

IFRS Compliance in the Year of the Pig: Hong Kong Impairment Testing

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Abstract

Several studies have assumed that the implementation of IFRS can enhance the quality of financial reports, in turn improving their reliability and usefulness (Wyatt, 2005; Barth et al., 2008). However, such studies generally suggest that the introduction of IFRS guarantees consistency and compliance in practice. Given that goodwill impairment testing under IFRS presents a technically challenging task (Hoogendoorn, 2006; Wines et al., 2007) that can materially impact the determination of economic profit, this study focuses on assessing the compliance quality of a large sample of Hong Kong listed firms that are mature IFRS adopters. By examining the detailed disclosures made by 264 large listed firms in 2007, three years after Hong Kong's implementation of IFRS, an alarmingly high rate of non compliance with HKAS 36 still exists among these goodwill-intensive firms, casting doubts over the hypothesis that lax compliance is a characteristic associated solely with early adoption.

Keywords: Goodwill, impairment, financial reporting standard, HKAS 36, Hong Kong.

1. Introduction

The globe's financial reporting landscape has undergone dramatic change over the course of the past decade. A key driving force for this has been the rapid uptake of IFRS in substitution for localised accounting rules.¹ This trend has been highly evident in the South East Asian zone, with numerous key regional economies, including Australia, New Zealand, Malaysia, Thailand and Singapore all adopting IFRS.

Hong Kong has also moved onto an IFRS reporting framework.² Given Hong Kong's prominence as a regional capital hub and financial centre and as a window on China (which has not thus far moved to IFRS adoption), the move to this new body of rules has an added and wider significance in Hong Kong's case than in many other adopter jurisdictions (Batten and Fetherston, 2002; Green, 2003).

A number of studies of the impact of the implementation of IFRS have assumed that the transition from local GAAP to IFRS can have a favourable impact on the quality of financial reporting information (Wyatt, 2005; Barth et al., 2008). The benefits flowing from the increasing harmonisation of accounting standards, a phenomenon driven substantially by the increasing uptake and spread of IFRS, have also been widely anticipated (Street, 2002).

Yet as with any substantial and complex change, variations may arise between anticipated and actual effects in the world of practice. One respect in which this theory practice gap is slowly becoming salient to researchers in the context of IFRS implementation relates to the question of compliance. This

represents a precondition to the achievement of harmonisation and unification of practice, yet in much of the accounting and reporting literature, this dimension of practice has been overlooked.

A particularly technically challenging element of the IFRS framework is its impairment testing regime (Hoogendoorn, 2006). The difficulties associated with the implementation of the IFRS impairment testing regime stem not only from the complex conceptual web woven through the standard which embodies the regime, IAS 36 *Impairment of Assets*, but also because of the intricately detailed disclosure regime prescribed within the standard (Lonergan, 2007; Carlin and Finch, 2008).

Testing goodwill for impairment requires not only the application of detailed financial modelling, but also results in a heavy compliance burden as firms reporting subject to IFRS are called upon to provide insight into the assumptions used, benchmarks referred to and processes used in the formation of a judgement on the value of the most vexed of all intangible assets. Yet if IAS 36 is to fulfil its promise, this high hurdle must be met.

However, a still nascent literature is raising questions as to whether this is occurring in the real world landscape of financial reporting. For a financial services hub and entrepot such as Hong Kong, much potentially turns on the answer to this question. Therefore, this study focuses on compliance levels and quality among a sample of large enterprises whose equity securities are listed for quotation on the Hong Kong Stock Exchange. The device used as a basis for interrogating the compliance issue is an assessment of the degree to which these

firms have adhered to the technical disclosure requirements of IAS 36 in relation to their conduct of goodwill impairment testing.

To avoid the confounding effects often associated with first time adoption of complex provisions, this study looks at practice in the third year after the onset of mandatory IFRS based reporting in Hong Kong. This interval allows for the avoidance of capturing errors of practice driven by early period adoption inexperience and thus supports the generation of greater clarity in relation to the underlying compliance picture.

To pursue this matter, the remainder of the research is designed as follows. Section 2 contains a brief overview of the relevant literature and an explanation of the gravity and implications of the compliance problem in financial reporting. Section 3 provides details of the data and methods drawn upon for the purposes of the study. Section 4 contains an overview and discussion of the empirical results, while conclusions for the research are set out in Section 5.

2. Overview of goodwill reporting arrangements in Hong Kong

Hong Kong adopted IFRS for all reporting periods commencing on or after 1 January 2005, with HKAS 36 *Impairment of Assets* embodying the requirements of the IFRS impairment testing framework in that jurisdiction.³ The implementation of this method to goodwill accounting and reporting marked a radical departure from prior practice in Hong Kong. Prior to the transition to IFRS, goodwill was typically written off against reserves upon acquisition, or less frequently, amortised against periodic earnings (Moliterno,

1993).

Thus the rise of IFRS based reporting represented a particularly stark contrast between the brutal simplicity of the prior indigenous reporting rules and the Byzantine nature of their new usurpers. Yet even with IFRS goodwill accounting rules and their close analogues in US GAAP in their relative infancy, concerns have emerged about their role and effect.

Watts (2003) represents an early and high profile example of some of the criticisms which have been levelled at the new complex approach to goodwill accounting and reporting. He characterises the FASB's decision to opt for an impairment testing based regime in SFAS142 as an error in judgement likely to leave open the pathway to aggressive earnings management and systematic asset value over statements.

Other commentators, including Massoud and Rayborn (2003) have expressed similar sentiments, and questioned the desirability of a reporting framework so reliant on subjective judgements without appropriate verification checks and balances. Others have asserted the existence of obvious technical flaws in the manner in which asset impairment standards have been drafted (Haswell and Langfield-Smith, 2008).

Consistent with the concerns raised in these conceptual contributions, evidence is accumulating in the empirical literature of an array of problems associated with impairment testing regimes.

These include a lack of evidence that earnings numbers derived under the present regime are more value relevant than those generated

under the previous capitalise and amortise regime (e.g. Chen et al., 2006); evidence that write off timing is consistent with managerial opportunism (Anantharaman, 2007); evidence of undue delays in recognising impairment losses (Henning et al., 2004; Hayn and Hughes, 2006; Ramanna and Watts, 2007) and evidence of gaming in the manner in which goodwill is allocated between reporting units⁴ in a bid to minimise the chance of forced impairment losses (Zhang and Zhang, 2007).

Contributions to the literature by practitioners have also expressed strong concerns about the operation and effect of the impairment based regime for goodwill reporting, one author recently offering the view that the IFRS impairment framework is likely to yield misleading results at odds with any discernible thread of logic or principle (Loneragan, 2007).

All of these authors express concerns, for varying reasons, about the quality of the information product emanating from the impairment testing framework for goodwill measurement and reporting. Yet in expressing their concerns, these contributors to the literature appear to have neglected the issue of compliance.

That is, many scientists appear to have assumed that preparers of financial reports systematically comply with the technical requirements of the accounting standards which embody the impairment testing framework and that the information quality deficiencies which are attributed to the operation of the framework result from factors such as the opportunistic exercise of discretion.

While not equating technical compliance with reporting standards and the quality or

serviceability of the resulting disclosures (following Schuetze, 1992; Clarke et al., 2003), the degree to which firms adhere to the requirements of applicable standards must nonetheless be viewed as a matter which has the capacity to materially influence and in cases of non compliance detract from the decision usefulness of financial statements.

Fraudulent deviation from required reporting norms and standards⁵ represents one well recognised species of financial reporting pathogen. The opportunistic exercise of discretion allowable within reporting frameworks represents another⁶ frequently researched problem. The degree of compliance with the technical architecture of the applicable reporting framework arguably represents a separate species of pathogen, differentiable from the former two on the basis of motivational foundation.

Specifically, whereas the motivations for fraudulent and legal but opportunistic reporting choices can typically be explained with reference to the wealth transfer effects of such behaviour, no such blanket explanation can be offered in relation to the degree of technical compliance. Arguably, the possible causal factors for this particular species of reporting pathogen may be far broader, including lack of understanding of reporting frameworks by preparers, lack of resources to fully implement the requirements of applicable standards on the part of preparers and lack of understanding and resources on the part of auditors, as examples.

Equally, the policy implications of systematic (but not fraudulently or opportunistically motivated) deviations from the precepts of mandatory reporting frameworks differ

materially from those raised in cases of fraud or by dint of excessive manoeuvre space within the boundaries (or at the intersection of the boundaries) of reporting standards.

Yet, as argued above, the compliance degree question has thus far been relatively overlooked in the financial reporting literature. Nonetheless, careful scrutiny of published research unveils a limited number of contributions which bear on this matter and which raise potent questions in relation to the actual impact of IFRS in the domain of practise.

In an examination of the relationship between compliance and analyst forecast errors, Hodgson et al. (2008) document an inverse relationship between these two constructs, highlighting the importance of the compliance issue from an empirical standpoint. The same authors (Hodgson et al., 2008) find that compliance varies according to auditor choice, reinforcing the notion that despite the “evenness” of the obligations imposed by IFRS, the practical context of application is uneven, due to inconsistent compliance.

Though valuable, these contributions are best viewed as preliminary. They open more questions than they resolve. These include the need to develop insight into whether unevenness in compliance afflicts certain forms of financial reporting constructs more than others, whether adoption effects offer a dominant or residual explanation for material compliance deviance and whether compliance is a constant phenomenon in a cross jurisdictional sense, or idiosyncratic depending on institutions and geography.

The setting, timing and focus of this paper support the capacity to bring insights to bear on

each of these matters and in so doing contribute to a broader understanding of the compliance issue and its implications. The methodology and data drawn upon to sustain these objectives are discussed in Section 3.

3. Data collection and research methodology

This study examines compliance practice pertaining to goodwill impairment disclosures amongst large Hong Kong Stock Exchange listed firms in the third year of IFRS implementation in that jurisdiction. In constructing the final research sample, a number of steps were involved. First, firms were required to be the members in Main Board of Hong Kong Stock Exchange (HKEx) as at December 2007.

At the year end December 2007, there were 1,048 firms listed on the HKEX with a total market capitalisation of \$20,536 billion. All firms were stratified by individual market capitalisation and the 500 largest firms selected for the next stage. As at December 31, 2007, these firms had an aggregate market capitalisation of \$20,242 billion and accounted for 98.57% of total market capitalisation.

Of these firms, 236 had no goodwill and were therefore excluded from the sample. Consequently, the final research sample comprised 264 firms with a total year end market capitalisation of \$12,922 billion, representing 62.93% of the total market capitalisation in HKEx as at December 31, 2007.

To allow for industry segmentation of data, all firms were allocated to one of five industry groupings comprising organizations with related principle lines of business. These were, Consumer Goods and Conglomerates; Financials; Telecommunications and Services;

Materials and Industrial Goods and Utilities, Energy and Construction.

An overview of the asset base and goodwill base of the research sample, arranged by industry sector and expressed in \$HK is set out in Table 1.

In approaching the research question, a two layered comparative methodology was designed. The first layer of the methodology requires a comparison to be made between the content of a firm's impairment testing disclosure and a checklist of requirements derived from the text of HKAS 36. This allows disclosures to be categorised according to a bimodal "comply" or "non-comply" taxonomy.

The second layer of the methodology looks beyond distribution of disclosures into the basic categories of "comply" and "non-comply" and recognises that within the "comply" category of disclosures there is a gradation of quality. Thus, as discussed below, an additional element of the methodology employed is the construction of multi-category disclosure quality taxonomies which provide a more nuanced perspective on disclosure practice than simple "comply" versus "non-comply" categorisations.

Bearing this in mind, several dimensions

of the IFRS goodwill reporting regime are of potential interest and can be investigated by dint of required disclosures under HKAS 36. The first relates to the role of cash generating units (henceforth CGUs) as the crucible within which the impairment testing process transpires.

Paragraph 80 of HKAS 36 requires that for the purpose of impairment testing, goodwill is to be allocated to each of the reporting entity's CGUs (or groups of CGUs) expected to benefit from the goodwill. To avoid the creation of an excessive reporting systems burden, this allocation is only required down to CGUs or groups of CGUs which represent the lowest level at which goodwill is monitored for internal management purposes.

However, to guard against inappropriate aggregation, paragraph 80 stipulates that the CGUs (or groups thereof) should not be larger than segments defined for the purpose of segment reporting.⁷

This is important, since the number of CGUs to which goodwill is allocated for the purposes of impairment testing itself has the capacity to impact on the likelihood of an impairment loss being recognised. Where elements of a group enterprise whose cash flows are imperfectly

Table 1: Overview of research sample

Sectors	Number of firms	Total assets (\$ million)	Total goodwill (\$ million)	Goodwill as % of total assets
Consumer Goods & Conglomerate	77	2,232,557.57	82,981.53	3.72%
Financials	25	33,189,160.81	332,073.77	1.00%
Telecommunication & Services	62	1,760,793.76	96,021.53	5.45%
Materials & Industrial Goods	37	531,686.67	11,193.52	2.11%
Utilities, Energy & Construction	63	2,422,749.97	39,435.56	1.63%
Total (n)	264	40,136,948.78	561,705.91	1.40%

correlated and whose risk profiles differ are fused as one CGU rather than two or more, the excess “headroom” between the estimated fair value and book value of the assets of better performing units serves as a shock absorber for the riskier or more poorly performing elements.

Were these elements disaggregated, the shock absorber effect would be removed, and the surplus of fair value over book value embedded in the less risky or stronger performing business elements could not foil deficiencies in riskier or weaker performing business elements, removing the capacity to avoid impairment write downs.

Thus, in coming to understand the characteristics of the goodwill reporting regime, developing an image of the apparent level of “aggregation” of CGUs as defined by reporting entities is of prime significance. This is pursued by comparing the number of reported controlled subsidiary entities, business segments and defined cash generating units for each firm in our sample.

The completeness and quality of disclosures relating to goodwill at the CGU level is also assessed by examining the extent to which each sample firm’s total goodwill balance can be reconciled with the sum of disclosed CGU goodwill allocations. Where the total disclosed goodwill of the firm does not reconcile to the total value of goodwill allocated to CGUs, the quality and completeness of disclosure is judged to be lower than where complete reconciliation is possible.

Having examined the aggregation issue, attention is turned to the manner in which recoverable amount of CGU assets has been estimated. This requires reference to fair value

or value in use, and disclosure which of these reference bases has been adopted. While it is likely that in most circumstances recoverable value will be determined by reference to value in use, the possibility that the fair (market) value of certain asset classes may be reliably determinable, for example, by dint of the existence of active markets for assets of the class in question, means that it will on some occasions be feasible to determine recoverable amount on a fair value basis.

HKAS 36 states that adoption of a fair value approach to the determination of recoverable amount is not dependent on the existence of an active market for the assets in question, but also makes clear the need for some reasonable basis for making a reliable estimate of the amount obtainable from the disposal of assets in arm’s length transactions between knowledgeable and willing parties as a prerequisite to the adoption of this method. Consequently, the circumstances in which this choice is exercised also represent an object of potential research interest, and the frequency with which sample firms resorted to either method is reported in Section 4 of the research.

While HKAS 36 calls for limited disclosure of the assumptions and processes used by an organization which has elected to use fair value as the benchmark for impairment testing, several specific and detailed disclosures are called for in the event that value in use is the basis adopted for the determination of recoverable amount. These appear designed to assist financial statements users to assess the robustness of the discounted cash flow modelling process used to estimate recoverable amount, and include in the contents of paragraph 134 (d) of HKAS 36.

Inspection of the assumptions made in relation to key factors such as discount rates, growth rates, forecast periods and terminal value periods supports the development of a more nuanced comprehension of the degree of conservatism or aggression inherent in the development of value in use estimates, meaning that these are also of primary interest in developing an understanding of the operation of the goodwill reporting regime. Consequently, an assessment of the disclosures relating to both discount rates and growth assumptions made by sample firms pursuant to HKAS 36 is reported in Section 4.

For generating quality assessments, it was necessary to develop a compliance and disclosure quality taxonomy for both discount rate and growth rate based disclosures. In relation to discount rate disclosures, the taxonomy applied required the allocation of each sample firm to one of four dimensions being “multiple explicit discount rates”, “single explicit discount rates”, “range of discount rates” and “no effective disclosure”.

Allocation of a firm to the first of these categories indicated that the firm was fully compliant with the requirements of HKAS 36 in relation to discount rate disclosures, and that the degree of transparency inherent in its disclosures was sufficient to allow an external analyst to develop meaningful insights into the process of impairment testing employed by the sample firm. Firms assigned to this category provided details of the specific discount rate used to discount cash flows for the purpose of impairment testing for each defined CGU, and used varying discount rates as the risk characteristics of CGUs varied.

Firms were assigned to the second category “single explicit discount rate” where they provided details of a specific discount rate for each CGU, but there was no observed variation in discount rates assigned to CGUs, even though CGU risk levels were arguably different. The quality of compliance and disclosure for firms in this category was assessed as lower than that of firms in the first category.

Firms were assigned to the third category “range of discount rates”, where they provided details of discount rates employed for the purpose of recoverable amount modelling and impairment testing, but rather than specifying a particular discount rate used in the context of testing for impairment in a particular CGU, simply provided details of a range of discount rates used across a range of CGUs. It is questionable whether this practice fulfils the disclosure requirements stipulated under HKAS 36, and it is clear that the quality of this form of disclosure is lower than in categories one and two, above.

Finally, where the degree of information provided in relation to discount rates was so limited that it would not sustain any meaningful external evaluation, firms were assigned to a fourth category, labelled “no effective disclosure”. These firms were judged not to have complied with the relevant requirements of HKAS 36, and the quality of their disclosures was poor.

In contemplating the quality of disclosures relating to growth rates as required under HKAS 36, a similar approach was adopted, with firms also characterised according to a four point taxonomy, anchored at the high quality end by the category “multiple explicit growth rates”

for each CGU and “no effective disclosure” at the low quality end. Two intermediate categories “range of growth rates” and “single growth rate” for all CGUs” (in that order of assessed quality) filled out the scale. In relation to the disclosures pertaining to the length of the forecast periods, “multiple forecast period” sat at the high quality end, and “no effective disclosure” at the low quality end, with “single explicit forecast period” as the intermediate category.

4. Results and discussion

In approaching the compliance issue in the Hong Kong context, the threshold question examined was the degree to which balance sheet goodwill could be reconciled with the total value of goodwill allocated to CGUs. The disclosure task required of firms to comply with this basic requirement is not challenging, and the data demonstrates that for many sample firms, did not represent a problem. As Table 2 shows, some 75% of sample firms fully complied with this threshold requirement by the third year of IFRS adoption in Hong Kong.

Troublingly, however, the remaining quarter of firms did not satisfy this basic

disclosure requirement, with most cases of non compliance being instances where financial reports exhibited a total dereliction of the need to produce sufficiently transparent disclosures. The basic impact of the lack of capacity to trace goodwill to the CGU level is to remove the capacity of financial statement users to make robust independent assessments of goodwill value, since the most forensic disclosure requirements of HKAS 36 are at the CGU level.

The next matter examined for the purposes of the study, described as the CGU aggregation phenomenon, is substantially more complex than the threshold matter of value reconciliation attended to above. Recall (from the discussion in Section 3) that the concern here is that firms reduce their impairment charge risk by defining fewer, larger CGUs as a means of offsetting strong and poor elements within their businesses and masking the existence of impairments where these may in fact have occurred.

Because of the information asymmetries inherent in conducting analysis of the aggregation issue drawing upon published financial statement data, it is necessary to

Table 2: CGU allocation compliance by sectors

Sectors	Number of firms	Fully compliant	Ostensibly compliant	Non-compliant
Consumer Goods & Conglomerate	77	59	-	18
Financials	25	21	-	4
Telecommunication & Services	62	48	1	13
Materials & Industrial Goods	37	31	-	6
Utilities, Energy & Construction	63	39	2	22
Total (n)	264	198	3	63
Percentage of the whole sample	100.0%	75%	1%	24%

approach evidence bearing on the aggregation phenomenon from an aggregate perspective, rather than on a firm by firm basis. The methodology prescribed in section three explains a rationale for a comparison between the number of business segments and CGUs defined by a firm, given the standard's explicit admonitions bearing on the size of CGUs relative to defined business segments.

However, there is little probative force in this comparison on an individual firm basis, given the enormous variety of idiosyncratic circumstances faced by each different enterprise included in the sample. However, the lack of probative value at the individual firm level does not translate to a lack of probative value at the portfolio level, since with a sufficiently sized sample, idiosyncratic factors may be expected to largely offset, leaving the trace of a core pattern.

As the data in Tables 3 and 4 demonstrate, a clear pattern does emerge from the data, bearing on the issue of CGU aggregation. An obvious concern relates to the 20% of firms which made no effective disclosures in relation

to the number of CGUs they defined. No further comment on this than that offered in relation to the goodwill balance sheet to CGU value reconciliation problem need be offered, since the consequences of these compliance failures are consistent.

Of more particular interest in this context is the systemic tendency evident in the data to define fewer CGUs than business segments, by a substantial margin. This is the dominant trend in the data, and provides a strong basis for concern that there are numerous instances in which firms incorporated into the research sample defined a smaller than appropriate number of CGUs, with the consequence of less rigour and robustness in the impairment testing process.

Where firms apply the requirements of HKAS 36 in relation to the testing for goodwill impairment, a key matter for transparency relates to the approach taken as a basis for determining whether or not impairment has occurred. A small but notable proportion of sample firms (almost 6% - some 15 firms) failed to provide any insight at all into the approach

Table 3: Business segments and CGU aggregation by sectors

Sectors	No. CGUs> No. Segments	No. CGUs= No. Segments	No. CGUs< No. Segments	No effective disclosure
Consumer Goods & Conglomerate (n=77)	8	14	39	16
Financials (n=25)	2	4	15	4
Telecommunication & Services (n=62)	12	12	27	11
Materials & Industrial Goods (n=37)	3	11	18	5
Utilities, Energy & Construction (n=63)	9	7	30	17
Total (n=264)	34	48	129	53
Percentage of the whole sample	12.8%	18.2%	48.9%	20.2%

Table 4: Analysis of controlled entities, business segments and CGUs by sectors

Sectors	Avg. No. controlled entities	Avg. No. business segments	Avg. No. CGUs	Avg. value goodwill (\$ mil)	Avg. goodwill per CGU (\$ mil)	Ratio CGUs to segments
Consumer Goods & Conglomerate (n=77)	38.92	3.30	2.15	1,077.68	501.82	0.65:1
Financials (n=25)	49.76	4.52	2.76	13,282.95	4,809.34	0.61:1
Telecommunication & Services (n=62)	30.92	2.74	2.30	1,548.73	673.36	0.84:1
Materials & Industrial Goods (n=37)	25.86	3.22	1.78	302.53	169.84	0.55:1
Utilities, Energy & Construction (n=63)	45.59	3.45	2.60	625.96	241.15	0.75:1
Total (n=264)	37.83	3.31	2.29	2,127.67	929.48	0.69:1

they had used in undertaking this task.

Recall that the two basic approaches provided for within the scope of the standard are the value in use approach and the fair value approach, with combination of these on a CGU by CGU basis possible, though, judging by the survey of practice distilled in Table 5, not on a common basis. A similarly small proportion of firms adopted a fair value approach to impairment testing.⁸ As Table 5 makes very clear, the overwhelmingly dominant practice approach to goodwill impairment testing adopted by firms included in the research sample was the value in use technique.

Much turns on this choice. As HKAS 36 makes clear, where the value in use approach is

used as a basis for impairment testing, detailed disclosures in relation to the key dimensions of cash flow models used as a basis for estimating value in use are required. Primary among these are disclosures relating to discount rates applied as central elements of these cash flow models.

As Table 6 shows, even amongst firms that clearly flagged that they had employed the value in use method for at least part of their overall impairment testing task, approximately 12% were mute on so fundamental a matter as to the discount rate employed for testing purposes, even in the presence of an explicit directive for disclosure of this information. A further 8.3% of firms provided disclosures of dubious value, indicating a range of rates applied across

Table 5: Method employed to measure recoverable amount of CGUs

Sectors	No. of firms	Fair value method	Value in use method	Mixed method	Method not disclosed
Consumer Goods & Conglomerate	77	1	71	1	4
Financials	25	1	21	2	1
Telecommunication & Services	62	4	53	1	4
Materials & Industrial Goods	37	-	35	1	1
Utilities, Energy & Construction	63	2	54	2	5
Total (N)	264	8	234	7	15
Percentage of the whole sample	100.0%	3.0%	88.6%	2.7%	5.7%

Table 6: Discount rate disclosures (value in use and mixed method used only)⁹

Sectors	Multiple discount rate (no. of firms)	Single discount rate (no. of firms)	Range of discount rate (no. of firms)	No effective disclosure (no. of firms)	Min discount rate (pre-tax) (%)	Max discount rate (pre-tax) (%)	Average discount rate (pre-tax) (%)
Consumer Goods & Conglomerate (n=72)	10	45	11	6	2.60	23.70	10.25
Financials (n=23)	8	11	1	3	3.10	25.90	9.26
Telecommunication & Services (n=54)	6	40	2	6	5.00	22.36	12.03
Materials & Industrial Goods (n=36)	3	30	1	2	4.68	20.00	10.77
Utilities, Energy & Construction (n=56)	4	36	5	11	5.00	20.00	10.94
Total (n=241)	31	162	20	28	2.60	25.90	10.80
Percentage	12.9%	67.2%	8.3%	11.6%			

the firm, but not assisting to lead users to an understanding of the central tendency amongst those rates, and thus to a capacity to develop strong insights into management assessments in relation to CGU risk levels.

The remaining 80% (approximately) of firms either disclosed the application of single or multiple explicit discount rates in the context of their impairment testing processes. At face value, holding aside questions as to whether an effective 20% non compliance rate with a mandatory disclosure requirement in audited financial statements produced by large listed corporations represents an acceptable state of affairs; it may appear that there are no substantial reasons for concern about this majority of firms.

Yet what is striking about this data is the infrequency with which firms which made explicit and meaningful discount rate disclosures disclosed multiple, CGU specific discount rates, and the frequency with which they disclosed the application of a blanket whole of firm discount rate. Clearly, some firms which disclosed the use of a single discount rate will have assigned goodwill to only one CGU. In other cases, firms may segment businesses with inherently similar characteristics for convenience of reporting and management, leading also to the adoption of a single whole firm rate.

Yet it is strongly arguable that these (and other similar scenarios) cannot adequately explain why 162 of 193 firms in the final research sample which made meaningful discount rate disclosures used only one discount rate. For many of these firms, the practical reality is that they have assigned goodwill to more than

Table 7: Growth rate disclosures (value in use and mixed method used only)

Sectors	Multiple discount rate (no. of firms)	Single discount rate (no. of firms)	Range of discount rate (no. of firms)	No effective disclosure (no. of firms)	Min growth rate (%)	Max growth rate (%)	Average growth rate (%)
Consumer Goods & Conglomerate (n=72)	5	18	2	47	0.00	21.00	3.48
Financials (n=23)	4	9	0	10	0.00	8.00	3.46
Telecommunication & Services (n=54)	5	15	2	32	0.00	15.60	3.73
Materials & Industrial Goods (n=36)	0	10	0	26	0.00	8.00	3.22
Utilities, Energy & Construction (n=56)	1	4	4	47	0.00	26.76	7.45
Total (n=241)	15	56	8	162	0.00	26.76	3.99
Percentage	6.2%	23.2%	3.3%	67.2%			

one CGU and the risk characteristics of their portfolios of CGUs are heterogeneous rather than homogenous.

This is of concern not only because the disclosure of a blanket discount rate removes valuable information in relation to intra firm risk variation from the public eye, but also because it heightens the risk that individual CGUs have been subjected to impairment testing at discount rates lower than appropriate to reflect true risk to cash flows.

The data clearly hints at the possibility that in at least some cases, inappropriately low discount rates may have been applied for the purposes of impairment testing. For example, in the consumer goods and conglomerates industry sector, the lowest observed discount rate was 2.6%. Having regard to risk free rates and equity premia prevailing at the time, this raises obvious concerns. However, beyond raising the question, the methodology employed for the purposes of this paper does not extend to an analytical approach amenable to the formation of judgements on the appropriate (or otherwise) level of discount rates.

Just as an analysis of the discount rate disclosures made by sample firms raised serious concerns, so too disclosures in relation to other dimensions of the value in use modelling process revealed problems in the domain of practice. The most obvious of these is the abject failure of almost seven in ten firms required to make growth rate disclosures to do so. This is a powerful example of the extreme deviation from required practice which can occur even where strong legal duties and other enforcement and quality assurance overlays might ostensibly conspire to drive compliance.

Table 8: Disclosure of forecast period by sectors

Sectors	Multiple forecast period (no. of firms)	Single forecast period (no. of firms)	Range of forecast period (no. of firms)	No effective disclosure (no. of firms)	Min forecast period (years)	Max forecast period (years)	Average forecast period (years)
Consumer Goods & Conglomerate (n=72)	3	59	4	6	1	21	5.77
Financials (n=23)	2	16	1	4	1	24	6.33
Telecommunication & Services (n=54)	-	49	-	5	1	24	5.53
Materials & Industrial Goods (n=36)	-	34	-	2	1	25	7.03
Utilities, Energy & Construction (n=56)	3	41	3	9	1	29	7.57
Total (n=241)	8	199	8	26	1	29	6.36
Percentage	3.3%	82.6%	3.3%	10.8%			

In effect, the void in growth rate disclosure encountered amongst sample firms is so profound as to obviate any meaningful systematic analysis of patterns in assumed growth rates amongst firms with goodwill. This very substantially detracts from any attempt to independently reason towards a view on the robustness of valuation judgements made in relation to goodwill by firms.

While disclosures in relation to assumed growth rates were strikingly poor in their quality, firms exhibited comparatively better practice in relation to their disclosures of cash flow forecast time horizons. Table 8 shows a substantial majority (approximately 85%) made disclosures amenable to generating at least some useful insights into the time horizons over which cash flow forecasts were prepared by sample firms. The main compliance concern raised by this data was the mean forecast interval length approaching 7 years, longer than the 5 years suggested by the standard without the benefit of justification and further amplification.¹⁰

5. Conclusion

We posit that the results set out in this paper should give a range of stakeholders interested in financial reporting considerable pause for thought about the important, though substantially overlooked dimension of compliance.

The results of analysis provide strong evidence of substantial deviation from required practice amongst a large sample of listed firms in a sophisticated economic jurisdiction. Further, given that the study examines practice several years after the implementation of IFRS in that jurisdiction, it is difficult to reconcile the results

with an “inexperience” or “implementation teething troubles” explanation.

The results set out above send a clear reminder that the spread of a consistent blanket of rules does not serve to guarantee the spread of a consistent blanket of practice, even in jurisdictions with strong institutional and regulatory frameworks which would generally be anticipated to promote compliance with promulgated mandatory rules.

Evidence of poor compliance with explicit

disclosure requirements embedded in mandatory reporting rules suggests a greater fragility to the global financial reporting edifice than may be apparent where the gaze of focus lies on bodies of rules rather than bodies of practice against rules. It also suggests harmonisation to be a far more complex and difficult construct than many have assumed. It is to be hoped that policy makers take greater account of this in future, as they work towards an improved global reporting framework.

Notes:

1. In some more unusual cases, certain jurisdictions have leapt from a position of having essentially no meaningfully consistently enforced accounting framework to the full of IFRS. In the Asia Pacific region, Cambodia represents an example of such a jurisdiction.
2. Hong Kong implemented mandatory IFRS for all reporting periods commencing on and after 1 January, 2005.
3. HKAS 36 is the functional equivalent of IAS 36. The two may be treated as interchangeable for all intents and purposes.
4. Or CGUs (cash generating units) in the IFRS terminology – see Carlin *et al.* (2007).
5. This type of pathogen has been termed “feral accounting” by Clarke *et al.* (2003). This was also the key interest of writers such as Briloff (1972); Mulford and Comiskey (2002); Schilit (2002) and Smith (1992).
6. This aspect of reporting is the focus of much of the agency based literature, for example, Healy (1985); Watts and Zimmerman (1986) as key source contributions.
7. Pursuant to HKAS 14 – *Segment Reporting*.
8. These firms raise concerns pertaining to the lack of quality discussions evident in most of their reports in relation to the basis upon which they benchmarked or estimated fair value. However, given that these represented a small residual of the total sample, this issue is not highlighted in detail here. For specific treatment of issues directly relating to the fair value for impairment testing, see Carlin *et al.* (2008).
9. Of 264 sample firms, 234 used the method of value in use and 7 applied the mixed method (combination of the value in use and fair value).
10. This was invariably not present where more extended timelines were adopted.

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