John Selwood's Q&As

This month John tackles an issue many auditors will not want to face but will probably come across during the transition to FRS 102: the useful economic life of goodwill and other intangible assets

Q A company currently uses 20 years as the useful economic life (UEL) for goodwill. Management has considered the impact of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* on this estimate and they have concluded that a five-year life is more appropriate. This is a huge change so what audit evidence do I need to obtain to support this new UEL?

A If you were to choose not to think about this too much, it could be very straightforward. As auditors, you could just focus on obtaining audit evidence to support the new UEL of five years. When preparing accounts using FRS 102, a five-year life will not be uncommon, because this is the maximum life where the UEL cannot be reliably estimated.

It is worth noting that five years is the maximum rather than a default, and the absence of reliable evidence regarding the UEL does not absolve management from considering whether a life shorter than five years might be appropriate. Equally, the existence of a five-year maximum in the absence of reliable evidence does not absolve management from seeking out evidence that might support a longer life were they to bother looking for it.

The auditors' determination of how much audit evidence is required will start, like the auditing of any other accounting estimate, by ensuring that they understand both how the estimate is made and the requirements of the relevant accounting framework (in this instance FRS 102, section 19). Of course, it is management who are responsible for determining the UEL of goodwill. The auditors will look at how management has determined the UEL and the evidence management used to reach their conclusions.

Also, auditors have to assess the degree of estimation uncertainty as part of their risk assessment. The risk of fraud should not be forgotten, as it is possible that management might be trying to manipulate the financial statements by using a UEL which is excessively long or short. Where the amortisation of goodwill is not subject to tax relief, it is not uncommon for management to err on the side of a longer life in order to maintain a strong balance sheet.

SAFEGUARDS AND NON-AUDIT SERVICES

If the auditor is asked to assist with the determination of an appropriate UEL then this is the provision of a non-audit service and management threats arise. If there is informed management, then most of the time auditors will be permitted to assist, provided appropriate safeguards are applied. If the entity is listed or no safeguards are sufficient to address the management threat then the auditor should not provide this service.

So far, so good with this question - however, an auditor who thinks about this more deeply might wonder how management originally justified a UEL of 20 years if there was no reliable

An auditor who thinks about this more deeply might wonder how management justified a UEL of 20 years if there was no reliable evidence supporting evidence. If there was justification, then FRS 102 permits a longer life; so why are management making this change? Has there been a change of circumstances to justify it? Is FRS 102 sufficiently different to FRS 10 in its approach to justify this change?

If this 20-year UEL was wrong, shouldn't the auditors have identified the issue before? Not doing so could leave them in an embarrassing situation

A CENTRAL ISSUE?

I could continue along these lines for some time but instead I will address what is sometimes a central issue in these cases: when applying FRS 10 *Goodwill and intangible assets,* some entities used the 20-year maximum UEL of goodwill as a default rather than a maximum. It is possible that FRS 102 will be applied in a similarly thoughtless manner, with a five-year life being the new default.

If there is insufficient audit evidence to support the 20-year life, then the reduction in UEL may be the correction of an error rather than a transitional adjustment. This means it will be separately presented and disclosed in the first financial statements that are produced applying FRS 102.

It is possible that management might not agree with this approach; they might resist the treatment of this as the correction of an error and the auditors will have to address this disagreement. If management cannot be persuaded to present this properly then the auditors would need to consider qualifying their opinion.

What troubles me about this situation is that the firm of auditors might have never raised the issue of the 20-year UEL in any of its previous audits. If this 20-year UEL was wrong, shouldn't the auditors have identified the issue before? Not doing so could leave the auditors in a professionally embarrassing situation. Because of the potential for issues such as these, a second partner review might be useful, to safeguard against any threats to independence arising.

A WAKE-UP CALL

This question and the issues it raises are a wake-up call for auditors to encourage management to consider changes of circumstance that affect the UELs of goodwill more regularly. Where possible, management might think about reviewing UELs in an accounting period prior to FRS 102 transition.

Having said all of this, it is perfectly reasonable that a longer UEL, justified under FRS 10, might reduce to five years or fewer when applying FRS 102 for the first time. FRS 10 para 22 says that uncertainty over UELs should not lead to unrealistically short lives. This is a slightly different approach to FRS 102. This illustrates that, on transition, auditors need to not only understand FRS 102, but also understand previous UK GAAP.

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