# John Selwood's Q&As

This month John returns to the thorny audit issues arising from the transition to FRS 102 and the useful economic life of goodwill

**Q My audit client has goodwill on their balance sheet where the useful economic life (UEL) has previously been determined at 20 years. Does FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* require the entity to reduce the UEL to five years and what are the mechanics of reducing this to five years? In particular, when do the five years begin and when should the amortisation first be accelerated?**

A As this was the most common question from delegates at the faculty roadshow during 2014, I have tried to answer it on a number of occasions. I use the word 'tried' because I am never entirely satisfied with the answer and it often seems a little simplistic. But this continues to be a hot topic, so I will try to make things as clear as possible or, failing that, to give some sort of structure to the uncertainties.

In my view, an easy mistake that auditors make in these situations is thinking that every entity using a UEL of 20 years has the same problem with the same solution. I see four different scenarios that are possible, and some of them have multiple solutions. The key to auditing this area is looking at the evidence to determine which scenario is present.

In all these scenarios I have assumed that management has elected to use the FRS 102, Section 35 exemption not to restate goodwill at transition, which will usually be the case.

FRS 102 asks that the estimate of a longer UEL be reliable and if it is not then the five-year limit applies

### SCENARIO 1

**20 years remains the appropriate UEL and there is sufficient evidence to support it.**

I hope that this is the most common scenario. From the original acquisition, management should have been diligent in its assessment of the UEL of goodwill and auditors should have been challenging when obtaining audit evidence to support the life.

I know that this might seem a slightly idealistic view but nevertheless it should be relatively common for entities to continue with their existing UEL. FRS 102 does not impose a maximum life of five years in all circumstances. It merely asks that the estimate of a longer UEL be reliable and if it is not then the five-year limit applies.

I have covered this ground before in a Q&A in the October 2014 issue of *Audit & Beyond* (bit.ly/1MODXVm), so I refer you to this.

Additionally, many entities did not chose the 20-year maximum imposed by FRS 10, and I would expect that if a UEL of 10, 15 or 18 years, for example, were used, then there would be plenty of evidence to support these more precise figures.

### SCENARIO 2

**The 20-year life is unsupported and on closer inspection is unsupportable.**

This looks like an error to me, and should be accounted for as such. If the facts on acquisition suggest that the UEL of 20 years is wrong then this is not a transitional adjustment. It should be dealt with in the transition accounts as a prior year adjustment resulting from an error, rather than as part of the first time adoption of FRS 102. More realistically, entities will be considering this issue now and addressing the problem in financial statements prior to transition, which seems very sensible to me.

### SCENARIO 3

**There was sufficient information to support the 20-year life on acquisition but circumstances have changed since then and a shorter life is now thought to be more appropriate.**

This is neither an error nor a transition adjustment. Instead, it is the revision of an accounting estimate and should be accounted for prospectively. Management will assess the UEL of goodwill from the beginning of the accounting period and the new rate of amortisation will not lead to revisions to the comparatives or opening balances. Prior year adjustments are only appropriate for changes to accounting policies, transitional adjustments or the correction of errors, and as this is a change of accounting estimate it does not fall into those categories.

When providing non-audit services, it could be easy to offer advice that might make life more difficult

The new UEL is whatever management determines it to be, subject to FRS 102's requirement that it can only exceed five years if the estimate is reliable.

### SCENARIO 4

**Management suggests that there was sufficient information to support the 20-year life on acquisition, under the requirements of FRS 10, and they say that circumstances have not changed since then. However, management now determines that the evidence to support the 20-year UEL is now insufficient, for the purposes of the FRS 102, and the five-year maximum now applies.**

This scenario is not without controversy. Part of the problem is that management might think, or indeed hope, that this is the scenario in which they find themselves, when the facts point to one of the scenarios above. Another part of the problem is that views differ on how big a gap exists between FRS 10 and FRS 102, when it comes to the reliability of, or certainty over, UELs. Many believe that this scenario is the least likely. And where management has previously selected a UEL of 20 years, it probably is the least likely, because 20 years was often used as a default.

The received wisdom among commentators is that the impact of FRS 102 on setting finite useful lives is either small or nothing at all. Therefore, if management says it is reducing its UEL only because of the application of FRS 102 then there needs to be some robust challenge of this.

There is no specific guidance from the Financial Reporting Council (FRC) on this scenario, so professional judgement by management and auditors alike is necessary. However, if it is FRS 102 that is driving the change it would be accounted for as a transitional adjustment. The balance at transition should not be amended and the increased rate of amortisation would be reflected in the comparatives and the current period.

As for whether the five years should run from date of acquisition or transition, different views continue to be expressed.

The FRC view seems to be that professional judgement should be applied. In these situations, that is rarely bad advice and I am happy to promote that approach.

### DIS-APPLYING THE FRS 102 EXEMPTION

As stated above, most of the time entities are applying the FRS 102 transitional exemption, in Section 35 of the standard, on business combinations, which permits the entity to not revisit the fair values on acquisitions prior to transition.

Another option for management is to choose to ignore this exemption and apply the approach in Section 19 of FRS 102 to the valuation of intangibles previously acquired. This can sometimes be a good option. But if you apply Section 19 of the standard for one acquisition, it has to be done for every subsequent acquisition.

### EVIDENCE, INDEPENDENCE AND SCEPTICISM

Auditors need to identify which scenario applies. Management might be inclined to push for a particular accounting treatment, which might be in some way advantageous to them. They might then try to make the facts fit the answer that they want.

Auditors should also be wary when providing non-audit services such as accountancy and advice on the impact of new standards. In an attempt to help the client, it could be very easy to offer advice that might make life more difficult down the line.

As always, the challenges faced by auditors in this area can be overcome through the proper application of independence and scepticism.

### ONE MORE THING

At the time of writing the Department for Business, Innovation & Skills is proposing that the five-year limit on UELs be extended to 10 years, which in practice might make this issue more straightforward to deal with for some entities.

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