SHINHAN FINANCIAL GROUP

Proposal of Alternatives for Goodwill Accounting

Issue Paper

This issue paper is irrelevant to the official position of KASB.

EXECUTIVE SUMMARY

Amortization of goodwill is not allowed according to IFRS 3. Instead, goodwill should be tested for the impairment periodically. Impairments become the only method for the subsequent accounting treatment of goodwill.

"But, is the periodic review on impairment the only and best way for subsequent accounting treatment of goodwill?"

We agree with the legislate point of IFRS 3 that the amortization of goodwill could distort the financial information, because the periods and patterns in which economic benefit from goodwill is consumed is hardly estimated.

However, we noted that some companies who perform the impairment test of goodwill and some researches raise many issues on the subsequent accounting treatment of goodwill, "impairment test".

The key points of issues on accounting treatment of goodwill in IFRS 3 that require only review on impairment are as follows:

1) Various assumptions and estimations used in verifying recoverable amount may bring up doubt on the reliability in impairment test of goodwill and financial information. In addition, due to given difficulty in verifying fair value estimates for goodwill, it is possible that management may use this discretion to avoid or delay the impairment of goodwill

2) Although goodwill consists of various components, impairment test is performed as a whole, without considering various components and natures of goodwill. Therefore, impairment of goodwill may not reflect the economic substance.

3) Generally, impairment of goodwill is influenced by the economic fluctuation. That is, the risk of impairment of goodwill can be underestimated at the time of economic expansion while it can be overestimated at the time of economic recession. Accordingly, it is apprehended that impairment of goodwill expands volatility of earnings in sympathy with the economic cycle.

There have been a number of disputes regarding the subsequent accounting treatment of goodwill e.g., amortization or impairment. However it has been hardly decided which would be superior, because each method has both merit and demerit.

The post implementation review of IFRS 3 is coming. Therefore, we think it is timely and worth considering whether current accounting treatment of goodwill is adequate in the view of companies who apply IFRS.

I. Introduction

Incorporated on September 1, 2001, Shinhan Financial Group (hereinafter, "SFG") is the first privately-held financial holding company to be established in Korea. We have experienced substantial growth through several mergers and acquisitions of the companies such as Goodmorning Shinhan Securities, Choheung Bank, Shinhan Life Insurance and LG card etc.

As a result of number of mergers and acquisitions over several years since the incorporation of the holding company, goodwill amounting to KRW 3,828 billion is carried on the consolidated financial statements as of end of 2012. This figure is substantial to SFG, considering that the last 3 year's average consolidated income amounts to KRW 2,702 billion.

Until 2010 which is the date of adoption of IFRS, SFG had amortized goodwill over a reasonable period within 20 years, accompanying the impairment test in the case that there is any indication of impairment in accordance with the Korean GAAP (previous GAAP).

SFG has been preparing and reporting the financial information in accordance with IFRS since 2011. Therefore, SFG has tested goodwill acquired in a business combination for impairment annually by comparing its carrying amount with its recoverable amounts in accordance with IFRS 3 and IAS 36.

II. Background

International accounting standard board (hereinafter “IASB”) has been issuing new interpretations continuously in an effort to improve the quality of financial information. The outstanding examples for this effort would be IFRS 3 and IAS 36. This new interpretations changed the subsequent accounting treatment of goodwill significantly. This new interpretations do not allow the amortization of goodwill anymore. Instead, companies should test goodwill for impairment annually.

IASB took away the amortization of goodwill from the subsequent accounting treatment of goodwill, because IASB believes the amortization of goodwill could trigger arbitrary accounting. IASB believes the removal of this arbitrary accounting could improve the quality of accounting information of goodwill.

However, even current IFRS which requires only test of goodwill for impairment permits discretionary authority to management of companies in respect of various assumptions and estimations required in the test of goodwill for impairment, which causes several issues.

There have been a number of disputes regarding the subsequent accounting treatment of goodwill over several decades and continues even now. It may seem to be early to determine whether IABS’s objective has been achieved to improve quality of accounting information as of now, especially, at a point that a new accounting treatment for goodwill has been implemented just a few years ago. Especially, it is almost impossible to analyze the usefulness of new accounting treatment for goodwill for the Korean companies because we have adopted IFRS just 2 years ago.

However, the empirical studies released recently raise doubt that IASB’s objectives has not been achieved to improve quality of accounting information by this new accounting treatment for goodwill.

Prior to IASB’s post implementation review of IFRS 3 ‘Business Combination’, we would like to raise an issue as to current accounting treatment for goodwill based on several studies and our analysis.

III. Analysis

1. Recent Research

Before starting to discuss main point of view, we would like to introduce several recent researches for accounting treatment of goodwill.

Several researches about accounting treatment of goodwill dealt with the empirical analysis on the influences which either impairment or amortization of goodwill has on stock values.

Based on this empirical analysis, this paper examines whether the objective of IASB and FASB to improve the quality of financial information is achieved.

- **Kevin K. Li and Richard G. Sloan(Has Goodwill Accounting Gone Bad?)(2012)**

Way of research	• Empirically examines effects on quality of financial information(value relevance and timeliness) by comparing the quality of accounting treatment both before and after the implementation of SFAS 142 • Reviews and compares the effects of goodwill accounting methods on stock price, using COMPUSTAT database of US companies and CRSP stock return database
Result of research	• SFAS 142 leads to relatively inflated goodwill balances and untimely impairments. • The announcements of goodwill impairments under SFAS 142 elicit limited market response. • Impairments under SFAS 142 are less timely and provide no more information about future profitability than impairments under SFAS 121. • Managers use the discretion granted by SFAS 142 to delay the reporting of goodwill impairments. • Management exploits the discretion afforded by SFAS 142 to temporarily overstate goodwill, earning and stock prices. • It is possible that supplementing periodic impairment with the systematic amortization of goodwill could lead to goodwill carrying values that better reflect the underlying economics and result in more efficient security prices.

- **Paul Van Hulzen, Laura Alfonso, Georgios Georgakopoulos and Ioannis Sotiropoulos (Amortisation Versus Impairment of Goodwill and Accounting Quality) (2012)**

Way of research	• Empirically examines the effects of new accounting standard on the quality of accounting information(value relevance and timeliness) • Reviews and compares the effects of goodwill accounting methods on stock price, using database of companies from Germany, France, Spain and the Netherlands

Result of research	• Due to fair value nature of the impairment expense, it is not more relevant than the amortisation expense, indicating that investors do not find it more useful in their valuation of share prices and therefore also not for decision making. • The results of the timeliness test do show increased timeliness regarding the impairment expense in comparison with the amortisation expense.

- **Dennis J. Chambers(Has Goodwill Accounting under SFAS 142 Improved Financial Reporting? (2007)**

Way of research	• Reviews on the point of value relevance by correlation analysis of the 3 accounting methods(only impairment, only amortization and mixed method) and stock price using COMPUSTAT database
Result of research	• Annual impairment testing of goodwill increases the value relevance of financial reports for large firms experiencing financial difficulties, which is not relevant to smaller firms or more profitable firms. • Elimination of systematic amortization reduced the quality of financial reporting. • A goodwill accounting system that allows both annual impairment testing and systematic amortization, while allowing firms the discretion to choose a firm-specific mix of each, provides the most value relevant goodwill accounting numbers.

As stated above, it looks that the objective of both of IASB and FASB to improve the quality of financial information by amending accounting treatment of goodwill (especially value relevance and timeliness) has not completely achieved.

2. Analysis

Current accounting treatment of goodwill, test of goodwill for impairment, has following problems and limitations.

1) Difficulty in verifying fair value and Management's Discretion

It is unavoidable to use various assumption and estimation related to future cash flow and discount rate in verifying recoverable amount for the purpose of test of goodwill for impairment. These arbitrary factors provide management with substantial discretion, which may deteriorate understandability and reliability of financial information. Further, it is possible that management may use this discretion to avoid or delay the impairment of goodwill.

Illustration 1 :

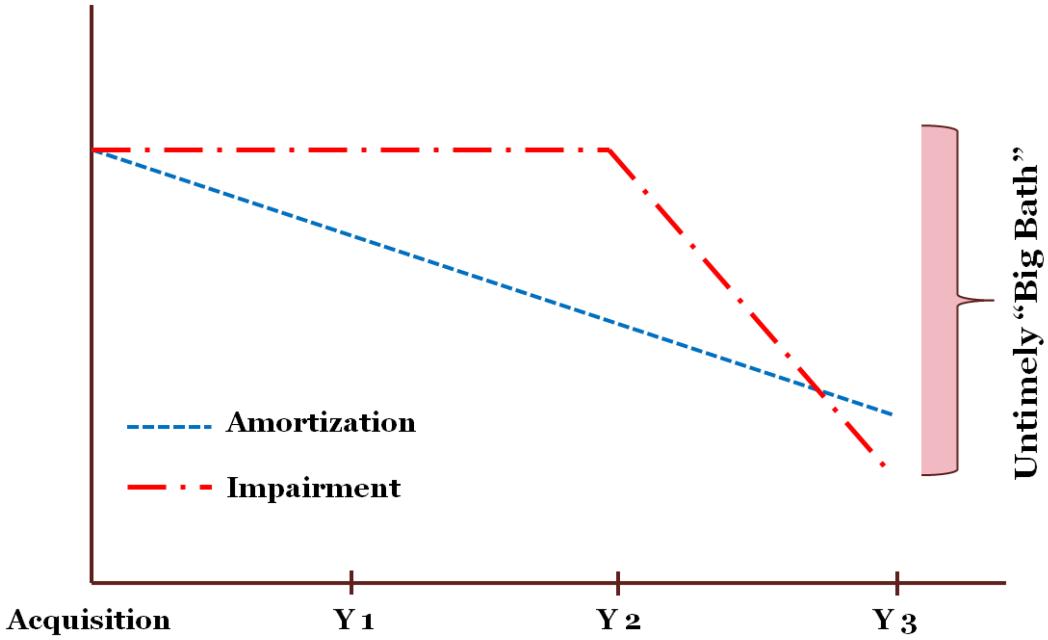
<Goodwill Impairment TEST>

In addition, internally generated goodwill other than goodwill acquired in a business combination is not recognized in the financial statements, because it does not meet requirements for the asset recognition. Nevertheless, this internally generated goodwill contributes to create future cash flows.

Current impairment model, which tests goodwill by comparing its carrying amount with recoverable amounts in the level of cash generated unit, may bring contradiction. In case that there is internally generated goodwill, impairment loss may not be recognized timely due to the effects which this internally generated goodwill has on the future cash flow, though benefit form goodwill acquired in a business combination is decreased. In this case, impairment loss which is not recognized in a timely manner in spite of decrease of value of goodwill can lead to distort financial information by being recognized with a significant amount once a certain point of time .(for example, Global Financial Crisis, Credit crunch. etc).

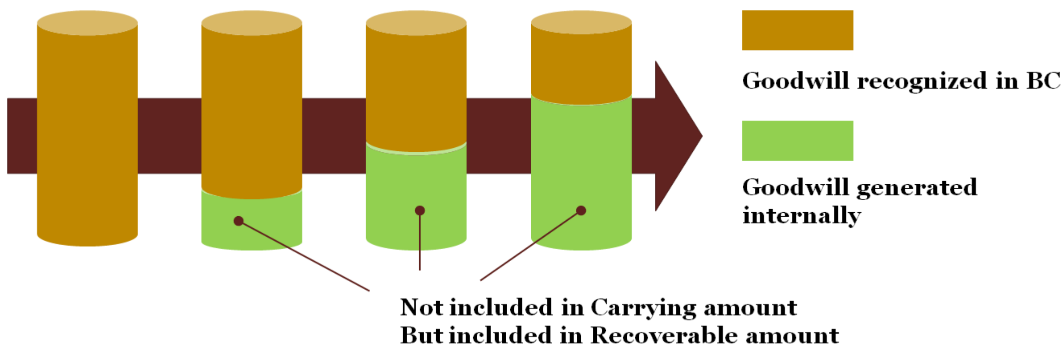
In addition, as Kevin K. Li and Richard G. Sloan show, a large number of managements use their discretion in order to avoid impairment of goodwill. In this regard, it is likely to result in inflated goodwill and subsequent untimely recognition of significant amount of impairment loss by big bath accounting.

Illustration 2 :



Is it TIMELY???

Illustration 3 :



Internally generated GW could hinder impairment

2) The Nature of goodwill

FASB noted components of goodwill in their ED (1999 and 2011) as follows, and IFRS included similar discussion in their ED as well.

- Component 1— The excess of the fair values over the book values of the acquired entity's net assets at the date of acquisition.
- Component 2— The fair values of other net assets that had not been recognized by the acquired entity at the date of acquisition.

- Component 3— The fair value of the "going-concern" element of the acquired entity's existing business.
- Component 4— The fair value of the expected synergies and other benefits from combining the acquiring entity's and acquired entity's net assets and businesses.
- Component 5— Overvaluation of the consideration paid by the acquiring entity stemming from errors in valuing the consideration tendered.
- Component 6— Overpayment or underpayment by the acquiring entity.

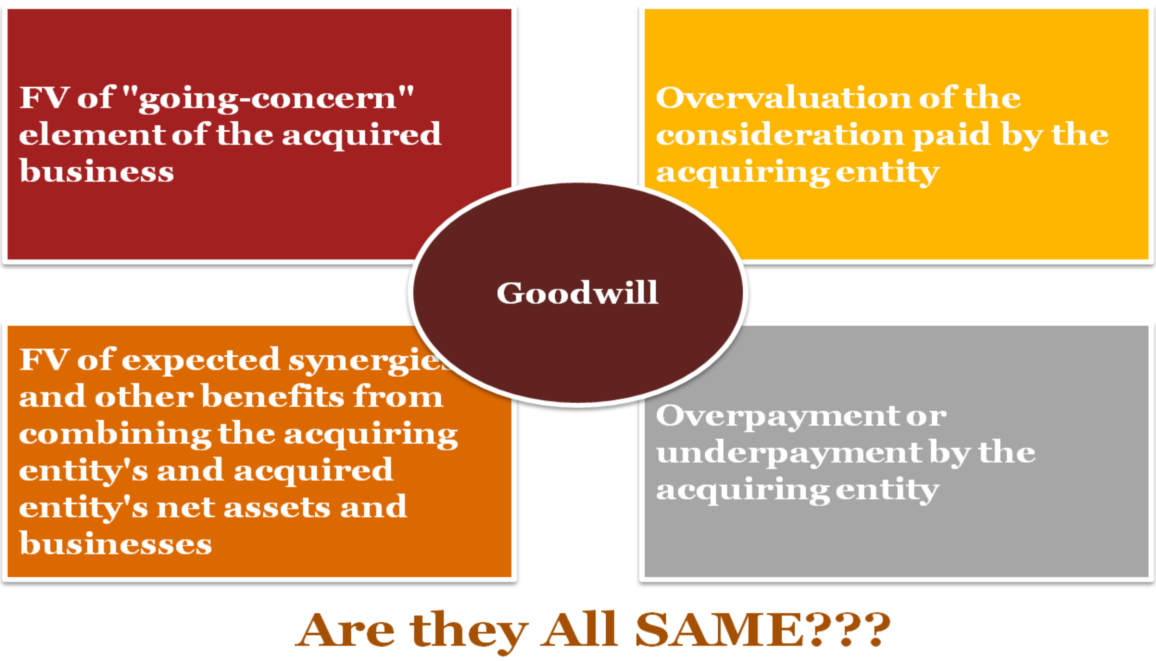
IARS and FASB require Component 1, Component 2 and Component 3 not to be included in the initial recognition of goodwill through fair valuation of individually identifiable assets, additional recognition of intangible assets and accurate measurement of consideration of acquisition respectively.

Component 3, Component 4 and Component 6 have their own causative factor and nature. And the patters in which each component is consumed can be different in each component. Current standards do not consider these diversities and varieties in the way of comparing goodwill's carrying amount with its recoverable amount. Accordingly, each component' characteristic is not reflected in impairment test adequately.

If some parts of goodwill components such as certain excess profitability in Component 3 or synergy effect which is consumed as time flows in Component 4 are expected to be consumed during certain period, it would be provide more useful information to amortize these parts during reasonably estimated period.

It can be reasonable not to include premium of management right, which is stated in the components above but included in the consideration of acquisition, in the goodwill amounts in terms of consolidated financial statements. However, current impairment test may cause premium of management right included in the goodwill amounts because this test method compares total recoverable amounts in the level of cash generating unit with carrying amount.

Illustration 4 :



3) Expansion of economic and profit volatility

When the consideration of the merger and acquisition is paid, excess profitability and the synergies with current business are considered. On the other hand, at the time of periodic goodwill impairment test, objective situations on this certain point of time are much considered because objective situations are more relevant to the preparation of reporting to authorities or auditors, if any.

In other words, economic situations at the time of periodic impairment test, future economic forecasting and recent business performance are more considered in estimating future cash flows in the level of cash generating unit than fundamental capability of cash generating unit in the long term.

Since the current impairment test model has economically fluctuated nature as stated above, the risk of impairment of goodwill can be underestimated at the time of economic expansion while it can be overestimated at the time of economic recession. Accordingly, it is apprehended that impairment of goodwill expands volatility of earnings in sympathy with the economic cycle.

This problem increases the possibility of recognition of significant impairment loss at once. Consequently, it may lead to lessen comparability of income, which is decreased by economic recession adding this significant impairment loss.

Both of Dynamic provisioning[1] and coming IFRS 9 are initiated to relieve the pro-cyclicality of allowance and accumulate supplementary capital by adjusting size of the accumulation of allowance flexibly. In line with these international trends, we need mitigate the economic adaptive nature of current impairment test model by allowing additional amortization of goodwill other than impairment of goodwill.

[1] "Dynamic Provisioning", one of the ways to have better pro-cyclicality, enhances the resilience of both individual banks and the banking system in the respect of loan provisions. By allowing earlier detection and coverage of credit losses in loan portfolios, dynamic provisioning enables banks to build up a buffer in good times that can be used in bad times.

IV. Empirical Results

As of December 31, 2012, the result of comparison of 1) impairment losses during 2010~2012 after IFRS adoption and 2) amortization expenses during 2007~2009 prior to IFRS adoption in 30 Korean companies whose carrying amounts of goodwill are over KRW 100 billion and are among top 100 companies regarding total market prices is as below:

(Unit: MKRW)

Goodwill Balance	20,961,794
1) Impairment Losses during 2010~2012	(-)234,515
2) Amortization Expense during 2007~2009	(-)3,764,136
GAP between 1) and 2)	**(-)3,529,621**

As seen above, impairment losses recognized during 3 years after IFRS adoption is a small fraction compared to the amounts accounted for as amortization expense during 3 years before IFRS adoption. This amount stands approximately 1.1 % of total goodwill amount and 6.2% of total amortization expense during 2007~2009 prior to IFRS.

Direct comparison could be difficult since those amounts are accounted for in different period. However, the fact that impairment loss accounted for during 3 years is merely 1.12% of total goodwill seems to be sufficient to support the result of studies of Kevin and Richard, which states that companies intend to delay impairment loss. In addition, this initial overstatement of assets and earnings may bring later understatement of earnings by "big bath" impairment. Therefore we are suspicious whether the significant impairment loss at this time (a big bath) provides timely financial information.

V. Our Suggestion

There have been a number of disputes regarding the subsequent accounting treatment of goodwill e.g., amortization or impairment. However it has been hardly decided which would be superior, because each method has both merit and demerit.

Dennis J. Chamber argued in his empirical studies in 2007 that either permitting both impairment and amortization in parallel or liberal choice for companies to select their own accounting treatment for goodwill considering their own characteristics could enhance the quality of accounting information rather than using only one accounting treatment between impairment and amortization.

It may seem to be early to determine whether IASB's objective has been achieved to improve quality of accounting information as of now, especially, at a point that a new accounting treatment for goodwill has been implemented just 10 years ago. Especially, it has been only 2 years for Korea to adopt this new accounting treatment.

However, as Dennis J. Chamber stated in his studies of 2007, we believe there are alternatives which is more useful to accounting treatment of goodwill. Therefore, prior to IASB's post implementation review of Business Combination, we would like to discuss with EEG members about various alternatives for impairment of goodwill; 1) permitting both impairment and amortization in parallel 2) liberal choice for companies to select their own accounting treatment for goodwill considering their own characteristics or 3) recognition of either impairment loss or amortization through other comprehensive income to improve the periodic comparability of earnings

Thank you.