

10

GOODWILL AND
INTANGIBLE ASSETS



ACCOUNTING
STANDARDS
BOARD

FINANCIAL REPORTING
STANDARD

*Financial Reporting Standard 10
'Goodwill and Intangible Assets' is
issued by the Accounting Standards Board
in respect of its application in the United
Kingdom and by the Institute of Chartered
Accountants in Ireland in respect of its
application in the Republic of Ireland.*

10

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Financial Reporting Standard 10 is set out in paragraphs 1-78.

The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold type, should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraphs 2 and 3 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The explanatory paragraphs contained in the FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

Appendix III 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on the FRS. The views of the member who dissented are set out in Appendix IV.

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SUMMARY

General

- a Financial Reporting Standard 10 'Goodwill and Intangible Assets' sets out the principles of accounting for goodwill and intangible assets. Its objective is to ensure that purchased goodwill and intangible assets are charged in the profit and loss account in the periods in which they are depleted.

The nature of goodwill and intangible assets

- b The accounting requirements for goodwill reflect the view that goodwill arising on an acquisition is neither an asset like other assets nor an immediate loss in value. Rather, it forms the bridge between the cost of an investment shown as an asset in the acquirer's own financial statements and the values attributed to the acquired assets and liabilities in the consolidated financial statements. Although purchased goodwill is not in itself an asset, its inclusion amongst the assets of the reporting entity, rather than as a deduction from shareholders' equity, recognises that goodwill is part of a larger asset, the investment, for which management remains accountable.
- c An intangible item may meet the definition of an asset when access to the future economic benefits that it represents is controlled by the reporting entity, either through custody or legal protection. However, intangible assets fall into a spectrum ranging from those that can readily be identified and measured separately from goodwill to those that are essentially very similar to goodwill. The basic principles set out for initial recognition, amortisation and impairment of intangible assets that are similar in nature to goodwill are therefore closely aligned with those set out for goodwill.

Initial recognition

- d Purchased goodwill and intangible assets should be capitalised as assets. Internally generated goodwill should not be capitalised and internally developed intangible assets should be capitalised only where they have a readily ascertainable market value.

Amortisation

- e The required approach seeks to charge goodwill to the profit and loss account only to the extent that the carrying value of the goodwill is not supported by the current value of the goodwill within the acquired business. Systematic amortisation is a practical means of recognising the reduction in value of goodwill that has a limited useful economic life. It is also a means of ensuring that where goodwill is not capable of continued measurement (so that impairment reviews cannot reasonably be performed each year), its depletion is recognised over a prudent, but not unrealistically short, period.
- f Reflecting the view of goodwill as the bridge between the value of an acquired business in the entity's own financial statements and the values of its net identifiable assets shown in the consolidated financial statements, the useful economic life of purchased goodwill is defined as the period over which the value of an acquired business is expected to exceed the values of its identifiable assets and liabilities.
- g There is a rebuttable presumption that the useful economic lives of purchased goodwill and intangible assets are limited and do not exceed 20 years from the date of acquisition. However, there may be grounds for rebutting that presumption and regarding the useful economic life as greater than 20

years, or even indefinite. This may be done only if the goodwill or intangible asset is expected to be capable of continued measurement (so that annual impairment reviews can be performed).

- h Where goodwill and intangible assets are regarded as having limited useful economic lives, they should be amortised over those lives. Where goodwill and intangible assets are regarded as having indefinite useful economic lives, they should not be amortised.
- i Companies legislation requires goodwill to be amortised over a limited period. Hence, where the financial statements of a company include goodwill that is not amortised, they should explain that the departure from this specific requirement is necessary for the overriding purpose of providing a true and fair view, also detailing the reasons for and the effect of the departure.

Impairment reviews

- j An asset is regarded as impaired if its recoverable amount (the higher of net realisable value and value in use) falls below its carrying value. Impairment reviews should be performed to ensure that goodwill and intangible assets are not carried at above their recoverable amounts. Where goodwill and intangible assets are amortised over a period that does not exceed 20 years, impairment reviews need be performed only at the end of the first full financial year following the initial recognition of the goodwill or intangible asset and, in other periods, if events or changes in circumstances indicate that its carrying value may not be recoverable in full. Where goodwill and intangible assets are not amortised, or are amortised over a period exceeding 20 years, impairment reviews should be performed each year.

Revaluation and restoration of past losses

- k Intangible assets with readily ascertainable market values may be revalued by reference to those market values.
- l The reversal of a past impairment loss may be recognised only if it can clearly and demonstrably be attributed to the unforeseen reversal of the external event that caused the recognition of the original impairment loss. Past impairment losses may not be restored when the restoration in value is generated internally.

Negative goodwill

- m Negative goodwill should be recognised and separately disclosed on the face of the balance sheet, immediately below the goodwill heading. It should be recognised in the profit and loss account in the periods in which the non-monetary assets acquired are depreciated or sold. Any negative goodwill in excess of the values of the non-monetary assets should be written back in the profit and loss account over the period expected to benefit from that negative goodwill.

Disclosures

- n There are few disclosure requirements other than those normally required for any type of fixed asset. Significant additional disclosure requirements include requirements to explain:
 - the bases of valuation of intangible assets
 - the grounds for believing a useful economic life to exceed 20 years or to be indefinite
 - the treatment adopted for negative goodwill.

FINANCIAL REPORTING STANDARD 10

Objective

- 1 The objective of this FRS is to ensure that:
 - (a) capitalised goodwill and intangible assets are charged in the profit and loss account in the periods in which they are depleted; and
 - (b) sufficient information is disclosed in the financial statements to enable users to determine the impact of goodwill and intangible assets on the financial position and performance of the reporting entity.

Definitions

- 2 The following definitions shall apply in the FRS and in particular in the Statement of Standard Accounting Practice set out **in bold type**.

Class of intangible assets:-

A category of intangible assets having a similar nature, function or use in the business of the entity.

Licences, quotas, patents, copyrights, franchises and trade marks are examples of categories that may be treated as separate classes of intangible assets. Further subdivision may be appropriate, for example where different types of licence have different functions within the business. Intangible assets that are used within different business segments may be treated as separate classes of intangible assets.

Identifiable assets and liabilities:-

The assets and liabilities of an entity that are capable of being disposed of or settled separately, without disposing of a business of the entity.

Impairment:-

A reduction in the recoverable amount of a fixed asset or goodwill below its carrying value.

Intangible assets:-

Non-financial fixed assets that do not have physical substance but are identifiable and are controlled by the entity through custody or legal rights.

An identifiable asset is defined by companies legislation as one that can be disposed of separately without disposing of a business of the entity. If an asset can be disposed of only as part of the revenue-earning activity to which it contributes, it is regarded as indistinguishable from the goodwill relating to that activity and is accounted for as such.

In the context of an intangible asset, control is normally secured by legal rights: a franchise or licence grants the entity access to the benefits for a fixed period; a patent or trade mark restricts the access of others. In the absence of legal rights, it is more difficult to demonstrate control. However, control may be obtained through custody. This could be the case where, for example, technical or intellectual knowledge arising from development activity is maintained secretly.

Where it is expected that future benefits will flow to the entity, but those benefits are not controlled through legal rights or custody, the entity does not have sufficient control over the benefits to recognise an intangible asset. For example, an entity may have a portfolio of clients or a team of skilled staff. There may be an expectation that the clients within the portfolio will continue to seek professional services from the entity, or that the team of staff will continue to make their expert skills available to the entity. However, in the absence of custody or legal rights to retain the clients or staff, the entity has insufficient control over the expected future benefits to recognise them as assets.

Software development costs that are directly attributable to bringing a computer system or other computer-operated machinery into working condition for its intended use within the business are treated as part of the cost of the related hardware rather than as a separate intangible asset.

The definition does not encompass assets, such as prepaid expenditure, that are not fixed assets.

Net realisable value:-

The amount at which an asset could be disposed of, less any direct selling costs.

Purchased goodwill:-

The difference between the cost of an acquired entity and the aggregate of the fair values of that entity's identifiable assets and liabilities. Positive goodwill arises when the acquisition cost exceeds the aggregate fair values of the identifiable assets and liabilities. Negative goodwill arises when the aggregate fair values of the identifiable assets and liabilities of the entity exceed the acquisition cost.

Readily ascertainable market value:-

The value of an intangible asset that is established by reference to a market where:

- (a) the asset belongs to a homogeneous population of assets that are equivalent in all material respects; and
- (b) an active market, evidenced by frequent transactions, exists for that population of assets.

Intangible assets that meet those conditions might include certain operating licences, franchises and quotas. Other intangible assets are by their nature unique: although there may be similar assets, they are not equivalent in all material respects and so do not have readily ascertainable market values. Examples of such assets include brands, publishing titles, patented drugs and engineering design patents.

Recoverable amount:-

The higher of net realisable value and value in use.

Residual value:-

The net realisable value of an asset at the end of its useful economic life. Residual values are based on prices prevailing at the date of acquisition (or revaluation) of the asset and do not take account of expected future price changes.

Useful economic life:-

The useful economic life of an intangible asset is the period over which the entity expects to derive economic benefit from that asset. The useful economic life of purchased goodwill is the period over which the value of the underlying business acquired is expected to exceed the values of its identifiable net assets.

If purchased goodwill includes intangible assets that have not been recognised separately because they cannot be measured reliably, the useful economic lives of those intangible assets will have a bearing on that of the goodwill as a whole.

Value in use:-

The present value of the future cash flows obtainable as a result of an asset's continued use, including those resulting from its ultimate disposal.

- 3 References to companies legislation mean:
- (a) in Great Britain, the Companies Act 1985;
 - (b) in Northern Ireland, the Companies (Northern Ireland) Order 1986; and
 - (c) in the Republic of Ireland, the Companies (Amendment) Act 1986 and the European Communities (Companies: Group Accounts) Regulations 1992.

Scope

- 4 **Subject to the provisions of paragraph 5, the FRS applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period. Although the requirements of the FRS that relate to business combinations are framed in terms of the acquisition of a subsidiary undertaking by a parent company that prepares consolidated accounts, they also apply whenever any reporting entity acquires a business or an investment accounted for using the equity method.**

- 5 **Reporting entities applying the Financial Reporting Standard for Smaller Entities (FRSSE) are exempt from the FRS unless preparing consolidated financial statements, in which case they should apply the FRS to such statements as required by the FRSSE currently in issue.***

- 6 **The requirements of the FRS apply to all intangible assets with the exception of:**
 - (a) **oil and gas exploration and development costs;**

 - (b) **research and development costs; and**

 - (c) **any other intangible assets that are specifically addressed by another accounting standard.**

* *At the time of publication of the FRS, the FRSSE currently in issue requires smaller entities adopting the FRSSE and preparing consolidated financial statements to apply SSAP 22 and UITF Abstract 3 rather than the FRS. It is envisaged that a future revision to the FRSSE will require such entities to apply the FRS and will withdraw the requirements of SSAP 22 and UITF Abstract 3.*

Initial recognition of positive goodwill and intangible assets

Goodwill

- 7 Positive purchased goodwill should be capitalised and classified as an asset on the balance sheet.**
- 8 Internally generated goodwill should not be capitalised.**

Intangible assets

- 9 An intangible asset purchased separately from a business should be capitalised at its cost.**
- 10 An intangible asset acquired as part of the acquisition of a business should be capitalised separately from goodwill if its value can be measured reliably on initial recognition. It should initially be recorded at its fair value, subject to the constraint that, unless the asset has a readily ascertainable market value, the fair value should be limited to an amount that does not create or increase any negative goodwill arising on the acquisition.**
- 11 FRS 7 'Fair Values in Acquisition Accounting' requires that where an intangible asset is recognised, its fair value should be based on its replacement cost. FRS 7 goes on to explain that the replacement cost will normally be the asset's estimated market value but that it may be estimated by other methods.*

* FRS 7 'Fair Values in Acquisition Accounting', paragraph 10.

- 12 It is not possible to determine a market value for unique intangible assets such as brands and publishing titles. Replacement cost may be equally difficult to determine directly. However, certain entities that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their values indirectly and these may be used for initial recognition of such assets at the time of purchase. Techniques used can be based, for example, on 'indicators of value'—such as multiples of turnover—or on estimating the present value of the royalties that would be payable to license the asset from a third party.
- 13 **If its value cannot be measured reliably, an intangible asset purchased as part of the acquisition of a business should be subsumed within the amount of the purchase price attributed to goodwill.**
- 14 **An internally developed intangible asset may be capitalised only if it has a readily ascertainable market value.**

Amortisation of positive goodwill and intangible assets

Requirement for amortisation

- 15 **Where goodwill and intangible assets are regarded as having limited useful economic lives, they should be amortised on a systematic basis over those lives.**
- 16 The circumstances in which useful economic lives may be regarded as longer than 20 years are set out in paragraph 19.
- 17 **Where goodwill and intangible assets are regarded as having indefinite useful economic lives, they should not be amortised.**

- 18 Companies legislation requires goodwill that is treated as an asset to be amortised systematically over a finite period. Where a company's financial statements depart from this requirement, the departure must be justified as being required for the overriding purpose of providing a true and fair view. The circumstances in which useful economic lives may be regarded as indefinite are set out in paragraph 19. The necessary disclosure requirements are set out in paragraph 59.

Determining useful economic lives

- 19 **There is a rebuttable presumption that the useful economic lives of purchased goodwill and intangible assets are limited to periods of 20 years or less. This presumption may be rebutted and a useful economic life regarded as a longer period or indefinite only if:**
- (a) **the durability of the acquired business or intangible asset can be demonstrated and justifies estimating the useful economic life to exceed 20 years; and**
 - (b) **the goodwill or intangible asset is capable of continued measurement (so that annual impairment reviews will be feasible).**
- 20 The transient nature of many business opportunities makes it appropriate for there to be a presumption that the 'premium' that an acquired business has over its net asset value cannot be maintained indefinitely. However, in some circumstances there may be grounds for regarding the premium as more durable and assigning it a longer or even indefinite economic life. Durability depends on a number of factors such as:
- the nature of the business
 - the stability of the industry in which the acquired business operates

- typical lifespans of the products to which the goodwill attaches
 - the extent to which the acquisition overcomes market entry barriers that will continue to exist
 - the expected future impact of competition on the business.
- 21 The useful economic lives of goodwill and intangible assets will usually be uncertain. This uncertainty does not in itself form grounds for treating a useful economic life as indefinite or for adopting a 20-year period by default. Where, for example, the useful economic life of goodwill or an intangible asset is expected to be less than 20 years, the FRS requires an estimate of the useful economic life to be made.
- 22 Whilst uncertainty forms grounds for estimating the useful economic life on a prudent basis, it does not form grounds for choosing a life that is unrealistically short.
- 23 Goodwill and intangible assets will not be capable of continued measurement if the cost of such measurement is viewed as being unjustifiably high. This will be the case when, for example:
- acquired businesses are merged with existing businesses to such an extent that the goodwill associated with the acquired businesses cannot readily be tracked thereafter
 - the management information systems used by the entity cannot identify and allocate cash flows at a detailed income-generating unit level
 - the amounts involved are not sufficiently material to justify undertaking the detailed procedures of annual impairment reviews.

- 24 **Where access to the economic benefits associated with an intangible asset is achieved through legal rights that have been granted for a finite period, the economic life of the asset may extend beyond that period only if, and to the extent that, the legal rights are renewable and renewal is assured. The amount of the asset that is treated as having the longer useful economic life should exclude those costs that will recur each time the legal right is renewed.**
- 25 There may be both economic and legal factors influencing the useful economic life of an intangible asset: economic factors determine the period over which it is expected that future economic benefits will arise; legal factors may restrict the period over which the entity continues to control access to these benefits. The useful economic life of an asset is the shorter of the period over which it is expected that the future benefits will arise and that over which it is expected that the entity will control the benefits.
- 26 It follows that where a legal right securing access to an intangible asset has been granted for a finite period, as may be the case with a patent or licence, the useful economic life assigned to the asset cannot in general exceed that finite period. It would be appropriate to assign a longer useful economic life only if, and to the extent that, the legal right is renewable and renewal is assured. Renewal may be regarded as being assured if:
- (a) the value of the intangible asset does not reduce as the initial expiry date approaches, or reduces only by an amount reflecting the cost of renewal of the underlying legal right;
 - (b) there is evidence, possibly based on past experience, that the legal rights will be renewed; and

- (c) where the entity is required to abide by any conditions under the terms of the legal right and breach of those conditions may prevent renewal, there is no evidence that any of those conditions have been or will be breached.
- 27 It follows that, where legal rights are essential to the benefits arising from the use of an intangible asset, the asset may be regarded as having an indefinite life only if such legal rights can remain in force indefinitely or are renewable indefinitely with each renewal process being assured.

Residual value

- 28 **In amortising an intangible asset, a residual value may be assigned to that asset only if such residual value can be measured reliably. No residual value may be assigned to goodwill.**
- 29 In practice, the residual value of an intangible asset is often insignificant. It is likely that the residual value of an intangible asset will be significant and capable of being measured reliably only when:
- (a) there is a legal or contractual right to receive a certain sum at the end of the period of use of the intangible asset; or
 - (b) there is a readily ascertainable market value for the residual asset.

Method of amortisation

- 30 **The method of amortisation should be chosen to reflect the expected pattern of depletion of the goodwill or intangible asset. A straight-line method should be chosen unless another method can be demonstrated to be more appropriate.**

- 31 The pattern of depletion of intangible assets will normally be relatively uncertain and occur with the passing of time. A straight-line method of amortisation will normally be the most appropriate. However, there may be circumstances, for instance where a licence entitles the holder to produce a finite quantity of a product, where another method is more appropriate. It is unlikely that there will be circumstances in which there is justification and evidence to support a method of amortisation for goodwill that is less conservative than straight-line.
- 32 A method of amortisation that aims to produce a constant rate of return on the carrying value of an investment is not one that aims to reflect the pattern of depletion of goodwill. Hence, interest methods, such as the 'reverse sum of digits' method, are not appropriate methods of amortising goodwill.

Review of useful economic lives

- 33 The useful economic lives of goodwill and intangible assets should be reviewed at the end of each reporting period and revised if necessary. If a useful economic life is revised, the carrying value of the goodwill or intangible asset at the date of revision should be amortised over the revised remaining useful economic life. If the effect of the revision is to increase the useful economic life to more than 20 years from the date of acquisition, the additional requirements of the FRS that apply to goodwill and intangible assets that are amortised over periods of more than 20 years or are not amortised become applicable.**

Impairment of positive goodwill and intangible assets

Requirement for impairment reviews

- 34 Goodwill and intangible assets that are amortised over a finite period not exceeding 20 years from the date of acquisition should be reviewed for impairment:**
- (a) at the end of the first full financial year following the acquisition ('the first year review'); and**
 - (b) in other periods if events or changes in circumstances indicate that the carrying values may not be recoverable.**
- 35** If an impairment is identified at the time of the first year review, this impairment reflects:
- (a) an overpayment;
 - (b) an event that occurred between the acquisition and the first year review; or
 - (c) depletion of the acquired goodwill or intangible asset between the acquisition and the first year review that exceeds the amount recognised through amortisation.
- 36** The requirements of the FRS are such that the recognition of an impairment loss must be justified in the same way as the absence of an impairment loss, ie by reference to expected future cash flows. In particular, a belief that the value of goodwill will not be capable of continued measurement in future does not justify writing off the whole balance at the time of the first year impairment review: it should be possible

to perform the first year impairment review by updating investment appraisal calculations. The remaining carrying value would then be amortised over a period not exceeding 20 years.

- 37 Goodwill and intangible assets that are amortised over a period exceeding 20 years from the date of acquisition or are not amortised should be reviewed for impairment at the end of each reporting period.**
- 38 After the first period the reviews need only be updated. If expectations of future cash flows and discount rates have not changed significantly, the updating procedure will be relatively quick to perform. If there have been no adverse changes in the key assumptions and variables, or if there was previously substantial leeway between the carrying value and estimated value in use, it may even be possible to ascertain immediately that an income-generating unit is not impaired.

Procedures for performing impairment reviews

- 39 Except as permitted in paragraph 40, impairment reviews should be performed in accordance with the requirements of the FRS on impairment of fixed assets and goodwill.**
- 40 The first year impairment review required by paragraph 34(a) may be performed in two stages:**
- (a) **initially identifying any possible impairment by comparing post-acquisition performance in the first year with pre-acquisition forecasts used to support the purchase price; and**

- (b) performing a full impairment review in accordance with the requirements of the FRS on impairment of fixed assets and goodwill only if the initial review indicates that the post-acquisition performance has failed to meet pre-acquisition expectations or if any other previously unforeseen events or changes in circumstances indicate that the carrying values may not be recoverable.
- 41 If an impairment loss is recognised, the revised carrying value, if being amortised, should be amortised over the current estimate of the remaining useful economic life.
- 42 If goodwill arising on consolidation is found to be impaired, the carrying amount of the investment held in the accounts of the parent undertaking should also be reviewed for impairment.

Revaluation and restoration of past losses

- 43 Where an intangible asset has a readily ascertainable market value, the asset may be revalued to its market value. If one intangible asset is revalued, all other capitalised intangible assets of the same class should be revalued. Once an intangible asset has been revalued, further revaluations should be performed sufficiently often to ensure that the carrying value does not differ materially from the market value at the balance sheet date.
- 44 Where an external event caused the recognition of an impairment loss in previous periods, and subsequent external events clearly and demonstrably reverse the effects of that event in

a way that was not foreseen in the original impairment calculations, any resulting reversal of the impairment loss that increases the recoverable amount of the goodwill or intangible asset above its current carrying value should be recognised in the current period.

- 45 **Except as permitted or required by paragraphs 43 and 44, goodwill and intangible assets should not be revalued, either to increase the carrying value above original cost or to reverse prior period losses arising from impairment or amortisation.**
- 46 An impairment review may identify that an impairment loss recognised in an earlier period has reversed in the current period. In general, such reversals will be the result of the internal generation of goodwill or intangible asset value. The FRS does not permit such restorations to be reflected in the financial statements. However, where the original impairment of goodwill or an intangible asset was caused by an external event and reverses because the external event reverses in a way that was not foreseen when the original impairment calculations were performed, the FRS requires the resulting restoration to be reflected in the financial statements.
- 47 **The amortisation charge for revalued assets should be based on the revalued amounts and the remaining useful economic lives of the assets. Amortisation charged before the revaluation should not be written back in the profit and loss account.**

Negative goodwill

- 48 If an acquisition appears to give rise to negative goodwill, the fair values of the acquired assets should be tested for impairment and the fair values of the acquired liabilities checked carefully to ensure that none has been omitted or understated. Negative goodwill remaining after the fair values of the assets and liabilities have been checked should be recognised and separately disclosed on the face of the balance sheet, immediately below the goodwill heading and followed by a subtotal showing the net amount of the positive and negative goodwill.
- 49 Negative goodwill up to the fair values of the non-monetary assets acquired should be recognised in the profit and loss account in the periods in which the non-monetary assets are recovered, whether through depreciation or sale.
- 50 Any negative goodwill in excess of the fair values of the non-monetary assets acquired should be recognised in the profit and loss account in the periods expected to be benefited.
- 51 Purchased goodwill (positive or negative) arising on a single transaction should not be divided into positive and negative components.

*Disclosures**Recognition and measurement*

- 52 The financial statements should describe the method used to value intangible assets.

- 53 The following information should be disclosed separately for positive goodwill, negative goodwill and each class of intangible asset capitalised on the balance sheet:**
- (a) the cost or revalued amount at the beginning of the financial period and at the balance sheet date;**
 - (b) the cumulative amount of provisions for amortisation or impairment at the beginning of the financial period and at the balance sheet date;**
 - (c) a reconciliation of the movements, separately disclosing additions, disposals, revaluations, transfers, amortisation, impairment losses, reversals of past impairment losses and amounts of negative goodwill written back in the financial period; and**
 - (d) the net carrying amount at the balance sheet date.***
- 54 The financial statements should disclose the profit or loss on each material disposal of a previously acquired business or business segment.**

Amortisation of positive goodwill and intangible assets

- 55 The financial statements should disclose the methods and periods of amortisation of goodwill and intangible assets and the reasons for choosing those periods.†**

* See paragraph 18 of Appendix I 'Note on Legal Requirements'.

† See paragraph 6 of Appendix I 'Note on Legal Requirements'.

- 56 Where an amortisation period is shortened or extended following a review of the remaining useful economic lives of goodwill and intangible assets, the reason and the effect, if material, should be disclosed in the year of change.
- 57 Where there has been a change in the amortisation method used, the reason and the effect, if material, should be disclosed in the year of change.
- 58 Where goodwill or an intangible asset is amortised over a period that exceeds 20 years from the date of acquisition or is not amortised, the grounds for rebutting the 20-year presumption should be given. This should be a reasoned explanation based on the specific factors contributing to the durability of the acquired business or intangible asset.
- 59 In addition, where goodwill in the financial statements of companies is not amortised, the financial statements should state that they depart from the specific requirement of companies legislation to amortise goodwill over a finite period* for the overriding purpose of giving a true and fair view. Particulars of the departure, the reasons for it and its effect should be given in sufficient detail to convey to the reader of the financial statements the circumstances justifying the use of the true and fair override.† The reasons for the departure should incorporate the explanation of the specific factors contributing to the durability of the acquired business or intangible asset required by paragraph 58.

* See paragraph 6 of Appendix I 'Note on Legal Requirements'.

† See paragraph 20 of Appendix I 'Note on Legal Requirements'.

- 60 Companies legislation requires goodwill that is treated as an asset to be amortised systematically over a finite period. Where a company's financial statements depart from the specific requirements of companies legislation for the overriding purpose of providing a true and fair view, they are required to disclose particulars of the departure, the reasons for it and its effect. UITF Abstract 7 'True and fair view override disclosures' gives guidance as to what such particulars should contain in order to provide the reader of the financial statements with a clear and unambiguous account of the reasons surrounding the departure from the statutory requirement. The specific factors will be unique to the circumstances of each case. The guidance in UITF Abstract 7 encompasses the disclosures necessary when it is not possible to quantify the effect of the departure, as will be the case when goodwill is not amortised.

Revaluation

- 61 **Where a class of assets has been revalued, the financial statements should disclose:**
- (a) **the year in which the assets were valued, the values and the bases of valuation; and**
 - (b) **the original cost (or original fair value) of the assets and the amount of any provision for amortisation that would have been recognised if the assets had been valued at their original cost or fair value.***
- 62 **Where any asset has been revalued during the year, the name and qualifications of the person who valued it should be disclosed.***

* See paragraph 19 of Appendix I 'Note on Legal Requirements'.

Negative goodwill

- 63 The financial statements should disclose the period(s) in which negative goodwill is being written back in the profit and loss account.**
- 64 Where negative goodwill exceeds the fair values of the non-monetary assets, the amount and source of the 'excess' negative goodwill and the period(s) in which it is being written back should be explained.**

Date from which effective

- 65 The accounting practices set out in the FRS should be regarded as standard in respect of financial statements relating to accounting periods ending on or after 23 December 1998. Earlier adoption is encouraged but not required.**

Transitional arrangements

- 66 Subject to the provisions of paragraphs 68 and 69, changes in accounting policy required to implement the requirements of the FRS should be applied retrospectively.**
- 67 The way in which prior period adjustments are made and disclosed is set out in FRS 3 'Reporting Financial Performance' and UITF Abstract 14 'Disclosure of changes in accounting policy'.**
- 68 Ideally, all goodwill that had previously been eliminated against reserves but would not have been fully written down under the requirements of the FRS would be reinstated by means of prior year adjustment on implementation of the FRS. However, the Board recognises that this will not be practicable in all circumstances, and therefore does not require reinstatement.**

- 69** In those cases where all goodwill previously eliminated against reserves is not reinstated on implementation of the FRS, the goodwill remaining eliminated against reserves should comprise one of the following:
- (a)** goodwill relating to acquisitions made before 23 December 1989 where the necessary information is unavailable or cannot be obtained without unreasonable expense or delay; or
 - (b)** all goodwill eliminated before the implementation of FRS 7; or
 - (c)** all goodwill previously eliminated.
- 70** Where goodwill that was previously eliminated against reserves is reinstated on implementation of the FRS:
- (a)** any impairment that is attributed to prior periods must be determined on the basis of impairment reviews performed in accordance with the FRS on impairment of fixed assets and goodwill;
 - (b)** the notes to the financial statements should disclose the original cost of the goodwill and the amounts attributed to prior period amortisation and, separately, prior period impairment;
 - (c)** it is not necessary to identify separately intangible assets that are subsumed within the goodwill.

71 If goodwill remains eliminated against reserves:**(a) the financial statements should state:**

(i) the accounting policy followed in respect of that goodwill;

(ii) the cumulative amounts of positive goodwill eliminated against reserves and negative goodwill added to reserves, net of any goodwill attributable to businesses disposed of before the balance sheet date^{*}; and

(iii) the fact that this goodwill had been eliminated as a matter of accounting policy and would be charged or credited in the profit and loss account on subsequent disposal of the business to which it related.

(b) the eliminated goodwill should not be shown as a debit balance on a separate goodwill write-off reserve but should be offset against the profit and loss account or another appropriate reserve. The amount by which the reserve has been reduced by the elimination of goodwill (or increased by the addition of negative goodwill) should not be shown separately on the face of the balance sheet.

** In the UK, disclosure of amounts pertaining to an overseas business need not be given if it would be seriously prejudicial to the business and official agreement has been obtained. For acquisitions before 23 December 1989 (in Northern Ireland, 1 April 1990), disclosure need not be made if the information necessary to calculate the amount with material accuracy is unavailable or cannot be obtained without unreasonable expense or delay. The exclusion of such amounts and the grounds for the exclusion should be stated. See also paragraph 8 of Appendix I 'Note on Legal Requirements'.*

- (c) in the reporting period in which the business with which the goodwill was acquired is disposed of or closed:**
- (i) the amount included in the profit or loss account in respect of the profit or loss on disposal or closure should include attributable goodwill to the extent that it has not previously been charged in the profit and loss account; and**
 - (ii) the financial statements should disclose as a component of the profit or loss on disposal or closure the attributable amount of goodwill so included.**

Where it is impractical or impossible to ascertain the goodwill attributable to a business that was acquired before 1 January 1989, this should be stated and the reasons given.

- 72 SSAP 22 provided guidance on the circumstances in which goodwill arising in the accounts of an individual company and eliminated against reserves should be regarded as a reduction in realised reserves. This guidance continues to apply to goodwill that remains eliminated against reserves under the transitional arrangements of the FRS. It is reproduced in Appendix V.
- 73 **Until an FRS on impairment is published, impairment reviews should be performed in accordance with the proposals set out in FRED 15 'Impairment of Intangible Assets and Goodwill', except that disclosure need not be made of discount rates used when an impairment loss has been measured by reference to value in use.**

- 74 **Any impairment loss relating to previously capitalised goodwill and intangible assets that is recognised on first implementing the FRS should be charged as an expense in the period.**
- 75 Companies legislation already requires a provision to be made for any permanent diminution in the value of a fixed asset. Therefore, any impairment loss relating to previously capitalised goodwill and intangible assets that is recognised on first implementing the FRS represents a change in an accounting estimate, which is charged as a loss in the period.
- 76 Examples of the adjustments that will be required under the transitional arrangements are summarised opposite:

<i>Circumstances</i>	<i>Requirements</i>	<i>Method</i>
(a) Goodwill previously eliminated against reserves	1 Leave eliminated against reserves until business disposed of.	If necessary, transfer from separate goodwill write-off reserve to another reserve. Deduct from profit on any future disposal.
	2 Capitalise at cost less amortisation or impairment attributed to previous periods. Amortise thereafter where appropriate.	Make prior year adjustment.
(b) Internally developed intangible assets that do not meet new recognition criteria	Write off.	Make prior year adjustment.
(c) Revalued purchased intangible assets	1 If asset has a readily ascertainable market value, update value.	Report value change as current year gain or loss.
	2 If asset does not have a readily ascertainable market value, restate at cost less amortisation or impairment attributed to previous periods.	Make prior year adjustment.

Withdrawal of SSAP 22 and UITF Abstract 3 and amendment of FRS 2

- 77 Except for smaller entities applying the FRSE, the FRS supersedes SSAP 22 'Accounting for goodwill' and UITF Abstract 3 'Treatment of goodwill on disposal of a business'.**
- 78 The FRS amends the second sentence of paragraph 47 of FRS 2 'Accounting for Subsidiary Undertakings' to:**

“The net assets compared should include any related goodwill that has not previously been either written off through the profit and loss account or attributed to prior period amortisation or impairment on applying paragraph 70 of FRS 10 'Goodwill and Intangible Assets'.”

ADOPTION OF FRS 10 BY THE BOARD

Financial Reporting Standard 10 - 'Goodwill and Intangible Assets' was approved for issue by a vote of nine of the ten members of the Accounting Standards Board. Mr Hinton dissented. His dissenting view is set out in Appendix IV.

Members of the Accounting Standards Board

Sir David Tweedie (Chairman)

Allan Cook (Technical Director)

David Allvey

Ian Brindle

Dr John Buchanan

John Coombe

Raymond Hinton

Huw Jones

Professor Geoffrey Whittington

Ken Wild

APPENDIX I

NOTE ON LEGAL REQUIREMENTS

Great Britain

- 1 In Great Britain, the statutory requirements relating to accounting for goodwill and intangible assets are set out in the Companies Act 1985. The main requirements that are directly relevant to goodwill and intangible assets and the requirements of FRS 10 are set out in Schedules 4 and 4A and are summarised below.
- 2 Schedule 4 does not apply to banking and insurance companies and groups. Requirements equivalent to those of Schedule 4 are contained in Schedule 9 (for banking companies and groups) and in Schedule 9A (for insurance companies and groups).

Goodwill

- 3 The acquisition method of accounting and the calculation of goodwill are described by paragraph 9(4) and (5) of Schedule 4A. The interest of the parent company and its subsidiaries in the adjusted capital and reserves of an acquired subsidiary undertaking must be offset against the acquisition cost. The resulting amount if positive must be treated as goodwill, and if negative as a negative consolidation difference.
- 4 The balance sheet formats in Schedule 4 require purchased goodwill, to the extent that it has not been written off, to be included under the heading of intangible fixed assets, and shown separately from other intangible assets. Note (3) to the formats states that amounts representing goodwill should be included only to the extent that the goodwill was acquired for valuable consideration. Internally generated goodwill may not be capitalised.

- 5 Paragraph 5 of Schedule 4 states that amounts in respect of items representing assets may not be set off against amounts in respect of items representing liabilities. For this reason, the FRS requires negative goodwill to be shown separately from positive goodwill on the face of the balance sheet.
- 6 Paragraph 21 of Schedule 4 requires that, where goodwill is treated as an asset, it must be depreciated systematically over a period chosen by the directors. The period chosen must not exceed the useful economic life of the goodwill. The period chosen and the reason for choosing that period must be disclosed in a note. (No residual value is permitted for goodwill.)
- 7 Paragraph 31(1) of Schedule 4 prohibits the revaluation of goodwill.
- 8 Paragraph 14 of Schedule 4A requires the notes to the accounts to state the cumulative amount of goodwill resulting from acquisitions in that and earlier financial years that has been written off. That figure must be net of any goodwill attributable to subsidiary undertakings or businesses disposed of before the balance sheet date. Paragraph 16 of Schedule 4A states that disclosure of amounts pertaining to an overseas business need not be given if it would be seriously prejudicial to the group's business and agreement has been obtained from the Secretary of State. Further, for acquisitions before 23 December 1989, disclosure need not be made if the information necessary to calculate the amount with material accuracy is unavailable or cannot be obtained without unreasonable expense or delay (paragraph 9 of Schedule 2 to the Companies Act 1989 (Commencement No. 4 and Transitional and Saving Provisions) Order 1990). The exclusion of such amounts and the grounds for the exclusion must be stated.

Intangible assets

- 9 Paragraph 9(2) of Schedule 4A requires, under the acquisition method of accounting, the identifiable assets and liabilities of an acquired undertaking to be included in the consolidated balance sheet at their fair values as at the date of acquisition. It defines “identifiable” as capable of being disposed of or discharged separately, without disposing of a business of the undertaking.
- 10 The following headings for intangible assets are set out in the balance sheet formats in Schedule 4:
- B Fixed assets
 - I Intangible assets
 - 1. Development costs
 - 2. Concessions, patents, licences, trade marks and similar rights and assets
 - 3. Goodwill
 - 4. Payments on account.
- 11 Note (2) on the balance sheet formats permits amounts in respect of assets to be included in a company’s balance sheet under the heading of concessions, patents, licences, trade marks and similar rights and assets only if either (a) the assets were acquired for valuable consideration and are not required to be shown under goodwill; or (b) the assets in question were created by the company itself.

- 12 Paragraph 18 requires that, where a fixed asset has a limited useful economic life, the purchase price or production cost less any residual value is reduced by provisions for depreciation calculated to write off that amount systematically over the period of the asset's useful economic life.
- 13 Paragraph 31(1) permits intangible assets, other than goodwill, to be included at their current cost. Where an intangible asset is valued at its current cost, the depreciation rules are to be applied by substituting the most recently determined value for the purchase price or production cost (paragraph 32(1)).

Provisions for diminution in value

- 14 Paragraph 19(2) of Schedule 4 requires provisions for diminution in value to be made in respect of any fixed asset that has diminished in value if the reduction in its value is expected to be permanent. Any provisions that are not shown in the profit and loss account must be disclosed (either separately or in aggregate) in a note to the accounts.
- 15 Paragraph 19(3) of Schedule 4 requires that where the reasons for which a provision was made have ceased to apply to any extent, the provision must be written back to the extent that it is no longer necessary. Where any amounts written back are not shown in the profit and loss account, they must be disclosed (either separately or in aggregate) in a note to the accounts.

Amortisation and other amounts written off fixed assets

- 16 The formats set out in Schedule 4 prescribe the headings under which depreciation and other amounts written off tangible and intangible fixed assets are to be included in the profit and loss account. Under Formats 1 and 3, such amounts are to be included in

cost of sales, distribution costs and administrative expenses. Under Formats 2 and 4, such amounts are to be shown as a separate heading.

Disclosure requirements

- 17 Disclosure of the accounting policies adopted by a company (including the policies regarding the depreciation and diminution in value of assets) is required by paragraph 36 of Schedule 4.
- 18 Paragraph 42 of Schedule 4 details the disclosures required of the movement on goodwill and intangible asset balances. The same level of detail is required as for other fixed assets.
- 19 Paragraphs 33 and 43 of Schedule 4 prescribe additional information to be given for any assets that have been revalued. This includes comparable amounts determined according to the historical cost accounting rules and details of the basis and date of the valuation and the qualifications of the valuer.

True and fair override

- 20 Sections 226(3) and 227(4) require the individual and group accounts of a company to comply with the provisions of Schedules 4 and 4A respectively. If, in exceptional circumstances, compliance with any of the provisions is inconsistent with the requirement to give a true and fair view, sections 226(5) and 227(6) require the directors to depart from those provisions to the extent necessary to give a true and fair view. Particulars of any such departure, the reasons for it and its effect are to be given in a note to the accounts.

Northern Ireland

- 21 The statutory requirements in Northern Ireland are set out in the Companies (Northern Ireland) Order 1986. They are similar to those in Great Britain. Most of the references cited above have parallel references in the Companies (Northern Ireland) Order 1986. The only exceptions are that:
- (a) the requirements of sections 226 and 227 of the Companies Act 1985 are found in Articles 234 and 235 of the Companies (Northern Ireland) Order 1986; and
 - (b) the transitional arrangements permitted by paragraph 9 of Schedule 2 to the Companies Act 1989 (Commencement No. 4 and Transitional and Saving Provisions) Order 1990 are found in paragraph 9 of the Companies (1990 Order) (Commencement No. 1) Order (Northern Ireland) 1990. They apply to acquisitions made before 1 April 1990.

Republic of Ireland

- 22 The statutory requirements in the Republic of Ireland that correspond to those listed above for Great Britain are shown in the following table.

<i>Great Britain</i>	<i>Republic of Ireland</i>
Section 226 of the Companies Act 1985	Section 3(1) of the Companies (Amendment) Act 1986
Section 227(4) and (6) of the Companies Act 1985	Regulations 15(1) and 14(4) of the European Communities (Companies: Group Accounts) Regulations 1992

Paragraph 5 of Schedule 4 to the Companies Act 1985	Section 4(11) of the Companies (Amendment) Act 1986
Schedule 4 to the Companies Act 1985:	The Schedule to the Companies (Amendment) Act 1986:
- notes (2) and (3) on the formats	- notes (1) and (2) on the formats
- paragraph 18	- paragraph 6
- paragraph 19(2) and (3)	- paragraph 7(1) and (2)
- paragraph 21	- paragraph 9
- paragraphs 31(1) and 32(1)	- paragraphs 19(1) and 20(1)
- paragraphs 33 and 36	- paragraphs 21 and 24
- paragraphs 42 and 43	- paragraphs 29 and 30
Schedule 4A to the Companies Act 1985:	European Communities (Companies: Group Accounts) Regulations 1992:
- paragraph 9(2), (4) and (5)	- Regulation 19(2), (4), (5) and (6)
- paragraphs 14 and 16	- no corresponding references
23	There are no transitional provisions in the Republic of Ireland that correspond to those given in paragraph 9 of Schedule 2 to the Companies Act 1989 (Commencement No. 4 and Transitional and Saving Provisions) Order 1990.

APPENDIX II

COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

- 1 At present, accounting for goodwill is addressed in International Accounting Standard (IAS) 22 'Business Combinations'. Other than IAS 9 'Research and Development Costs', there are at present no IASs addressing intangible assets.
- 2 The objective of IAS 22 is to write off goodwill over the estimated useful economic life of the original purchased goodwill. The difference between this approach and the approach adopted in the FRS gives rise to a number of differences in the detailed requirements. IAS 22 states that:
 - (a) purchased goodwill should be amortised over its estimated useful economic life in all circumstances.
 - (b) the amortisation period should not exceed five years unless a longer period, not exceeding 20 years from the date of acquisition, can be justified.
 - (c) the unamortised balance of goodwill should be reviewed at each balance sheet date and, to the extent that it is not expected to be recoverable, it should be written down. The write-down may not subsequently be reversed.
 - (d) one of two treatments should be adopted for negative goodwill. The benchmark treatment requires the fair values of the non-monetary assets acquired to be reduced proportionately until the negative goodwill is eliminated. The permitted alternative treatment requires negative goodwill to be shown as deferred income in the balance sheet and released to the profit and loss account on a

systematic basis over a period that does not exceed five years, unless a longer period not exceeding 20 years can be justified.

- 3 In August 1997, the International Accounting Standards Committee (IASC) published two Exposure Drafts, E60 'Intangible Assets' and E61 'Business Combinations'. The proposals in those Exposure Drafts would align the international requirements for goodwill with those for intangible assets and would reduce the extent of the differences between the FRS and IASs.
- 4 Like the FRS, E60 and E61 propose a rebuttable presumption that goodwill and intangible assets have useful economic lives of 20 years or less. They also propose that if the presumption can be rebutted, the goodwill or intangible asset may be amortised over a longer period providing that annual impairment reviews are also performed. The most significant difference between IASC's proposals and the requirements of the FRS is that, under the proposals in E60 and E61, goodwill and intangible assets cannot be regarded as having an indefinite life and must be amortised in all circumstances.
- 5 Other aspects of E60 and E61 that would give rise to differences between the FRS and international requirements include proposals that:
 - internally developed intangible assets may be capitalised whenever their costs can be measured reliably, rather than only when they are of a type that is traded on an active market. E60 specifically states that the costs of generating brands, mastheads and other similar assets cannot be measured reliably. Given this, it is expected that there will be few intangible assets which, in practice, can be capitalised under the proposals in E60 that could not be capitalised under the FRS.

- details of intangible assets whose individual values exceed 5 per cent of total assets should be disclosed.
- costs of research and development, software, advertising, pre-opening costs, and any other significant costs incurred on intangible items charged in the profit and loss account in the year should be disclosed.
- negative goodwill attributable to future costs or losses that were identified in the acquirer's purchase plan (and not provided for as identifiable liabilities) should be released as these costs or losses occur.
- other negative goodwill should be released on a systematic basis over the useful lives of the non-monetary assets acquired. Where such negative goodwill exceeds the value of the non-monetary assets, the excess should be released to the profit and loss account immediately.

E60 and E61 do not propose to require the values assigned to intangible assets to be capped at amounts that do not create or increase negative goodwill. Neither do they propose to require first year impairment reviews to be performed.

APPENDIX III

THE DEVELOPMENT OF THE FRS

The need for a review

- 1 The FRS, when implemented, replaces SSAP 22 'Accounting for goodwill'. The SSAP permitted a choice of two approaches to accounting for purchased goodwill. The preferred approach was immediate elimination against reserves. The permitted alternative approach was capitalisation as an asset, with subsequent write-off by systematic amortisation through the profit and loss account. SSAP 22 prohibited the recognition of internally generated goodwill.

- 2 In the late 1980s, the Accounting Standards Board's predecessor body, the Accounting Standards Committee, started a project to replace SSAP 22. On its inception, the Board decided to continue this project. The decision was taken for several reasons. First, the Board took the view that there was a need to restrict accounting for goodwill to a single method. Secondly, it believed that with the growing practice of separating intangible assets from goodwill, there was a need to codify best practice in accounting for intangible assets. The similarities between goodwill and certain types of intangible assets acquired with a business made it appropriate to review the two together. Finally, the Board recognised that SSAP 22's preferred method of accounting for goodwill, whereby it was eliminated immediately against reserves, attracted criticism and was becoming less accepted internationally. Following its revision in 1993, IAS 22, the International Accounting Standard on accounting for business combinations, prohibited SSAP 22's preferred approach.

Different approaches to accounting for goodwill

Elimination against reserves

- 3 The preferred method of accounting for purchased goodwill under SSAP 22 was immediate elimination against reserves. The principal rationale for this treatment was that it was consistent with the accepted practice of not including internally generated goodwill on the balance sheet. It can further be argued that goodwill is not an asset that should be recognised by a reporting entity since it is not a right to future economic benefits controlled by the entity.

- 4 However, the practice of eliminating goodwill against reserves has weaknesses:
 - immediate elimination of goodwill gives the impression that the acquirer's net worth has been depleted or even eliminated.

 - the problem of equity depletion has encouraged companies to reduce amounts attributed to purchased goodwill by separately valuing brands and similar intangible assets at the date of purchase. Given that such intangible assets are very similar in nature to goodwill and the allocation of value between the two can be subjective, it is widely thought to be inappropriate that the goodwill should be accounted for differently.

 - management is not held accountable for the amount that it has invested in goodwill: it is not taken into account when measuring the assets on which a return must be earned, and there is no requirement to disclose a loss if the value of the goodwill is not maintained.

- although there is consistency in the balance sheet treatment of purchased and internally generated goodwill, there is no consistency in the profit and loss account treatment: the costs that can be attributed to building up internally generated goodwill are offset against profits in the profit and loss account, whereas the costs of acquired goodwill are not charged against profits in this way unless the acquired business is sold.
- this inconsistency serves to make companies that grow by acquisition appear more profitable than those that grow organically.

Capitalisation and compulsory amortisation

- 5 An alternative approach to accounting for purchased goodwill, permitted by SSAP 22 and widely adopted internationally, is to capitalise it and amortise it on a systematic basis over a finite period. This approach is based on the rationale that purchased goodwill has a value at the time of recognition but that this value diminishes over time as the purchased goodwill is gradually replaced by internally generated goodwill.
- 6 This approach is also open to criticism. In 1990, the Accounting Standards Committee issued Exposure Drafts ED 47 'Accounting for goodwill' and ED 52 'Accounting for intangible assets'. They proposed that purchased goodwill and intangible assets should be capitalised and amortised systematically over their estimated useful economic lives, which in general should not exceed 20 years and in no circumstance could exceed 40 years. Opposition to the proposals was strong: 93 per cent of corporate respondents and 73 per cent of all respondents opposed ED 47; 80 per cent of corporate respondents and 62 per cent of all respondents opposed ED 52.

- 7 Those opposing the proposals argued primarily that, where large sums were spent on maintaining and developing the value of an acquired business, a requirement to amortise a significant part of the investment over an arbitrary period had no economic meaning.

Capitalisation and annual impairment reviews

- 8 Many of the respondents opposed to amortisation of purchased goodwill agreed that it should be capitalised but thought that it should subsequently be written down only if and to the extent that the carrying value of the goodwill was not supported by the current value of goodwill in the acquired business.
- 9 This approach is based on the premise that purchased goodwill is neither an identifiable asset like other assets nor an immediate loss in value. Rather, it represents the balance of the purchase consideration that remains after recognising all the identifiable assets and liabilities in the consolidated financial statements. Essentially, it forms a bridge between the cost of the investment shown as an asset in the acquirer's individual financial statements and the identifiable assets and liabilities recognised in the consolidated financial statements of the combined entities. Although purchased goodwill is not in itself an asset, its inclusion amongst the assets of the reporting entity, rather than as a deduction from shareholders' equity, recognises that goodwill is part of a larger asset, the investment, for which management remains accountable.
- 10 This method ensures that the financial statements reflect management's success in maintaining the value of the goodwill and generating a return from its investment. It can be criticised for treating purchased goodwill differently from internally generated goodwill, although this is true for all methods of accounting for purchased goodwill. Other issues are that:

- impairment reviews, which rely on forecasts of future cash flows, can be subjective.
- impairment reviews are onerous and may not be feasible on an annual basis. Where goodwill has a finite life, amortisation may provide a much simpler, yet adequate, method of reflecting the depletion in value of the goodwill.
- amortisation of goodwill is required by companies legislation.

The FRS's approach to accounting for goodwill

- 11 The Board recognised when it started its review that goodwill is something of an accounting anomaly. It arises from a distinct transaction that must be accounted for, yet—as illustrated above—each method of accounting for it results in inconsistencies with other aspects of financial reporting. No single method is universally accepted as being the correct one. Preferences for one method or another tend to be determined by the conceptual and practical issues deemed to be the most important in the light of each individual's particular experience.
- 12 To gather as many arguments as possible, the Board issued a Discussion Paper that explored a number of options.* Six possible methods were discussed:
- 1 Capitalisation and amortisation over a finite period.
 - 2 Capitalisation and annual impairment reviews.

* Discussion Paper 'Goodwill and Intangible Assets', December 1993.

- 3 A combination of methods 1 and 2, with method 2 being used only in the special circumstances where goodwill had an indefinite life believed to exceed 20 years.
 - 4 Immediate elimination against reserves.
 - 5 Immediate elimination to a separate goodwill write-off reserve.
 - 6 Transfer to a separate goodwill write-off reserve, with annual reviews of recoverability and any impairments being charged to the profit and loss account.
- 13 Methods 2, 3 and 6 represented a departure from traditional methods of accounting for goodwill. Their aim was to recognise the cost of goodwill as a loss only to the extent that the value of goodwill within the acquired business had reduced below the carrying value of the purchased goodwill.
- 14 No overall consensus emerged from the responses to the Discussion Paper. The method that individually achieved greatest support was method 5—immediate transfer to a separate write-off reserve. However, more respondents favoured capitalisation methods than favoured elimination methods.
- 15 Given the arguments made by respondents, and in the light of both the direction being taken internationally and the previous opposition to ED 47's proposals for compulsory amortisation, the Board decided to develop proposals based on method 3—capitalisation with a combination of amortisation for goodwill with a finite life and annual impairment reviews for goodwill with an indefinite life expected to exceed 20 years. In combining the amortisation and impairment options, the Board was seeking to overcome the practical and legal issues that would arise under method 2.

- 16 In favouring capitalisation rather than elimination against reserves, the Board was influenced in particular by the arguments that:
- (a) a method requiring elimination against reserves would treat goodwill very differently from brands and similar intangible assets. Given that such assets are very similar in nature to goodwill and that the allocation of a purchase cost between the two can be subjective, it would be possible for a reporting entity's results to be shown in a more favourable light merely by classifying expenditure as an intangible asset rather than goodwill, or vice versa.
 - (b) immediate elimination of goodwill against reserves fails to demonstrate management's accountability for goodwill as part of the investment in an acquired business. The goodwill is not included in the assets on which a return must be earned, and under methods 4 and 5 no charge would be made in the profit and loss account if the value of the goodwill were not maintained.
- 17 The Board acknowledged that under method 6, whereby goodwill would be transferred to a separate goodwill write-off reserve and reviewed annually for impairment, there would be greater accountability. However, some companies told the Board that a requirement to perform detailed impairment reviews every year would be unacceptably onerous. An alternative could have been to require impairment reviews only when there was an indication that the goodwill had become impaired. But the Board took the view that, in the absence of amortisation, such a requirement would be insufficient to ensure that all impairment losses would be recognised on a timely basis. Losses could remain undetected until a major problem came to light.

- 18 In developing its chosen approach, the Board conducted extensive consultations with preparers, users and auditors of financial statements, in particular addressing concerns that the procedures proposed for impairment reviews were too complicated. The simplified proposals were field-tested by seven large acquisitive groups and, after further refinement, formed the basis of the Working Paper* for subsequent debate at a public hearing.
- 19 The proposals received broad support from the majority of those responding to the Working Paper. They formed the basis of the proposals for accounting for goodwill exposed in FRED 12 and the requirements subsequently included in the FRS.

The FRS's approach to accounting for intangible assets

- 20 Intangible assets lie on a spectrum ranging from those that can readily be identified and measured separately from goodwill to those that are essentially very similar to goodwill. Companies legislation permits intangible assets to be recognised separately from goodwill only where they are capable of being disposed of separately from a business of the reporting entity.†
- 21 In its Discussion Paper, the Board expressed a view that certain intangible assets such as brands and publishing titles could not be disposed of separately from a business and, further, that there was no generally accepted method of valuing such intangible assets. Given this, and given that the dividing line between goodwill and intangible assets can be unclear, the Board proposed in the Discussion Paper that intangible assets acquired as part of the acquisition of a business should be subsumed within the value attributed to goodwill.

* Working Paper 'Goodwill and Intangible Assets', June 1995.

† See paragraph 9 of Appendix I 'Note on Legal Requirements'.

- 22 This proposal met with strong opposition. Corporate respondents stressed that intangible assets could be critical to their businesses and that it was important to account for them separately.
- 23 The Board accepted these arguments and in its subsequent Working Paper proposed that intangible assets could be recognised separately from goodwill if they met the legal and conceptual requirements for identifiability and could be measured reliably on initial recognition. But to prevent the results of the reporting entity being shown in a more or less favourable light merely by classifying expenditure as an intangible asset rather than goodwill, or vice versa, the Board proposed that the accounting for intangible assets should be aligned with that for goodwill.
- 24 This proposal was accepted by most respondents to the Working Paper. It formed the basis of the accounting for intangible assets exposed in FRED 12 and subsequently required by the FRS.

The detailed proposals for positive goodwill and intangible assets

Capitalisation of internally generated intangible assets

- 25 In general, the FRS requires the costs of developing intangible assets internally to be charged as an expense as they are incurred. This requirement primarily reflects the Board's objective of aligning the treatment of intangible assets that are similar in nature to goodwill with the treatment of goodwill. The requirement also acknowledges that, at present, the measurement of the value of an intangible asset is often subjective. This is especially true in the absence of a transaction price, which establishes a ceiling on the value attributed to a purchased intangible asset.

- 26 The exception that permits capitalisation of intangible assets with readily ascertainable market values recognises that such assets are clearly distinguishable from goodwill and readily measurable. It is appropriate to treat those assets in the same way as tangible fixed assets, the costs of which can be capitalised whether they are purchased or self-constructed.
- 27 The Board acknowledges that there may be other intangible assets that would be more appropriately treated in the same way as tangible fixed assets, ie with the costs being capitalised even where the asset is developed internally. However, the Board believes that it would be very difficult to define the basis on which they could be distinguished from intangible assets that are similar in nature to goodwill. Hence, it would be difficult to ensure that only those assets that are genuinely different in nature from goodwill were treated as falling within this 'other' category. The approach that the Board has adopted is simpler and more objective.

Valuation of purchased intangible assets

- 28 There are two reasons for restricting the fair values that can be assigned to intangible assets to those that do not create or increase negative goodwill: first, the restriction aligns the treatment of purchased intangible assets with that of purchased goodwill and, secondly, it recognises that the values of intangible assets can be subject to a significant degree of uncertainty. Given this subjectivity, the Board regards it as appropriate to restrict the values to those that do not exceed the ceiling established by the purchase price.

Amortisation of goodwill

- 29 The required approach seeks to charge goodwill in the profit and loss account only to the extent that the carrying value of the goodwill is not supported by the current value of the goodwill within the acquired business. Systematic amortisation is a practical means of recognising the reduction in value of goodwill that has a limited useful economic life. It is also a means of ensuring that where goodwill is not capable of continued measurement (so that annual impairment reviews would not be feasible), its depletion is recognised over a prudent but not unrealistically short period.
- 30 The FRS defines the useful economic life of goodwill as the period over which the value of the underlying business is expected to exceed the values of the identifiable net assets. This reflects the link between the carrying value of the goodwill and the continuing value of the goodwill in the acquired investment.

Useful economic lives in excess of 20 years

- 31 The economic benefits that goodwill and intangible assets represent are generally more nebulous than those of tangible assets. The useful economic lives of goodwill and intangible assets are correspondingly less certain than those of tangible assets and the Board believes that there should be a presumption that they do not exceed a specified maximum period, chosen to be 20 years. The Board recognises that there will be circumstances where there are valid grounds for rebutting the presumption. Such grounds will be based on the nature of the intangible asset or of the investment underlying a goodwill balance.

- 32 Given the uncertainty in the useful economic life of goodwill or an intangible asset, the Board believes that it would be inappropriate to assume that it exceeds 20 years unless it will be possible to monitor the reasonableness of the resulting amortisation charge. For this reason, the ability to perform impairment reviews is one of the conditions that must be met in order to rebut the 20-year presumption.
- 33 The choice of 20 years as the presumed maximum useful economic life of goodwill and intangible assets is based largely on judgement. This period was first proposed in the Working Paper. Most respondents to the Working Paper and FRED 12 regarded it as reasonable and accordingly the Board has not changed it in the FRS. Twenty years is not entirely consistent with IAS 22, the International Accounting Standard on goodwill: IAS 22 contains a presumption that the useful economic life of goodwill does not exceed five years and sets 20 years as the absolute maximum. Nevertheless, the alignment of the presumed maximum life in the FRS with the maximum life specified by IAS 22 avoids the unnecessary complexities created by introducing a third arbitrary period.*
- 34 The inconsistency between IAS 22's presumed maximum life of five years and the FRS's presumed maximum life of 20 years reflects different underlying approaches. Whilst IAS 22 defines the useful economic life of goodwill as the period benefiting from the original purchased goodwill, the FRS defines it as the period over which the value of the underlying business continues to exceed the values of the identifiable net assets. The latter will normally be longer.

* At the date of publishing the FRS, IASC has published proposals that would remove the 20-year limit. For further details see Appendix II.

Indefinite useful economic lives

- 35 There may be circumstances in which goodwill or an intangible asset can be regarded as having an indefinite life. In such circumstances, amortisation over an arbitrary period may not be an appropriate method of reflecting the depletion of the goodwill or intangible asset. This will be the case where the value of the goodwill or intangible asset is expected to be capable of continued measurement in future. In such circumstances, the Board believes that a true and fair view will be given only if the goodwill or intangible asset is not amortised, but is instead subject to annual reviews for impairment.
- 36 The Board has been advised that non-amortisation of goodwill constitutes a departure from the specific requirement of companies legislation to depreciate the value attributed to goodwill over a limited period that does not exceed its useful economic life. However, departure from specific requirements such as this one is permitted by companies legislation in exceptional circumstances where it is necessary for the overriding purpose of providing a true and fair view.* Accordingly, the Board has limited the circumstances in which it proposes that goodwill is not amortised to those circumstances where systematic amortisation would not provide a true and fair view. It has also incorporated within the disclosure requirements the disclosures that are required by companies legislation where advantage has been taken of the true and fair override provisions.

* See paragraphs 6 and 20 of Appendix I 'Note on Legal Requirements'.

Impairment reviews

- 37 It is accepted practice that an asset should not be carried at more than its recoverable amount, ie the higher of the amount for which it could be sold and the amount recoverable from its future use.
- 38 Systematic amortisation ensures that the carrying value of an asset is reduced to reflect any gradual reduction in the asset's recoverable amount over its useful economic life. An asset that is amortised in an appropriate manner is unlikely to become materially impaired unless it is impaired on initial recognition or subsequent events or changes in circumstances cause a sudden reduction in the estimate of the recoverable amount. Thus, where goodwill and intangible assets are amortised over a period not exceeding 20 years, a requirement for an impairment review to be performed each period would be unnecessary and unduly onerous. The Board believes that, in such circumstances, impairment reviews are necessary only at the end of the first full financial year following initial recognition and, thereafter, if subsequent events or changes in circumstances indicate that the carrying value may not be recoverable.
- 39 The requirement to perform an impairment review at the end of the first full financial year following the initial recognition of goodwill and intangible assets ensures that any impairment arising on acquisition (ie any overpayment) is recognised as a loss at that time, rather than being amortised over the life of the asset.
- 40 The longer the useful economic lives assigned to goodwill and intangible assets, the greater is the risk that the recoverable amounts will fall below the carrying values in future. Where an amortisation period exceeds 20 years, the Board believes that the risk is sufficiently high to require amortisation to be supplemented by annual reviews for impairment.

Revaluations and restoration of past losses

- 41 The FRS prohibits capitalisation of internally generated goodwill and permits internally developed intangible assets to be capitalised only if they have readily ascertainable market values. Revaluation of goodwill and intangible assets has the effect of recognising values that have been internally developed. Hence, the FRS permits revaluation only of intangible assets that have readily ascertainable market values.
- 42 Following the recognition of an impairment loss, the value of the impaired goodwill or intangible asset may return towards its previous carrying value. Such an increase will usually be attributable to the internal generation of goodwill or intangible asset value, and as such should not be recognised as a restoration of a past loss.
- 43 Less frequently, the increase in value may be attributable to the unexpected reversal of an external event that caused the original impairment to be recognised. In these limited circumstances, the reversal of the impairment loss can be measured more reliably (by reference to the original impairment) and is required by companies legislation to be recognised in the financial statements.* Accordingly, the FRS permits restoration of past losses in such circumstances.

* See paragraph 15 of Appendix I 'Note on Legal Requirements'.

Negative goodwill

- 44 Negative goodwill can be attributed to two causes:
- a bargain purchase—the assets have been purchased for less than the aggregate of their individual fair values, perhaps because the vendor needs to achieve a quick sale
 - future costs or losses—the purchase price has been reduced to take account of future costs, such as reorganisation costs, or losses that do not represent identifiable liabilities at the balance sheet date.
- 45 There are a number of methods of accounting for negative goodwill that can be regarded as consistent with the FRS's approach to positive goodwill. Those methods and the Board's reasons for choosing the method required by the FRS are discussed below.

Goodwill attributable to a bargain purchase

- 46 Where negative goodwill is attributed to a bargain purchase, the acquirer can be viewed as having purchased the group of assets at a discount to their individual fair values.
- 47 In these circumstances, the value of the business acquired is not less than the fair values of its net assets. It may therefore be argued that the negative goodwill should be recognised as an immediate gain, reflecting the advantageous transaction that the acquirer has undertaken. Since the gain is unrealised, it cannot be recognised in the profit and loss account. Instead, like other revaluation gains, it should be recognised in the statement of total recognised gains and losses.

- 48 The Board believes that, in the same way as a revaluation reserve is treated as being realised as the asset is depreciated or sold, so negative goodwill becomes a realised gain as the asset purchased at a bargain price and valued at fair value is depreciated or sold. An alternative option is therefore to require negative goodwill to be recognised as a gain only when that asset is charged against realised profits, either through depreciation or cost of sales. At this point, the gain may be recognised in the profit and loss account.
- 49 FRED 12 proposed that negative goodwill attributed to a bargain purchase should be released immediately in the statement of total recognised gains and losses. The Board took the view that this approach would be more consistent with the proposal that positive goodwill should be written down as soon as it became impaired. However, a majority of the respondents to FRED 12 opposed this proposal, arguing that a requirement to recognise a gain on non-monetary assets before the gain was realised was inconsistent with the requirements of other standards. The Board accepted this argument and the FRS requires negative goodwill to be released as the non-monetary assets acquired are used or sold.
- 50 The assets that are considered in determining the periods in which negative goodwill is released in the profit and loss account are the non-monetary assets only. This reflects the Board's view that, where a business with both monetary and non-monetary assets is purchased, it is unlikely that the monetary assets would be purchased at an artificially low price, since they can generally be disposed of individually at their fair values.

- 51 The Board considered a method of accounting for negative goodwill that would require negative goodwill to be eliminated against the fair values of the non-monetary assets acquired. Those supporting this method argue that it:
- is consistent with the principle that assets should initially be recognised at cost.
 - helps to prevent unrealistically high fair values being assigned to assets whose values are very subjective. There is a view that true bargain purchases are not as common as optimistic purchasers tend to believe them to be and that cost may represent a realistic estimate of fair value.
 - is objective and simple to apply.
- 52 However, the Board has taken the view that fair values can be different from cost and that a method that requires assets to be stated at amounts lower than their fair values is inconsistent with the requirements in FRS 7 'Fair Values in Acquisition Accounting'. The Board has also taken into consideration the fact that, if such a method were used, the impact of the negative goodwill on the financial statements would not be transparent.
- 53 The FRS instead requires negative goodwill to be shown separately. But just as positive goodwill is not viewed in the FRS as an asset, so negative goodwill is not viewed as a liability. The Board regards both as the bridge between the consolidated financial statements and the investment shown as an asset in the acquirer's own financial statements. Accordingly, negative goodwill is recognised next to positive goodwill.

Negative goodwill attributable to future reorganisation costs

- 54 Where negative goodwill is attributable to future costs and losses that do not represent identifiable liabilities at the acquisition date, the value of the acquired business is being viewed as being no higher than the price paid for it. The assets that have been acquired are encumbered in such a way that their combined value in use is less than their individual fair values, until the costs or losses materialise and eliminate the difference.
- 55 One method of accounting for the negative goodwill arising in these circumstances is to release it as the reorganisation costs or losses subsequently materialise. The rationale is that the negative goodwill is released to match the costs that gave rise to it. But this method raises a number of issues:
- (a) the treatment of future reorganisation costs or losses varies depending on whether the acquisition gives rise to positive goodwill or to negative goodwill. Where the net goodwill is positive, the amount by which it has been reduced by an expectation of future costs or losses cannot be written back as the costs or losses are incurred.
 - (b) both the fair values of non-monetary assets and the allocation of negative goodwill between its two possible causes can be subjective. Stringent conditions would be necessary to ensure that fair values were not overstated thereby attributing too much negative goodwill to future costs and losses. Such conditions would add to the complexity of the requirements.
 - (c) views have been expressed that the gain in the value of the investment that arises when the future costs or losses have been incurred might

not be a realised gain that can be recognised in the profit and loss account. However, respondents to FRED 12 strongly opposed the proposal that negative goodwill attributable to future reorganisation costs or losses should be released in the statement of total recognised gains and losses. They argued in particular that, if a loss of positive goodwill is charged in the profit and loss account, a reversal of negative goodwill should be credited in the same statement.

- 56 It can further be argued that a separate accounting treatment for negative goodwill arising in expectation of future costs or losses is unnecessary: such negative goodwill, like that arising from a bargain purchase, should be released as the non-monetary assets are recovered. The argument is that the value of the income-generating units acquired (which will be equal to the present value of the expected future cash flows) is less than the aggregate of the values attributed to the individual assets, so the non-monetary assets in their present state and condition can be viewed as being encumbered or impaired.* This impairment is recognised by deferring the release of the negative goodwill until the acquired assets are recovered through depreciation or sale.
- 57 In requiring negative goodwill to be treated in the same manner, whatever its cause, the Board was influenced by the arguments set out above. It notes that the requirement to perform impairment reviews whenever negative goodwill appears to have arisen will eliminate much of the negative goodwill that would otherwise be attributed to future costs or losses.

* *The monetary assets are unlikely to be impaired, since it is likely that they will be capable of being realised individually at their fair values.*

Negative goodwill in excess of the fair values of the non-monetary assets

- 58 As negative goodwill is expected to occur rarely, negative goodwill in excess of the fair values of the non-monetary assets acquired is expected to occur only extremely rarely and in unusual circumstances. Given this, the FRS does not prescribe the period over which 'excess' negative goodwill should be written back.
- 59 The FRS does not permit purchased goodwill to be divided into positive and negative components. The Board believes that, since goodwill is viewed as a residual, it would be inappropriate to subdivide a net balance into positive and negative components. Thus, the amounts that can be attributed to any factors identified as causing negative goodwill are limited to the total negative goodwill arising on the acquisition.

Transitional arrangements

- 60 Ideally, all goodwill that had previously been eliminated against reserves but would not have been fully written down under the requirements of the FRS would be reinstated by means of a prior year adjustment. However, the Board recognises that this will not be practicable in all circumstances and envisages that some or all of this goodwill will remain eliminated against reserves. In order to provide some degree of consistency to the various possibilities for reinstatement that might be chosen, the Board has limited them to those set out in paragraph 69 of the FRS. The 23 December 1989 cut-off point stems from the transitional provisions in companies legislation. The FRS 7 cut-off point recognises that goodwill calculated before then was measured on a different basis.

- 61 The Board considered including a requirement to reinstate goodwill acquired in the previous year. However, it concluded that, unless acquisitions made in the previous year were the only acquisitions for which goodwill remained at the balance sheet date, this limited requirement would not achieve proper comparability based on consistent application of the FRS's requirements. The profit and loss account would still reflect only part of the cost of the benefits conveyed by the goodwill of past acquisitions. Clearly, the further back any adjustments can be made, the greater the degree of comparability that will be achieved.

Changes made following exposure of FRED 12

- 62 The majority of respondents to FRED 12 were broadly supportive of its overall approach. The minority who were opposed to the approach divided into those who would prefer compulsory amortisation and those who would prefer immediate elimination of goodwill against reserves. Only a small minority supported the alternative view put forward in Appendix IV of the FRED. The Board's reasons for rejecting compulsory amortisation and immediate elimination against reserves are set out above.
- 63 A number of changes to the detailed proposals were suggested by respondents and considered by the Board. The more significant changes that have been made in the light of the responses received are:
- the removal of the procedures to be used in performing impairment reviews. They are to be published as a separate FRS encompassing the impairment of all fixed assets and goodwill. FRED 15 'Impairment of Fixed Assets and

Goodwill' sets out the procedures to be used for impairment reviews until that FRS is published. Changes that have been made to the impairment procedures as a result of responses to FRED 12 are explained in FRED 15.

- simplification of the procedures for performing 'first year' impairment reviews. The Board accepts the argument that a requirement to perform a full first year impairment review for every acquisition would be unduly onerous, particularly for smaller companies. The FRS permits the first year impairment review to be performed on a simpler basis, with a full review being required only if the simpler review indicates a potential impairment.
- a change in the requirements relating to negative goodwill. The changes are explained above.
- clarification of the transitional arrangements. A large majority of respondents to FRED 12 (including all who were users of financial statements) supported the Board's proposal to permit but not require reinstatement of goodwill that had previously been eliminated against reserves. However, many felt that it was unclear how goodwill would be reinstated and what, if any, constraints would be placed on the extent and timing of reinstatement. The requirements have been clarified in the FRS.
- the addition of a new requirement for any 'old' goodwill that remains eliminated against reserves to be netted against another reserve and not shown separately on the face of the balance sheet. The Board agrees with respondents who suggested that it could be misleading and

confusing to allow goodwill to appear in two places on the face of the balance sheet, with the two balances being subject to different impairment and amortisation requirements. The FRS now requires entities that wish to highlight goodwill as a separate balance to capitalise it as an asset and subject it to the new requirements for amortisation and/or impairment reviews.

- 64 A small minority of respondents to FRED 12 opposed the proposal that internally developed brands and mastheads could not be capitalised and the related proposal that purchased brands and mastheads could not be revalued. They argued that reliable valuation techniques exist and that, where brands and mastheads are fundamental to a business, their inclusion makes balance sheets more relevant and comparable and is important for accountability.
- 65 The Board considered these arguments. However, it has concluded that the restrictions on capitalisation and revaluation of brands and mastheads stems more from the view that such assets are very similar in nature to goodwill and so should be treated in the same way as goodwill than from the view that their values cannot be measured reliably. The Board further notes that:
- internationally, there are no moves to permit brands and similar assets to be carried at valuations
 - reporting entities are not prevented from disclosing (and are indeed encouraged to disclose) estimated values for key intangible assets within the operating and financial review.

APPENDIX IV

DISSENTING VIEW

- 1 Mr Hinton dissents from the FRS because he does not agree that goodwill should be capitalised as an asset and amortised, or that revaluation of identifiable intangible assets should be prohibited. He advocates an alternative approach, which, he believes, places greater emphasis on the needs of users and the nature of goodwill, recognising that it is neither an asset nor an immediate loss in value. He concludes that goodwill should not be presented as an asset or in any way amortised but should be deducted from shareholders' equity. He notes that over 95 per cent of UK companies with goodwill at present deduct such goodwill from shareholders' equity by write-off to reserves or to a goodwill reserve.

Needs of users

- 2 Users of financial statements in the UK have indicated that whilst they treat any amounts attributed to goodwill with considerable scepticism, they are concerned to hold management accountable for the amounts spent on goodwill. Immediate write-off with the amounts subsumed within reserves as practised by many companies reporting goodwill has clouded such accountability. The measure of such accountability is the relationship between the amounts spent and the likelihood and timing of improved earnings and cash flows. Mr Hinton believes that users are thus concerned with stewardship and whether goodwill has been impaired, but not with reporting goodwill as an asset with either indefinite retention or arbitrary amortisation to operating profit, both of which they have long ignored.

Nature of goodwill

- 3 Goodwill is not an asset as defined in the draft Statement of Principles for Financial Reporting and possesses unique characteristics that distinguish it from an asset. It may or may not have any relationship to the expenditures incurred to create it; there is no reliable or continuing relationship of value with any historical cost and such cost frequently and quickly loses any significance it may ever have possessed. Mr Hinton believes that, if goodwill is not an asset and is qualitatively different from assets as generally recognised, it is misleading to report it as such.

Amortisation

- 4 The FRS defines the useful economic life of purchased goodwill as the period over which the value of the underlying business acquired is expected to exceed the values of its identifiable net assets. Mr Hinton notes that this position is unique to the FRS in that traditional guidance on useful economic life emphasises the factors likely to impact the goodwill actually acquired. He regards the definition as inconsistent with the use of a rebuttable presumption that the useful life does not exceed 20 years. He notes that what is being reported is some measure of the current value of the acquired business compared with the current value of its identifiable assets and that this has little to do with the original purchased goodwill.
- 5 The original purchased goodwill cannot have an indefinite or long life. In reality, purchased goodwill is incapable of being separately measured in the years after purchase and inevitably wanes, only to be replaced in whole or in part by new goodwill arising from current expenditures and events. In effect, the FRS allows internally generated goodwill to be revalued (which is otherwise precluded by the FRS) and offset against declining purchased goodwill.

6 The approach taken in the FRS regards amortisation as necessary to recognise that goodwill has a limited useful life or as a surrogate for annual impairment reviews where such frequent reviews are not feasible. Mr Hinton does not accept this justification. He argues that:

- FRED 17 'Measurement of Tangible Fixed Assets' defines depreciation as the measure of the cost of the economic benefits of tangible fixed assets that have been consumed during the period. Amortisation is the equivalent process for intangible fixed assets. Yet goodwill differs from other costs in that it is not consumed in any way in operations. Although it contributes to earnings, it arises primarily as a result of earnings or the expectation of them. Any decrease in the value of goodwill is not associated with the income of any period or allocable to any period on any rational or systematic basis.
- Where amortisation is viewed as a surrogate for annual impairment reviews, the FRS requires the goodwill (already acknowledged not to be an asset) to be reported in the balance sheet for up to 20 years irrespective of its value, providing that nothing has happened to indicate that the value might be less than that reported. Mr Hinton believes that this fails to hold management sufficiently accountable for the values assigned to the goodwill.
- In both cases, the FRS requires operating profit to be charged with a meaningless cost.

- 7 Mr Hinton takes the view that a proper matching of costs and revenue does not call for amortisation of every asset: it calls for amortisation of only those assets that can be related to operations on some realistic and systematic basis so that the charge reasonably reflects the cost of the economic benefits consumed during the period. Since goodwill is not consumed or depleted as a matter of course, amortisation is not relevant. Further, he believes that the life of purchased goodwill is indeterminable and not measurable and therefore that any period of amortisation is completely arbitrary.

Identifiable intangible assets

- 8 Mr Hinton notes that whilst the FRS recognises the growing importance attached to intangible assets and permits the inclusion at the date of purchase of intangible assets that are measurable on some recognised basis, it is inconsistent in precluding the subsequent revaluation of such intangibles. He takes the view that if an intangible asset is capable of measurement on some recognised basis at acquisition, it must be capable of subsequent measurement on such a basis and subsequent valuation should be permitted. He believes that this would encourage the development of methodology in this area to the ultimate benefit of users.

An alternative view

- 9 Irrespective of whether the consideration is cash, shares or debt, purchased goodwill reduces shareholders' current equity for the prospect of enhanced profit in the future. Part of shareholders' funds (in terms of 'hard assets') has been disbursed: if cash is used, it has gone; if shares, the company could have received cash for the share issue as opposed to goodwill. In both cases, something tangible has been exchanged for something intangible.

- 10 Mr Hinton believes that goodwill should be deducted from shareholders' equity to reflect the fact that shareholders' funds have been used. This treatment would recognise that goodwill is neither an asset nor an immediate loss in value. In order to facilitate accountability and subsequent monitoring, the deduction should be by way of establishing a goodwill reserve within shareholders' equity. This presentation of goodwill as a separately identified balance (quasi-asset) would stress stewardship for the amounts spent but not in such a way as to suggest it is an asset, which it is not. It would also meet the requirements of the Companies Act as regards amortisation since such goodwill would be viewed as written off, thus avoiding arbitrary allocations to earnings.
- 11 While the business continued to be held, the goodwill would be kept under review for permanent impairment. This would be achieved by using high-level impairment indicators to identify possible impairment and using the full impairment reviews outlined in FRED 15 only for goodwill whose value was in doubt. Mr Hinton takes the view that the impairment reviews set forth in FRED 15 are highly subjective but that such subjectivity would be less sensitive where goodwill was not reported as an asset.
- 12 Intangible assets would be identified as set forth in the FRS. Only those intangible assets with a recognised market value or otherwise measurable on some recognised basis would be capitalised as assets at acquisition; the remainder would form part of goodwill. Only those intangible assets with a clear finite economic life and whose use could be related to earnings on a rational basis would be amortised. Intangible assets not amortised would be reviewed for impairment in the same manner as goodwill. Significantly, subsequent revaluation would be permitted.

APPENDIX V

EFFECT ON REALISED PROFITS OF ELIMINATION OF GOODWILL AGAINST RESERVES

This text reproduces guidance given in Appendix 2 of SSAP 22 'Accounting for goodwill'. The guidance has been reproduced in the FRS because it continues to apply to goodwill acquired before, and not reinstated on, implementation of the FRS. The text is largely unchanged from that contained in SSAP 22 to avoid losing any of the nuances that were considered carefully before SSAP 22 was published.

This appendix is for guidance only and does not form part of the Statement of Standard Accounting Practice.

- “ 1 [The legal definition of realised profits] is relevant only in the case of an individual company. In the case of goodwill arising on consolidation, the distinction between realised and unrealised reserves is not relevant. Distributions are made from the profits of individual companies, not by groups, and hence the elimination of consolidation goodwill has no effect on the distributable profits of any company.
- 2 Where it is the policy of an individual company to eliminate goodwill against reserves immediately on acquisition, the question arises whether such elimination constitutes a reduction of realised reserves. To the extent that the goodwill is considered to have suffered an actual diminution in value, the write-off should be charged against realised reserves. In other cases, where goodwill is written off on acquisition as a matter of accounting policy, rather than because of an actual diminution in value, realised reserves should not

be reduced immediately. However, the standard is based on the concept in [UK companies legislation] that purchased goodwill has a limited useful life so that ultimately its elimination must constitute a realised loss. It may in some circumstances (e.g., where a company lacks sufficient distributable reserves to cover the purchase cost of the goodwill) be appropriate to charge the elimination of goodwill initially to a suitable unrealised reserve, thereby spreading the effect of the elimination of goodwill on realised reserves over its useful life rather than impairing realised reserves immediately. The Accounting Standards Committee is advised by the Department of Trade and Industry that the restriction regarding the use of the revaluation reserve set out in paragraph 34(3) of Schedule 4 has the effect that this reserve should not be charged with the write-off of goodwill.* A suitable unrealised reserve may exist as a result of the crediting to reserves of negative goodwill – see paragraph 3 below. To maintain parity of effect as regards distributable reserves with the amortisation method permitted by [SSAP 22], the amount written off should then be transferred from unrealised reserves to realised reserves so as to reduce realised reserves on a systematic basis in the same way as if the goodwill had been amortised. In case of doubt on the points in this paragraph, legal advice should be sought.

* *Companies legislation has since been amended to clarify that the revaluation reserve may not be used for goodwill write-off. Paragraph 34(3B) of Schedule 4 to the Companies Act 1985 prohibits the reduction of the revaluation reserve in any circumstances other than those specified earlier in that paragraph. The specified circumstances do not include the write-off of goodwill.*

- 3 Where negative goodwill arises in the accounts of an individual company it should be credited initially to an unrealised reserve, from which it may be transferred to realised reserves in line with the depreciation or realisation of the assets acquired in the business combination which gave rise to the goodwill in question. On the introduction of this standard, amounts representing negative goodwill which arose on prior acquisitions may already have been credited to reserves. To the extent that the assets acquired have, on the introduction of this standard, been depreciated or realised, the relevant amount or reserves may be regarded as realised.”

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