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# **Compliance with IAS 36 from a true and fair view point of view**

Accounting and Finance

Bachelor's thesis

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The thesis examines compliance with international accounting standard IAS 36 from the viewpoint of the true and fair view concept. The study is limited to goodwill impairment. True and fair view is an undefined concept, but in the thesis its intended meaning is understood by relevance, reliability, comparability and understandability. Based on prior literature, the thesis finds substantial incompliance with the standard in defining cash-generating units, use of discount rates, level of disclosure, and recording a recognized impairment. The findings indicate that impairments are avoided or delayed, which leads to financial statements that do not give a true and fair view.

**Key words:** IAS 36, true and fair view, financial reporting, transparency, goodwill, impairment test.

Tutkielma tarkastelee kansainvälisen tilinpäätösstandardin IAS 36 noudattamista oikean ja riittävän kuvan käsitteen näkökulmasta. Tutkielma rajoittuu liikearvon arvonalentumisen tarkasteluun. Oikea ja riittävä kuva on käsitteenä määrittelemätön, mutta tutkielmassa sen merkitys on ymmärretty relevanssin, luotettavuuden, vertailtavuuden ja ymmärrettävyyden kautta. Aiempaan kirjallisuuteen perustuen tutkielmassa havaitaan huomattavia puutteita standardin noudattamisessa rahavirtaa tuottavien yksiköiden määrittelyssä, tuottovaatimusten käytössä, liitetietojen tasossa sekä havaitun arvonalentumisen kirjaamisessa. Havaintojen mukaan arvonalentumisia vältetään tai viivästytetään, mikä johtaa siihen, että tilinpäätökset eivät anna oikeaa ja riittävää kuvaa.

**Avainsanat:** IAS 36, oikea ja riittävä kuva, taloudellinen raportointi, läpinäkyvyys, liikearvo, arvonalentumistesti.

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# **1 Introduction**

## **1.1 Background of the thesis**

The topic of the thesis is the international accounting standard IAS 36 and the concept of true and fair view in the financial reporting. Firstly, the topic has been chosen because the true and fair view is a relevant and central concept in the world of accounting. The purpose is to examine how the IAS 36 standard contributes to giving a true and fair view in the financial reporting. Second, the topic is interesting because there are not many papers that discuss the link between IAS 36 and the true and fair view. A possible reason for this could be that the true and fair view concept is not used in the IAS/IFRS standards. Standard IAS 36 is of interest because applying the standard is not a simple task. IAS 36 is perceived as a complex, detailed and atypical accounting standard among the IFRS standards (Mazzi et al. 2016, 354). The thesis aims at finding out whether the complexity of IAS 36 affects the true and fair view given by the financial report where the standard has been applied.

## **1.2 Purpose and limitations**

The purpose of the thesis is to look at the international financial reporting standard IAS 36 from the true and fair view point of view and to find answers to the research questions which are the following: 1. How does IAS 36 contribute to giving a true and fair view in financial reporting? and 2. What kind of challenges does IAS 36 cause to giving a true and fair view in financial reporting? The research methodology of the thesis is a literature review, which means that the questions will be answered based on prior research on the subject.

The limitations of the thesis are as follows. Of the assets that IAS 36 covers, in the thesis only goodwill will be examined. IAS 36 allows the recoverable amount of an asset or a cash-generating unit to be determined by two alternative methods, value in use or fair value less cost of disposal. The thesis focuses on examining cases where the recoverable amount has been determined based on value in use. Due to the international nature of the standard in question, the prior literature used in the thesis will not be limited geographically, even though European literature might be emphasized. However, also for example Australian research will be discussed.

## **1.3 Structure of the thesis**

The thesis consists of an introduction, a literature review (chapters 2–4), a conclusion and a summary. Chapter 2 covers the basic information about IAS 36 – the relevant concepts in the standard, the impairment process and the disclosure requirements. Chapter 3 examines the concept of true and fair

view. The purpose of chapter 3 is to look at the meaning of the concept, discuss the connection between the concepts of true and fair view and fair presentation, and present different views on the true and fair view concept. Chapter 4 concentrates on the compliance with IAS 36 from the true and fair view point of view. In the conclusions I will explain the most central findings based on the literature review, and the summary will consist of the main points of the thesis. A list of references will be found at the end of the thesis.

## 2 IAS 36

### 2.1 Central concepts in IAS 36

The revised IAS 36 standard, Impairment of assets, was published by International Accounting Standards Board (IASB) in March 2004 (Petersen & Plenborg 2010, 419). According to paragraph 1 in IAS 36, the objective of the standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. The standard should be applied in accounting for the impairment of all assets apart from inventories, contract assets or assets arising from costs to obtain or fulfil a contract that are recognized in accordance with IFRS 15, deferred tax assets, assets arising from employee benefits, financial assets that are within the scope of IFRS 9, investment property that is measured at fair value, biological assets related to agricultural activity within the scope of IAS 41, contracts and assets within the scope of IFRS 17, and non-current assets classified as held for sale in accordance with IFRS 5. As shown in the previous list, mostly all the assets not covered by IAS 36 are covered by another IAS or IFRS standard.

The impairment test is conducted to measure the recoverable amount of the asset. According to IAS 36, the definition of recoverable amount is the higher of an asset's value in use and fair value less costs to sell. In practice the most common method for measuring the recoverable amount is the value in use method, possibly due to the lack of information about the asset's market value. If the recoverable amount of the asset is less than its carrying amount (i.e. book value), an impairment loss is recognized, and the carrying amount will be reduced to the recoverable amount. (Petersen & Plenborg 2010.) Paragraph 19 in IAS 36 allows the use of only one of the methods to measure the recoverable amount in cases where either of the recoverable amounts exceeds the asset's carrying amount. In that case, the asset is not impaired, and it is not necessary to estimate the other amount.

Apart from the recoverable amount, another relevant concept in IAS 36 is a cash generating unit (CGU). Therefore, other critical topics covered by the standard are the identification of CGUs and allocation of assets to them (Mazzi et al. 2016, 355). A CGU is the basic testing unit against which impairment assessment testing proceeds (Carlin & Finch 2009, 327). According to paragraph 6 in IAS 36, a CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the inflows from other assets or groups of assets. IAS 36 provides limited guidance on how to define a CGU, despite of the fact that according to the standard a unit or group of units should not be larger than operating segment determined in accordance with IFRS 8 (Petersen & Plenborg 2010, 425).

## 2.2 Testing the impairment

As the value in use method for measuring the recoverable amount of the CGU is the more commonly applied method, in this section will be explained how the impairment test should be conducted when using this method. Of the assets covered by IAS 36 the focus will be on goodwill, in line with the chosen limitation of the thesis. According to the standard, goodwill and intangible assets with indefinite useful lives should be tested for impairment on a yearly basis. Other assets should be tested for impairment if there is an indication that an impairment has occurred. (Mazzi et al. 2016, 355.)

As goodwill represents resources that cannot be identified or quantified reliably, it cannot be tested for impairment separately. Therefore, goodwill is allocated to a single CGU or a group of CGUs that benefit from the acquired goodwill. (Petersen & Plenborg 2009, 422.) According to paragraph 80 in IAS 36, apart from not being larger than an operating segment, each unit or group of units to which goodwill is allocated shall represent the lowest level within the entity at which the goodwill is monitored for internal management purposes. As mentioned above, to determine whether an impairment has occurred, the asset's (CGU's) carrying amount is compared to the estimated recoverable amount. The carrying amount of a CGU represents the sum of the carrying amounts of the assets allocated to the CGU, as the separate assets have known carrying amounts (Carlin & Finch 2009, 327).

According to paragraph 30 in IAS 36, the following elements shall be reflected in the calculation of the value in use of an asset (according to paragraph 74, same principles apply for a CGU). (1) an estimate of the future cash flows the entity expects to derive from the asset, (2) expectations about the possible variations in the amount or timing of those future cash flows, (3) the time value of money, represented by the current market risk-free rate of interest, (4) the price for bearing the uncertainty inherent in the asset, and (5) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset. Furthermore, according to the standard, estimating the value in use involves the following steps: estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal and applying the appropriate discount rate to those future cash flows.

The required 'appropriate discount rate' is further defined in paragraph 55 of the standard. The discount rate shall be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted. The standard defines this appropriate discount rate as the return that investors would require if they

were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset.

According to paragraph 33 in the standard, the cash flow projections shall be based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. The cash flow projections shall be based on the most recent budgets or forecasts which principally cover a maximum period of five years. The cash flow projections beyond the period covered by the budget or forecast shall be extrapolated using a steady or declining growth rate. Paragraph 33 shows that a substantial part of the application of IAS 36 is dependent on management judgment. According to Mazzi et al. (2016, 354), the standard allows subjectivity in its application, and it is adaptable to managerial needs and unable to limit creative accounting. Later in the thesis I will look at how these qualities of the standard affect the true and fair view given by the financial reports where the standard has been applied.

According to paragraph 104 in the standard, an impairment loss shall be recognized for a CGU if, and only if the recoverable amount of the CGU is less than the carrying amount of the CGU. The impairment loss shall be allocated to reduce the carrying amount of the CGU in the following order: (1) first, to reduce the carrying amount of any goodwill allocated to the CGU, and (2) then, to the other assets of the CGU pro rata on the basis of the carrying amount of each asset in the unit.

The IAS 36 standard recognizes the possibility of reversing an impairment loss if there is an indication that an impairment loss recognized in prior periods may no longer exist or may have decreased. However, according to paragraph 124, the reversal does not concern goodwill. An impairment loss recognized for goodwill shall not be reversed in a subsequent period. The reason for this is that IAS 38 standard prohibits the recognition of internally generated goodwill, and, according to paragraph 124 in IAS 36, any increase in the recoverable amount of goodwill is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognized for the acquired goodwill.

### **2.3 Disclosure requirements**

IAS 36 contains extensive requirements for disclosure. The standard requires companies to disclose, among other things, the methodology and the parameters used in their impairment tests (Glaum et al. 2013, 165). Disclosure is required on different levels: classes of assets, segments, and individual assets or CGUs.

The standard recognizes separate requirements for disclosure in CGUs where goodwill or intangible assets with indefinite useful lives have been allocated. These requirements are presented in paragraph 134 in the standard. For other types of assets, disclosure of assumptions used to determine the recoverable amount of assets is according to the wording of the standard ‘encouraged’.

In CGUs where goodwill or intangible assets with indefinite useful lives have been allocated the disclosure requirements cover, among others, the carrying amount of goodwill allocated to the unit and the basis for determining the recoverable amount (value in use or fair value less cost of disposal). When the value in use method is used for determining the recoverable amount, the entity shall disclose each key assumption on which the management has based its cash flow projections, a description of management’s approach to determining the value(s) assigned to each key assumption, the period over which the management has projected cash flows, the growth rate used to extrapolate the cash flow projections beyond the period, and the discount rate(s) applied to the cash flow projections.

### 3 True and fair view

#### 3.1 Meaning of the concept

The true and fair view concept was introduced in the fourth EU company law directive in the 1970s after the UK, Ireland and Denmark had joined the European Community (EC). According to article 2 of the fourth directive, a company's accounts shall be drawn up clearly and in accordance with the provisions of the directive, and they shall give a true and fair view. The concept was new for all the EC member countries, except for UK, Ireland and the Netherlands, all of which had previously applied a similar concept. The adaptation of the concept in EU legislation is one reason for the interest in the concept in academic and professional literature. (Evans 2003.)

The concept of true and fair view has never been officially defined, and because of the dynamic nature of the concept, it had been argued that a definition would neither be possible nor desirable (Evans 2003, 312). However, it is important to understand what is meant with the concept, and there are some descriptions about the possible meaning. According to Evans (2003), the consensus appears to have been that the concept has taken on a technical meaning, which can not be derived from the natural meanings of the words 'true' and 'fair', or not from these alone. Kirk (2006, 210) brings up that neither 'true' nor 'fair' as separate words have a precise definition, but the meaning could vary dependent on time and place. Alexander & Eberhartinger (2009) refer to the meaning of the concept as giving a valid and not misleading picture of the enterprise.

Egan & Xu (2020), in turn, bring to attention that the true and fair view concept could have different meanings to different users. Their research covered managers and external auditors, and according to the findings, managers and audit committee members understood the concept to reflect commercial substance, while external auditors understood the concept through accounting-standard compliance. As part of their conclusions, Egan & Xu (2020) introduced the concepts 'deficient' and 'defective', when describing the relationship between accounting standards and true and fair view. An accounting standard is seen to be deficient, if it does not address an element of commercial substance that is of importance to giving a true and fair view. A standard is defective if compliance with it leads to a view that is not true and fair.

As presented previously, compliance with the accounting standard does not automatically mean that the reporting gives a true and fair view. Accountants have been criticized for assuming that if the numbers in the report are constructed in compliance with current mandatory and legislative

requirements, then the accounts are true and fair. Yet what is reported does not necessarily give a reasonable view of the true financial health of the company. (Ferry & Lehman 2018.)

This has been recognized even in the fourth EU company law directive. The directive states, first, that where following the provisions of the directive is insufficient to provide a true and fair view, additional information must be provided. Second, according to the directive, where in exceptional cases the application of a provision of this directive would be incompatible with the obligation to give a true and fair view, that provision must be departed from in order to give a true and fair view (Evans 2003, 319). This principle is called the true and fair view override.

### **3.2 Different views on the concept**

As the true and fair view concept is a part of an EU directive, and in that way an applicable principle in all the EU, it would be natural to think that the concept has a shared meaning in the EU. This view is supported by Wüstemann & Kierzek (2006), who argue that a ‘European’ true and fair view principle exists, and it must be interpreted consistently in all member states. Their statement is based on the European Court of Justice’s statement that the application of true and fair view principle must as far as possible be guided by the accounting principles included in the Fourth Company Law Directive.

A fact that challenges Wüstemann & Kierzek’s (2006) statement is the different implementations of the true and fair view override in the EU countries. As the override is a part of an EU directive, it should be implemented in the national legislation of each member state. However, this is not the case. According to Alexander and Eberhartinger (2009), neither Germany nor Austria have implemented the override. In Germany the implementation of true and fair view without an overriding function is supported, among other factors, by the rule that the specific legal provision overrides the more general one. The true and fair view principle is perceived to be the general provision in relation to the specific legal accounting methods. (Alexander & Eberhartinger 2009, 576.)

Of the EU member states, for example France and Romania have implemented the true and fair view override. In Italy the override is limited to exceptional cases, suggesting that the rules should normally be fair enough to be followed. (Alexander et al. 2018, 1973.) Also, in Finland the override of true and fair view principle has been implemented in the law.

### 3.3 True and fair view and fair presentation

As this thesis discusses the relationship between the IAS 36 standard and the concept of true and fair view, it is reasonable to look at the meaning of true and fair view from the IAS/IFRS perspective. In the IFRS terminology, no reference is made to true and fair view. Instead, the equivalent concept is fair presentation. This concept is introduced in IAS 1, which states that financial statements should present fairly the financial position, financial performance, and the cash flows of an enterprise. According to the standard, the concept of fair presentation shall be interpreted based on existing standards and interpretations by the International Financial Reporting Interpretations Committee (IFRIC). (Evans 2003, 317.)

One similarity between the concepts of true and fair view and fair presentation is that as well as in the EU directive, also in the IAS 1 standard there is a so-called fair presentation override. The IFRS (or IAS) standards have always relied on considering the economic substance rather than legal form (Alexander et al. 2018, 1958). In my opinion, the override reflects the ‘substance over form’ principle.

IAS 1 requires the enterprise to provide additional disclosures where IAS requirements would be insufficient to reflect particular transactions or events. If management concludes that compliance with the requirements of a standard would lead to misleading reporting, the objective of the requirement must be considered. The management must consider why the objective cannot be achieved or why it is not relevant in the enterprise’s case. In case of departure of a requirement of standard, IAS 1 requires full disclosure, including disclosure of the financial impact of the departure. (Evans 2003, 317.)

The fair presentation override follows the same structure as the true and fair view override, that is it requires the preparers of financial statements in the first place to provide additional disclosures. Departure from a requirement of a standard is an activity of last resort. It appears that the application of the override is not anticipated, as, according to IAS 1 paragraph 10, the appropriate application of the IAS standards, with additional disclosure, if necessary, results, in virtually all circumstances, in financial statements that achieve a fair presentation (Evans 2003, 317).

There has been discussion in the literature about whether the concepts of true and fair view and fair presentation have the same meaning. Nobes (2009, 417) presents different views on the question. According to Nobes (2009), the answer to the question is dependent on the jurisdiction, because the legal and linguistic context will affect the answer. Nobes (2009) discusses the different translations

of the concepts into German, Italian and French. According to Evans (2003), the concepts of true and fair view are related, and they are sometimes treated as equivalents.

Based on the presented literature it can be stated that true and fair view and fair presentation are close concepts, and that their meaning is overlapping. In the context of this thesis, the concepts will be perceived as equivalents, and therefore there are no issues in examining the IAS 36 standard from the true and fair view point of view, which will be done in section 4. Paragraph 15 in IAS 1 requires the financial reporting preparers to present information in a manner which provides relevant, reliable, comparable and understandable information. These four adjectives can be understood to describe even the intended meaning of true and fair view, and in section 4 the relationship between IAS 36 and true and fair view will be looked at keeping these attributes (relevance, reliability, comparability, understandability) in mind.

## 4 The true and fair view in IAS 36

This section looks at how IAS 36 is applied in practice by the preparers of financial statements. The section is based on prior research in the area, and will cover the choice of CGUs, use of discount rates, risk adjustment, making an impairment loss, and compliance with the disclosure requirements. The purpose of the section is to examine the findings of the prior research in the light of giving a true and fair view in financial reporting.

### 4.1 Choice of CGUs

As explained in section 2.1, IAS requires the financial statement preparers to define CGUs to which the goodwill is allocated for impairment testing. According to the standard, the number of CGUs shall not be smaller than the number of the company's operating segments.

The correct definition of a CGU is important because the number of CGUs to which goodwill is allocated for the purpose of impairment testing itself has the capacity to impact whether an impairment loss will be recognized. Where an enterprise's units whose cash flows are imperfectly correlated and whose risk profiles differ are fused as one CGU rather than two or more, the excess headroom between the recoverable amount and carrying amount of the assets of the better performing units serves as a shock absorber for the riskier or more poorly performing units. If the units, on the other hand, were defined as separate CGUs, the shock absorber effect would be removed, which would, in turn, remove the capacity to avoid impairment write down. (Carlin & Finch 2011, 375.)

According to the prior research, there are some deficiencies with the definition of CGUs. Petersen & Plenborg (2010, 421) found that some firms don't define a CGU, which means that they don't comply with IAS 36. According to Carlin & Finch (2009, 328), firms appear to systematically define fewer CGUs than appropriate, which may result in an inappropriate delay in the recognition of the impairment losses. In both cases, the above explained shock absorber effect is strongly present. Based on the findings, the conclusion can be made that number of CGUs defined by the firm affects the likelihood of recognizing an impairment loss.

When the findings are analyzed from the point of view of true and fair view, it seems obvious that the results of an impairment test cannot give a true and fair view, if the requirements of the IAS 36 standard have not been followed, which is the case when firms have not defined CGUs at all. Even when the CGUs are defined, but they are fewer than would be appropriate judging by the conditions of the particular firm, the result of the impairment test will not give a true and fair view. When no or

few CGUs are defined, the impairment test is likely to lead to avoiding an impairment write down which could have been actual if the correct number of CGUs have been used. As a result, the financial statement gives a misleading view of the firm's financial position.

## 4.2 Use of discount rates

IAS 36 standard requires that pre-tax cash flows shall be discounted with pre-tax discount factor. The standard suggests that the pre-tax discount rate can be calculated by an iterative process, so that discounting either pre-tax cash flows with a pre-tax discount rate or after-tax cash flows with an after-tax discount rate yields identical results. Using this method requires that value in use is estimated by applying an after-tax approach, followed by an iteration process to find a pre-tax discount factor that yields the same value as the after-tax approach. (Petersen & Plenborg 2010, 430.)

Another method to calculate the pre-tax discount rate is to divide the after-tax discount rate with the reciprocal value of the corporate tax rate ( $1 - \text{corporate tax rate}$ ). According to the standard, this method shall only be applied under the strict assumption that future cash flows of the CGU are infinite and constant. (Petersen & Plenborg 2010, 430.)

In their research, Petersen and Plenborg (2010) found substantial non-compliance with the standard in the aspects mentioned above. Half of the respondents (54 in total) in the research announced that they discount the pre-tax cash flows with a pre-tax discount rate, while the rest used after-tax discount factor. Furthermore, according to the findings, the iterative process required by the standard to transform an after-tax discount factor into a pre-tax discount factor was not used by any of the respondents. Instead, the methods most frequently used were dividing the after-tax discount rate with the reciprocal value of the corporate tax rate or using the weighted average cost of capital (WACC).

When the pre-tax discount rate is estimated by dividing the after-tax discount rate with the reciprocal value of the corporate tax rate, it leads to a biased estimated value in use. When applying this method, the pre-tax discount rate is too low, which leads to too high an estimated value. The shorter the lifetime of the project (the period of the cash flows), the bigger the error in the estimate. The same issue arises when using WACC as the discount rate; the estimated values based on pre-tax cash flows are biased upwards as the pre-tax discount rate is too low. (Petersen & Plenborg 2010, 431–432.)

The study of Carlin and Finch (2009) supports the findings of the Petersen and Plenborg (2010). The purpose of the study is to compare the single 'whole of firm' discount rates disclosed by sample firms with independently generated central point 'whole of firm' discount rates. It is notable that IAS 36 requires the use of individual discount rates for each CGUs. However, available empirical evidence

shows that in a substantial number of instances, firms disclose the application of single discount rate as an element of the estimation of the recoverable amount of all CGUs (Carlin & Finch 2009, 328).

To make comparisons with the discount rates disclosed by the sample firms, Carlin and Finch develop independent estimates of discount rates using the capital asset pricing model (CAPM). CAPM is chosen as the method for estimating an appropriate discount rate as it represents the current market assessment and the risks specific to the CGU asset (Carlin & Finch 2009, 329). As the risk-free rate of interest is used approximately 5,9 per cent and as a market risk premium 6 per cent.

For the classification of the results, the firms are divided into five groups based on the discount rate used compared to the estimated appropriate discount rate. Because any technique for estimating discount rates is subject to potential error, the variances between independently estimated and observed actual discount rates are interpreted with a degree of care. Therefore, any observed discount rates that fall within a band of plus or minus 150 basis points of independently estimated discount rates are regarded as falling within a reasonable expected range. Apart from the expected range, the classification covers between 150 and 250 basis points below and above the expected range, and over 250 basis points below and above the expected range. (Carlin & Finch 2009.)

According to the results, the discount rates disclosed by 31 of the 105 sample firms (30 per cent), fall within the expected range with a deviation of plus or minus 150 basis points. Majority of the sample firms, 38 per cent, disclose a discount rate that is over 250 basis points below the estimated appropriate discount rate. The research shows, equally to the research by Petersen and Plenborg (2010), that firms tend to apply discount rates below appropriate. As stated above, a downwards biased discount rate leads to an upwards biased estimated recoverable amount, and therefore a possibly avoided impairment loss write down. The deficiencies in the discount rate estimations lead to financial statements giving a view of the firm's financial position that is not true and fair.

The study covers the measurement of goodwill intensity, which is calculated as goodwill divided by net profit before tax. Goodwill intensity is a measure of sensitivity of sample firm reported profit to goodwill impairment charges. The greater the goodwill intensity value, the greater the risk of losses in the current period. A goodwill intensity score of less than zero implies unprofitability of the firm, and impairment expenses will further increase the current period losses. (Carlin & Finch 2009, 330.)

The results concerning the connection between goodwill intensity and the applied discount rate of the firms suggest that higher goodwill intensity firms do not systematically select lower than expected discount rates to a greater degree than lower goodwill intensity firms. According to the findings, 50

per cent of the goodwill covered by the research is possessed by firms that applied a discount rate within the expected range. A substantial part, 33 per cent, of the goodwill researched belongs to firms that applied a discount rate over 250 basis points below expectation, while only 4 per cent belongs to firms applying a discount rate above the estimated appropriate rate. (Carlin & Finch 2009, 332–333.)

### **4.3 Risk adjustment**

IAS 36 requires that the risk specific to the asset or the CGU must be accounted for. This can be done by either adjusting the cash flow or the discount rate (Petersen & Plenborg 2010, 432.) Research shows that the most common method is the risk-adjusted discount rate method (see Carlin & Finch 2009 and Petersen & Plenborg 2010.) When the risk has been taken into account in the estimated cash flows, this has, according to Petersen and Plenborg (2010), been done by making a conservative estimate of the free cash flows or by weighing the likelihood of possible future cash flows, both of which might lead to a biased result.

When the risk-adjusted discount rate method is used, cash flows should be discounted with the WACC or a variant thereof that reflects the risk of each CGU. The study shows that majority of the firms that used WACC as the risk-adjusted discount rate used different WACCs across CGUs. However, some firms use the risk-free rate of interest as their risk-adjusted discount rate, which clearly doesn't lead to correct risk adjustment, as the risk-free rate does not take risk into account. (Petersen & Plenborg 2010.)

The findings of Petersen and Plenborg (2010) show that the requirements of IAS 36 concerning risk adjustment have at least partly been complied with in most of the firms that the study covers. For the correct risk adjustment, the discount rate for each CGU should principally be individual. Therefore, the above-mentioned findings of Carlin & Finch (2009) concerning the use of a single discount rate for all the CGUs show that risk adjustment has not been taken into account. When the risk specific to the cash flows of the CGUs is not taken into account, the cash flows have too high estimated values, or the discount rates are too low. Both options lead to an estimated recoverable amount that exceeds the amount calculated with risk-adjusted parameters. From the 'true and fair' point of view, the deficiencies in risk adjustment lead to possibly avoided impairment loss write downs.

### **4.4 Making an impairment loss write down**

IAS 36 requires an impairment loss write down whenever the impairment of goodwill is recognized, that is, the standard doesn't allow managerial discretion in this matter. However, research finds that

managers use some discretion when estimating the variables used in the impairment tests. According to Avallone & Quagli (2015, 112), overestimation of the cash flow growth rate is one method used to avoid or reduce impairment losses. Apart from influencing the result of the test by choosing the variables, studies show that managers might leave a recognized impairment loss unrecorded.

André et al. (2016) examined the differences in impairments between US and European firms. The results find that US firms are more likely to record an impairment loss, and when impairing, US firms impair a much greater percentage of their goodwill. Of firms exhibiting economic impairment according to the measures used in the study, only 20–25 per cent recorded an impairment, which could be a sign of untimely impairment recognition. According to the results, US firms make goodwill impairments timelier than European firms. (André et al. 2016, 350.)

Making an impairment loss is found to be related not only with declining economic performance but also with management and firm-level incentives, such as big bath behavior, income smoothing, and loss avoidance (Choi & Nam 2020, 2). Consistent with this, Trottier (2013) examines the likelihood of a manager recording an impairment and how the impairment recognition is affected by the reversibility of the impairment and the existence of a bonus plan. In the research, the participants were asked to evaluate the likelihood of a manager recording a recognized impairment on a scale of 1 (very unlikely) to 7 (very likely). The mean overall response to the question is 4,85, which shows that managers do not mechanically apply accounting rules but exercise some discretion when making decisions (Trottier 2013, 9.)

Recording the impairment is, according to the result, most unlikely under the conditions of irreversibility and a bonus plan. That is, the research participants believe that a manager will be less likely to recognize an impairment loss if he has a bonus plan and reversals are not permitted. Allowing the reversal of the loss increases the likelihood of recording the impairment of the manager with a bonus plan to the same level as a manager without a bonus plan. (Trottier 2013, 3.)

As the impairment loss recognized for goodwill is irreversible and there are no changes in sight in this matter, the conclusion that can be made based on the research presented is that not all recognized goodwill impairments are reported by the managers, and especially not by managers with a bonus plan. When a recognized impairment loss is not reported, the financial statements cannot give a true and fair view of the firm's financial situation. However, there is evidence that apart from exercising discretion to delay the impairment, managers exercise discretion to prompt impairments. Accelerated impairments are found to be positively associated with the current share price as well as future

expected cash flows. (Choi & Nam 202, 18.) To show a true and fair view in the financial statement, the goodwill impairment should be recognized and recorded timely.

#### **4.5 Compliance with disclosure requirements**

The purpose of disclosure requirements is, among other things, to reduce information asymmetries between company managers and investors and between different types of investors. Timely, transparent and reliable information reduces investors' estimation risks and allows better evaluation of management's decision-making. On the other hand, when companies don't comply with accounting disclosure requirements, they withhold potentially relevant information from the capital markets. When the incompliance is intentional, the information presented is likely to be biased. (Glaum et al. 2013.)

Compliance with disclosure requirements has been studied by Glaum et al. (2013) in wide research covering 17 European countries. The research examines compliance with IAS 36-required disclosure by company- and country-level determinants, and substantial incompliance is found. According to the findings, country-specific factors like accounting traditions play a role in the compliance despite the use of common IFRS standards. Company-level determinants that affect compliance according to the research are, for example, importance of goodwill position, prior experience with IFRS, type of auditor, the existence of audit committee, ownership structure and the strength of the enforcement system. Likewise, Gros & Koch (2018, 146) find that there is a connection between the enforcement environment and the disclosure behavior.

According to the findings of Glaum et al. (2013), the importance of goodwill position is positively associated with compliance with the disclosure requirements. The results show that a 10 per cent increase in the ratio of goodwill to total assets is associated with a 13.8 per cent increase in the compliance index, holding everything else constant. This is good news from the viewpoint of true and fair view, as it shows that firms with higher amounts of goodwill are more likely to be compliant with the disclosure requirements. On the contrary, the fact that the disclosure compliance is affected by country-specific factors, as the accounting traditions, impedes the comparability of the financial statements from different countries applying IFRS. (Glaum et al. 2013.)

Like Glaum et al. (2013), also Baboukardos & Rimmel (2014) find significant incompliance with the disclosure requirements of IAS 36. The compliance is measured by a numerical scale from 0 to 1, and the mean level of compliance with IAS 36 requirements was only 0.29. From the sample of 75 firms,

30 companies were found to exhibit no compliance with the IAS disclosure requirements. (Baboukardos & Rimmel 2014, 8.)

In their research, Mazzi et al. (2016) find that there is some variation in the managers' opinions about the usefulness of the mandatory disclosure required by IAS 36. According to the results, some managers think that the mandatory disclosure is sufficient for stakeholders' decision-making, while others think that it is too detailed, or it is redundant. These views could provide some answers to the above-mentioned findings about incompliance with the disclosure requirements. If preparers are not convinced of the usefulness of the disclosures, they may not consider non-disclosure as an incompliance. (Mazzi et al. 2016, 366.)

Another possible explanation for the incompliance is that the level of disclosure is management's strategic decision which is affected by the direct and indirect costs of the disclosure. Even though an increased level of disclosure might decrease the company's cost of capital, this does not seem to be a strong enough incentive to the management to increase compliance and the quality of impairment testing related disclosure. (Gros & Koch 2018.)

## 5 Conclusions

In this section I will look at the findings of the thesis from the point of view of the research questions presented in the introduction. The research questions are 1. How does IAS 36 contribute to giving a true and fair view in financial reporting? and 2. What kind of challenges does IAS 36 cause to giving a true and fair view in financial reporting? Apart from examining the answers to the research questions, some thoughts about improving the standard and its applicability will be presented.

The purpose of the IAS 36 standard is to make sure that goodwill (and other assets covered by the standard) are not recorded in the financial statements to a higher value than its recoverable amount. Therefore, the standard prevents the financial statements from presenting an overly optimistic view of the company's financial position. This is in line with the prudence principle in accounting and increases the reliability of the statements. Consequently, compliance with IAS 36 should result in financial statements that give a true and fair view of the value of the goodwill.

Another aspect in IAS 36 that contributes to giving a true and fair view is the existence of the overriding principle. As explained earlier, the IAS 1 standard requires that the financial statements present fairly the financial position, financial performance, and the cash flows of an enterprise, and allows departure of a standard if compliance with the standard would result in misleading reporting. According to the conclusion at the end of section 3.3, the concepts 'fair presentation' and 'true and fair view' can be seen as equivalents. Therefore, the possibility to depart from a standard in order to comply with the fair presentation probably leads to financial reporting that is giving a true and fair view, as well.

The main challenge with IAS 36 and giving true and fair view in the financial reporting is the complexity of the standard. The goodwill impairment test procedure prescribed by IFRS is complex, onerous and costly (Choi & Nam 2020, 2). The complexity leads, according to the findings of this thesis, to significant non-compliance with the requirements of the standard in many aspects. Deficiencies were found, first, in the choice of CGUs and the use of discount rates. Companies tend to define fewer CGUs than appropriate, which creates a shock absorber effect and might lead to avoided goodwill impairment recognition. According to prior literature, discount rates used in the impairment testing are often too low. A possible explanation for the deficiencies with the discount rate determination could be the requirements of using a pre-tax discount rate while, according to Petersen and Plenborg (2010, 430) most academic books use an after-tax discount rate.

Another challenge with the standard and giving a true and fair view is the fact that IAS 36 allows substantial management discretion. The literature referred to in the thesis finds that discretion is exercised when recording a recognized impairment loss and when disclosing information. According to the findings, managers might not record an impairment loss, especially when having a bonus plan, or impairment is recorded accelerated or delayed. Research finds that there is substantial incompliance with the disclosure requirements, which might be explained by the management's views of the usefulness of the required disclosure. The lack of disclosure increases information asymmetry between management and investors.

As the complexity of IAS 36 is recognized as a reason behind the deficiencies in its application, the research of Morais (2020) about the complexity of the IFRS and IAS standards is of interest. Unfortunately, the research find that between 2005 and 2016 the standards have become more complex (Morais 2020, 59). IAS 36 has been accused of being so complex, unwieldy and conceptually challenged that systematic compliance with its requirements is not possible (Carlin & Finch 2011, 387). Mazzi et al. (2016, 355) suggest that IASB could consider providing more detailed information on the implementation of IAS 36. It seems clear that in its present form, IAS 36 does not completely fulfil its objective and preparing a financial statement showing a true and fair view of the company's financial position based on IAS 36 is a difficult task.

## 6 Summary

This thesis examines compliance with IAS 36 from the point of view of true and fair view. Of the assets covered by IAS 36, the thesis is limited to goodwill, and the examined method for measuring the recoverable amount of an asset (CGU) is the value in use method. The thesis provides answers to the following research questions: 1. How does IAS 36 contribute to giving a true and fair view in financial reporting? and 2. What kind of challenges does IAS 36 cause to giving a true and fair view in financial reporting? The research questions are of interest because there are not many previous studies that discuss the connection between the standard and the true and fair view.

Financial reports show a true and fair view if they are, among other things, relevant, reliable, comparable and understandable. Based on prior literature, the thesis finds that there are significant deficiencies in the compliance with IAS 36. The findings show that when applying the standard, the firms tend to define fewer CGUs than appropriate, use lower than expected discount rates, and avoid recording a recognized impairment loss or affect the variables in the impairment test process so that impairment will not be recognized. Furthermore, firms fail to comply with the required level of disclosure. These deficiencies lead to financial statements that do not give a true and fair view of the firm's financial position.

The findings suggest that IAS 36 is a difficult standard to apply, and full compliance with the standard is hard to achieve. Therefore, the thesis implicates that in its present form and wording, IAS 36 doesn't completely fulfil its objective. More detailed information on the implementation of the standard is requested (Mazzi et al. 2016, 355).

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