently, disclosures are designed to assist financial statements users for having enough financial information in order to evaluate the robustness of the discounted cash flow model when determining CGU recoverable amount.

In order to support more understanding the conservatism or aggression inherent degree in estimating CGU recoverable amount by adopting the method of value in use, discount rates, growth rates should be looked into.

With regard to investigating key assumptions, developing a compliance and disclosure taxonomy for both discount rates and growth rates is necessary (Carlin *et al.*, 2014; Carlin & Finch, 2008). The taxonomy applied for discount rates requires each sample firm to put one of four groups being "multiple discount rates", "single discount rates", "range of discount rates" and "no effective disclosure".

Allocation of firms in the first group revealed that reporting firms were fully compliant with the requirements of HKAS 36 in relation to discount rates. The firms assigned to this group have the perceptions to disclose the details of the specific discount rates used to discount cash flow for testing purpose for each CGU. It also points that disclosure quality was proper in providing useful insights for financial users to trust the goodwill impairment testing process employed by the sample firms.

Firms were assigned to the second group "single discount rates" revealed that they disclosed single discount rate for each CGU, though CGU risk inherent levels were generally different. So the same discount rate applied for all CGUs did not reflect the true value of present values when discounted from future cash flows in the discounted cash flow model. As a result, compliance level in this category was judged to be lower than that of firms in the first category.

Being allocated to the third group "range of discount rate", firms disclosed discount rates in range, indiscrete rates for calculating CGU recoverable amount. Financial users do not know exactly the specific discount rates used for each CGU. If it is the case, goodwill impairment testing method and impairment losses were employed and calculated in a relative level. So disclosure quality of firms in this category was assessed as lower than the two above categories.

The fourth group "no effective disclosure" was assigned to firms that inadequate disclosures were conducted. As a result, there is no meaningful information for financial users who want to test the robustness of

goodwill impairment process. Therefore, firms in this group were judged to be poor.

Pertaining to disclosure quality of growth rates, a similar approach was adopted. More specifically, firms were assigned to one of four groups, namely, “multiple growth rates”, “single growth rates”, “range of growth rates” and “no effective disclosure”. The compliance level descends from the first to the fourth category.

#### 4. Results and Discussion

The research interest of this research focuses on requirements of disclosure of goodwill impairment under HKAS 36. As analysed above, the first interest issue was the degree to which total value of each sample firm’s goodwill balances could be completely reconciled to the sum of goodwill values allocated to defined CGUs. In the financial statements of the first-time adopters, 267 firms revealed evidence of three classes of practice.

The data in Table 2 show that the first and domain class consisted of 178 firms that total values of goodwill balances were equal to values of goodwill allocated to CGUs. These firms were assessed as being fully compliant with disclosure requirements of Paragraph 80, HKAS 36. The second class comprised only one firm of Guang Dong, pertaining to which small immaterial value<sup>1</sup> of goodwill has not been allocated to a CGU and no explanation of difference to be made. The third class comprised 88 firms (making up one-third of total sample) failed to disclose goodwill allocation to CGUs. This implies that the model of goodwill impairment testing was impossible to be done. Therefore, these firms in this class were judged not to comply with disclosure requirements of HKAS 36.

The percentages of fully compliant by sectors ranged between 53.85% (7 of 13 firms in Utilities) and 75% (18 of 24 firms in Financials), whereas the percentages of non-compliant by sectors varied from Financials sector (25%) to Utilities (38.5%), except sectors of Energy (40%) and Telecommunication (50%) because of the small numbers.

In contemplating the results of Table 2, one-third sample firms failed to provide details of disclosures pertaining to Paragraph 80 of HKAS 36. Failure in providing details of reconciliation between goodwill balances and goodwill allocated to CGUs creates more difficulties for financial report users to have independent evaluation of the robustness of goodwill impairment model.

**Table 2: CGU Allocation by Sectors**

Sectors	No. of firms	Fully compliant	Ostensibly compliant	Non-compliant <sup>2</sup>
Conglomerates	15	10	-	5
Consumer Goods	64	45	-	19
Energy	5	3	-	2
Financials	24	18	-	6
Industrial Goods	18	11	-	7
Information Technology (IT)	16	11	-	5
Materials	13	8	-	5
Properties & Construction	38	27	-	11
Services	57	36	-	21
Telecommunications	4	2	-	2
Utilities	13	7	1	5
<b>Total (n)</b>	<b>267</b>	<b>178</b>	<b>1</b>	<b>88</b>
<b>Percentage</b>	<b>100%</b>	<b>66.6%</b>	<b>0.4%</b>	<b>33%</b>

For having insights of CGU aggregation, it is necessary to have comparison between the number of CGUs and the number of business segments which is illustrated in Table 3. According to Paragraph 80, CGUs or groups of CGUs to which goodwill is allocated for the purpose of impairment testing represent the lowest level within the firm at which goodwill is monitored for internal management purposes and should not be larger than segments as defined for segment reporting purposes.

The data in Table 3 show the relationship between the number of CGUs and the number of business segments. Of 187 sample firms which provided sufficient disclosures to know identification of their CGUs, 15% of firms reported more number of CGUs than the number of business segments whereas 23% of observations defined the number of CGUs was the same with number of defined business segments. Two cases above suggest lower risks of CGU aggregation issue. About 62% of 187 sample firms recognized fewer numbers of CGUs than

<sup>1</sup> Materiality is determined by reference to the dollar value of the reconciliation gap compare against the dollar value of total goodwill balance of the firm.

<sup>2</sup> Non-compliant firms are those who failed to allocate any goodwill balances to CGUs. This practice is absolutely contrary to the disclosure requirements of Paragraph 80, HKAS 36.

the number of business segments. This indicates that there is likely to monitor goodwill at a higher level than defined business segments conducted by the firms. So it suggests that there is a higher risk of inappropriate CGU aggregation in the process of goodwill impairment testing and the content of Paragraph 80 may be violated.

**Table 3: Segments and CGU Aggregation by Sectors**

Sectors	No. CGUs> No. Segments	No. CGUs= No. Segments	No. CGUs< No. Segments	No effective disclosure
Conglomerates (n=15)	1	-	9	5
Consumer Goods (n=64)	9	12	26	17
Energy (n=5)	2	-	2	1
Financials (n=24)	3	4	11	6
Industrial Goods (n=18)	1	5	6	6
Information Technology (n=16)	2	2	7	5
Materials (n=13)	-	2	6	5
Properties & Construction (n=38)	1	2	24	11
Services (n=57)	5	12	22	18
Telecommunications (n=4)	2	-	-	2
Utilities (n=13)	2	4	3	4
<b>Total (n=267)</b>	<b>28</b>	<b>43</b>	<b>116</b>	<b>80</b>
<b>Percentage</b>	<b>10%</b>	<b>16%</b>	<b>44%</b>	<b>30%</b>

Investigating in each sector, CGU aggregation risk is distributed unevenly. More specifically, firms in sectors of Properties & Construction and Conglomerates reported the number of CGUs lower than the number of business segments with 63.16% and 60% of total sample respectively, whereas firms in Telecommunication and Energy represented more number of CGUs than the number of business segments. The number of CGUs equals to that of business segments is seen in the firms in Utilities and Industrial Goods with percentage of 30.77% and 27.78% of total sample respectively, higher than that of other sectors.

It is notable that high proportion of firms failed to provide effective disclosure in relation to CGU aggregation and business segments, accounting for 30% of the sample. Apparently, it is more difficult for financial users to evaluate the robustness of goodwill impairment testing under the requirements of HKAS 36.

The data in Table 4 show more evidence for evaluating appropriate CGU aggregation by using descriptive analysis of controlled entities, business segments and CGUs. It is a fact that controlled entity is considered as meaningful indicator for evaluating the risk of inappropriate CGUs aggregation because it is largely related to goodwill through the firm's acquisition transactions in business combinations.

The data in Table 3 and Table 4 were consistent each other. Averagely, firms recorded 0.68 CGUs for each defined business segment. It means that the number of CGUs is lower than that of business segments. To look back Paragraph 80, it shows that the inappropriate CGU aggregation existed in the whole sample with the first-adopters in Hong Kong.

**Table 4: Analysis of Controlled Entities, Business segments and CGUs by Sectors**

Sectors	Avg. No. Controlle d Entities	Avg. No. Business Segments	Avg. No. CGUs	Avg. value Goodwill (\$ mil)	Avg. Goodwillper CGU (\$ mil)	Ratio CGUs to Segments
Conglomerates (n=15)	73.53	5.80	3.50	1,573.20	449.49	0.60
Consumer Goods (n=64)	28.70	2.56	1.85	230.87	124.72	0.72
Energy (n=5)	24.60	3.40	3.50	3,030.35	865.82	1.03
Financials (n=24)	49.12	4.33	2.67	11,527.39	4,322.77	0.62
Industrial Goods (n=18)	23.72	3.06	2.25	327.42	145.52	0.74
IT (n=16)	23.68	3.06	2.09	917.46	438.79	0.68
Materials (n=13)	23.23	2.92	1.75	149.64	85.51	0.60
Properties & Construction (n=38)	52.36	4.08	1.81	152.15	83.84	0.44
Services (n=57)	28.35	2.84	2.08	228.57	110.06	0.73
Telecommunications (n=4)	36.25	2.75	7.00	12,324.37	1,760.63	2.55
Utilities (n=13)	30.00	2.83	2.90	775.63	267.46	1.02
<b>Total (n=267)</b>	<b>35.54</b>	<b>3.29</b>	<b>2.24</b>	<b>1,613.83</b>	<b>720.67</b>	<b>0.68</b>

The next interest issue of disclosure for goodwill impairment testing was the selection of approach

employed in estimating CGU recoverable amount and then determined whether impairment losses have occurred. Descriptive statistics has been used to know the frequencies of each method applied in the impairment regime, which is illustrated in Table 5.

**Table 5: Approach Employed for Determining Recoverable Amount of CGUs**

Sectors	No. of firms	Fair Value Method	Value in Use Method	Mixed Method	Method not disclosed
Conglomerates	15	1	11	1	2
Consumer Goods	64	-	58	-	6
Energy	5	-	5	-	-
Financials	24	-	19	2	3
Industrial Goods	18	-	14	-	4
Information Technology	16	-	13	1	2
Materials	13	-	10	1	2
Properties & Construction	38	1	31	1	5
Services	57	2	45	3	7
Telecommunications	4	-	4	-	-
Utilities	13	-	10	-	3
<b>Total (n)</b>	<b>267</b>	<b>4</b>	<b>220</b>	<b>9</b>	<b>34</b>
<b>Percentage</b>	<b>100%</b>	<b>1.5%</b>	<b>82%</b>	<b>3.5%</b>	<b>13%</b>

The data in Table 5 show that the main approach adopted by first-time adopters is the value in use. Out of 267 firms, 220 used the method of value in use (making up 82% of the whole sample). 34 firms provided no information related to calculating recoverable amount of CGUs (accounting for 13%), suggesting that financial statement users have no information to evaluate the robustness of goodwill impairment testing regime.

A small number of firms adopted fair value and mixed method, made up about 5% of the whole sample. For these firms, using fair value for estimating recoverable amounts of CGUs have reduced burden disclosures and avoided to provide details of subjective and complicated assumptions such as assumptions of discount rates, growth rates and forecast periods. However, when using fair value, reporting firms are to disclose appropriate benchmark asset portfolios, current prices in active markets for which can be reliable measured.

Specifically, CGU recoverable amounts were measured under fair value method mainly in the final sample based on active markets, latest transactions, valuations from valuers, net realisable values, and net assets adjusted. However, disclosures of the calculation method tended to be too brief and rather uninformative. Too brief disclosures pertaining to fair value assumptions for measuring CGU recoverable amounts cannot provide enough information for financial statement users to evaluate the robustness of goodwill impairment regime.

For instance, recoverable amount was calculated based on the latest transactions, some questions were raised and received no answers, such as when did the latest transactions occur? Is this CGU similar to CGU in the latest transactions? Could the price of this CGU compare to the other CGUs? Were the risk levels and market related to CGU/CGUs the same or different to the others? So the more disclosures should be presented in the financial statements, the more financial users would know the assumptions and policies related to goodwill impairment testing regime and then evaluate whether the robustness of this method.

The main method to be employed for measuring recoverable amount of CGUs is the value in use. Pertaining to this method, key assumptions of discount rate, growth rate and forecast period have been disclosed. The standard states that discount rate is pre-tax rate that reflects current market assessment of the time value of money and the risks specific to the asset or group of assets for which the future cash flow estimates have not been adjusted. This also implies that discount rates applied should show variation across CGUs where business risk inherent differs.

However, the data in Table 6 show that disclosure practices of discount rates cause more controversial issues under the requirements. It is notable that it is less likely to disclose different discount rates for each of their defined CGUs. Instead of disclosing multiple discount rates, single discount rates were selected for all CGUs in the whole sample, with the high percentage of firms used value in use method to calculate recoverable amount of CGUs (153 in 229 firms, accounting for 67%). Applying single discount rates for all CGUs has blurred the different risks inherent across CGUs, therefore it was more likely to have incorrect present values that was discounted from future cash flow.

Remarkably, nearly a fifth of those firms disclosing the value in use method failed to provide any meaningful disclosures pertaining to discount rates. In these instances, the firms absolutely ignored the discount rate issue even though discount rates play very importance in the impairment testing regime. This denotes that discount rate disclosures were not complied with standard requirements. Consequently, financial report users



know nothing about how the firms calculate CGU recoverable amount and the accuracy of goodwill impairment under the standard prescriptions.

Another controversial feature is the wide range of discount rates applied by firms in each sector. In some instances, discount rates were disclosed too low, for example firms in Financials disclosing discount rate of 1.4%, much lower than common estimates of the long run pre-tax risk free rate. By using too low discount rates in impairment testing regime, it is more likely to overstate CGU recoverable amount, and therefore defer potential impairment expenses. So the “*true and fair*” view of, in all material respects, items in the financial reports has been largely violated. There is substantial variation of discount rates, ranging from 1.4% at the lowest point to 23.13% at the highest point, mean of pre-tax discount rate of 9.59%, and standard deviation of 3.56%.

In comparison with sectors pertaining to average discount rate, reporting firms in Energy and Telecommunication applied high rates, 12.52% and 12.08% respectively, whereas in sectors of Materials and Financials, discount rates were about 8.25%.

**Table 6: Discount Rate Disclosures (Value in Use and Mixed Method Used Only)<sup>1</sup>**

Sectors	Multiple Discount Rate (no. of firms)	Range of Discount Rate (no. of firms)	Single Discount Rate (no. of firms)	No Effective Disclosure (no. of firms)	Min Discount Rate (pre-tax)	Max Discount Rate (pre-tax)	Average Discount Rate (pre-tax)
Conglomerates (n=12)	5	1	4	2	4.40%	16.00%	10.05%
Consumer Goods (n=58)	5	6	40	7	3.80%	18.30%	9.18%
Energy (n=5)	-	2	3	-	5.00%	17.20%	12.52%
Financials (n=21)	3	1	12	5	1.40%	17.80%	8.27%
Industrial Goods (n=14)	-	1	12	1	4.68%	20.00%	9.06%
IT (n=14)	1	-	10	3	5.58%	18.00%	9.06%
Materials (n=11)	-	-	9	2	5.00%	12.10%	8.25%
Properties & Construction (n=32)	2	2	20	8	5.00%	19.23%	9.58%
Services (n=48)	4	-	35	9	4.50%	23.13%	10.40%
Telecommunications (n=4)	1	1	1	1	8.00%	17.00%	12.08%
Utilities (n=10)	1	-	7	2	7.00%	15.23%	10.65%
<b>Total (n=229)</b>	<b>22</b>	<b>14</b>	<b>153</b>	<b>40</b>	<b>1.40%</b>	<b>23.13%</b>	<b>9.59%</b>

Similar difficulties were existed in the disclosures employed by firms pertaining to growth rate estimates employed for the purposes of CGU recoverable amount modelling. The data in Table 7 illustrate very details of growth rate disclosure in practice.

The most profound in disclosing growth rate is that there is a high level of non-compliance with disclosure requirements in relation to growth rate. About 76% of firms did not disclose growth rates even though HKAS 36 states very clearly about this issue.

Of those firms disclosing growth rates, most firms provided single growth rates for future time periods, consistent across all defined CGUs (about 18% of sample). This is inconsistent with the standard requirements that growth rates can vary across defined CGUs and forecast horizon.

In dimension of sectors, firms in sectors of Consumer Goods and Utilities completely failed to disclose growth rates in the discounted cash flow model. As a result, financial statement users have nothing information in judging model of impairment testing related to goodwill. The range of growth rate is from 0% to 13%, and average growth rate is 3%.

<sup>1</sup>: Of 267 first-time adopters in the sample, 220 employed value in use method and 9 used both value in use and fair value (mixed method).

**Table 7: Growth Rate Disclosures (Value in Use and Mixed Method Used Only)**

Sectors	Multiple Discount Rate (no. of firms)	Range of Discount Rate (no. of firms)	Single Discount Rate (no. of firms)	No Effective Disclosure (no. of firms)	Min Growth Rate (%)	Max Growth Rate (%)	Average Growth Rate (%)
Conglomerates	2	-	-	10	0.00%	6.90%	2.87%
Consumer Goods	1	1	13	43	0.00%	8.30%	3.00%
Energy	-	-	-	5	n/d	n/d	n/d
Financials	1	-	7	13	0.00%	13.00%	4.82%
Industrial Goods	1	1	1	11	0.00%	5.80%	0.50%
IT	-	-	1	13	5.50%	5.50%	5.50%
Materials	-	-	4	7	0.00%	6.80%	2.50%
Properties & Construction	-	1	3	28	0.00%	5.00%	2.00%
Services	4	1	11	32	0.00%	10.00%	3.00%
Telecommunications	1	-	1	2	1.00%	5.80%	2.45%
Utilities	-	-	-	10	n/d	n/d	n/d
<b>Total (n=229)</b>	<b>10</b>	<b>4</b>	<b>41</b>	<b>174</b>	<b>0.00%</b>	<b>13.00%</b>	<b>3.00%</b>

## 5. Conclusion

In comparison with the previous approaches, HKFRS framework for accounting, reporting and testing of goodwill impairment has resulted in high degree of complexity both in techniques and practices. Clearly, volume of works relating to goodwill impairment as well as cost related to have been spent much by both preparers and management. More specifically, based on the prudence principle, goodwill is carried at no more than its recoverable amount, reporting firms adopted many subjective assumptions under management judgements, so evaluating which the best outcome is not easy for financial statement users, policy makers and very auditors who audit this item in consolidated financial statements.

Even though it is not easy to adopt in practice by the transparency level pertaining to goodwill impairment, disclosures under HKAS 36 would far exceed than that of previous regime. For financial statement users, opportunity to have much information of goodwill impairment testing process helps them to assess the robustness of goodwill impairment testing regime and transparency of this item in the financial statements.

Unfortunately, the results of this study show that for the large listed first-time adopters in Hong Kong, the rates of non-compliance with the requirements of HKAS 36 were surprising high and disclosure quality of goodwill impairment was striking low. Thus, there is evidence to believe that lax compliance is a feature of early adoption of IFRS, including the accounting standard of *Impairment of Assets*. So, the efficacy of HKAS 36 is really questionable in this case.

There are some reasons to explain the non-compliant levels in the first year adoption of HKFRS, including HKAS 36. One reason may be misinterpretation of materiality principle and what is and is not required to disclose in the financial statements. However, materiality of disclosures is mainly of a qualitative nature and not of a quantitative nature so it is difficult to ascertain. The other reason is that they lacked experiences with facing the challenges of the new and complicated issues in the first year adoption of goodwill impairment. This raises the concerns about the reliability and the "true and fair" expression, *in all material respects*, of consolidated financial statements.

Through this study, the levels of compliance by testing goodwill impairment regime has been investigated for providing the real insights of goodwill impairment in the first year transition to IFRS. Further research of this issue pertaining to provisions of the accounting standard would help to determine whether this issue is improved in the post transition years when the first-time adopters get more experiences applying both in techniques and practices.

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