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Feedback on the International Accounting Standards Board Discussion Paper on Business Combinations—Disclosures, Goodwill and Impairment

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Dear Sir/Madam:

Business Combinations—Disclosures, Goodwill and Impairment

I am pleased to submit my feedback on the questions raised in the above Discussion Paper ("DP") issued by the International Accounting Standards Board ("Board"). These comments are made solely in my personal capacity and do not represent the views of my employer, Singapore Management University or any other organization or entity that I am associated with.

The Board should be congratulated for producing a timely and thought-provoking DP. It is timely to revisit the existing impairment testing procedures in International Accounting Standard (IAS) 36 *Impairment of Assets* as there are clearly limitations to the impairment model. It is also thought-provoking in that the Board is proposing a novel method of mitigating the shielding effect that is implicit in the IAS 36 model.

To provide a focused and concise feedback, this letter presents views on major issues rather than responses on a question by question basis.

1. *Should disclosures be made of the expected benefits (primarily synergies) and the extent to which management's objectives for the acquisition are realized?*

It is without doubt that such disclosures will be beneficial to investors and users of financial information. Too often, acquisitions are made at substantial premiums leaving significant questions on the extent of overpayment. Disclosures have the benefit of making management accountable for their acquisition decisions and information on expected benefits presents a yardstick by which the wisdom of the acquisition decision can be measured.

However, there are valid concerns that the acquiring companies may have on such disclosures. To be meaningful, the disclosures should be specific (e.g. type of synergies), quantifiable (e.g. extent of synergies), strategic (how it changes the cash flows for existing businesses and potential gaps in existing businesses) and the uncertainties that must exist in any of these estimates. There are significant costs arising from these disclosures. The most significant costs relate to the proprietary costs leading to loss of competitive advantage or attracting undue attention from competitors, regulators of anti-trust regulation and the market place. The other costs relate to information costs. The costs of ensuring that the information is reliable are not trivial. Finally, there is a cost of reputation loss should the acquisition result in actual results that deviate from the expectations. Although these costs should not overwhelm the benefits of information, one does have to consider if the desired effects would be achieved.

The acquisition process is often fraught with uncertainties and time pressure to win the "prize". The deals process can be haphazard and driven by emotion and gut feel. Whether sufficient due diligence has been done to enable the acquirer to meaningfully provide the information in a rational process is questionable. If the process is haphazard as is often the case in an acquisition, mandatory disclosures about objectives and expectations of the acquisition may lead to ex-post justification of the acquisition. This would be putting the cart before the horse – get the target first and then work out the rationale for disclosure purposes. While this need not always be the case, one cannot out-rule the possibility, given the nature of negotiations. Because of the commercially sensitive nature of acquisitions, acquiring companies may resort to "boiler plate" qualitative statements that do not provide detailed information of a specific acquisition. The Board may want to consider the realistic outcomes of mandating disclosures of this nature.

It is worthwhile to consider if there are other metrics that may be disclosed. There are two types of goodwill that are intrinsic in an acquisition. What is commonly understood as goodwill is the core goodwill, or inherent goodwill. It exists in the acquired company before acquisition and represents the synergies within the acquired entity (where the fair value of the acquired entity is greater than the fair value of the sum of identifiable net assets). If the acquisition is made at fair value of the acquired entity and this amount is reliably measurable, the goodwill acquired will be at fair value.

However, in highly desirable acquisitions, the acquired entity is not bought at fair value but at a premium to the fair value. The excess, known as the "control premium" can be a highly risky asset turning into a "winner's curse" if there is excess overpayment.

As a minimum, investors would like to know the extent of the "control premium" paid for the acquisition. This is the excess of the acquisition price over the fair value of the acquired entity. If the acquirer is compelled to disclose this premium, the acquirer would naturally want to support the reason for paying the premium, even if the disclosures are not mandatory. The "control premium" is the combination goodwill that the acquiring company expects to realize from the synergies between the acquirer and the newly acquired entity.

As such, I would propose to the Board that the following disclosures be considered to establish accountability for the acquiring company:

1. Fair value of the entity that is acquired as at date of acquisition.
2. Fair value of the identifiable net assets (this is disclosed currently in the footnote of the cash flow statement).
3. Core goodwill (excess of (1) over (2)).
4. Purchase price of the acquired entity (as with (2), this is currently disclosed in the footnote to the cash flow statement).
5. Control premium paid for the entity (excess of the purchase price (4) over the fair value of the entity (1)).

6. How the acquiring company expects to recoup the control premium – the process, amount, timing and uncertainty of cash flows that relate to the expected realization.

Crystallizing the disclosures to the above metrics may provide measures that are meaningful to investors and goes beyond a litany of words that are vague and template driven. It also provides a metric by which investors can hold the acquiring company accountable to in future periods.

2. *Should goodwill impairment be replaced by amortization or even immediate write off?*

I agree with the Board's preliminary decision that goodwill impairment should not be replaced by amortization or the immediate write off methods of previous standards. In the first place, the process of impairment is never a simplistic straight-line phenomenon. It would be naïve to ever assume such a process of decline. The economics of businesses attest to this. Companies that are viable do not have finite lives to their core goodwill. Their goodwill will never diminish. Other firms on the hand suffer steep declines, never in a predictable manner.

The firm as a bundle of net assets will continue to exist more profitably as a whole than as stand-alone individual assets if the net assets can be harnessed to generate a greater output than they can as individual assets. Ronald Coase in his famous thesis *The Nature of the Firm*, posits that firms will continue to exist if they can organize inputs and processes better than the markets can. Hence, compelling firms to amortize goodwill on a straight-line basis over an arbitrary number of years undervalues the strength of an economically important asset that makes the firm what it is.

Second, using the same formula for all companies is not recognizing the unique decision-making process of each company and the wisdom or folly of their acquisitions.

Third, allowing acquiring companies to use amortization in place of impairment is to unintentionally create perverse incentives for them to over-pay and/or acquire non-value creating acquisitions. The smoothing effect of amortization over an extended period of time does not jolt the market place as much as a steep impairment at each year end. The unrelated diversification frenzy of the 1980s saw no discipline for the buyers as the amortization impact then (often over a 40 year period) shielded the companies from any steep write offs.

The immediate write off is a more severe form of amortization. In the previous standard IAS 22, acquirers were able to write off goodwill to retained earnings or shareholders' equity immediately. This wiped off the "memory" altogether of bad purchases, without any penalty to the acquiring companies. As such, this method has no support from an information or conceptual perspective and should not be revived. I agree with the Board's view that goodwill is indeed an asset and should not be written off on the day of its origination.

3. *Should the goodwill impairment methodology of IAS 36 be changed?*

I understand the Board's concern that there is a shielding effect arising from the initial headroom that already exists in the acquiring company's businesses before acquiring the new business. The initial headroom comprises of the following which already exists before the acquired entity is annexed to the existing business: (1) unrecognized goodwill in the existing business (2) its unrecognized identifiable net assets and (3) unrecognized differences between the fair value and carrying amounts of the recognized identifiable net assets within the existing business. Presumably, the existing business is part of the cash-generating unit into which the acquired entity is annexed.

The proposed methodology is logical. However, there are a few simplifying assumptions that underlie its implementation.

(1) The acquired goodwill remains as a separate element from the unrecognized goodwill in the headroom. It appears to continue to have this separate identity even after acquisition and is tracked as a separate asset (refer diagram on page 62). However, the acquired goodwill comprises both combination and core goodwill. In the post-acquisition period, it is expected that synergies will arise (or diminish) through integration of the acquiring and acquired businesses. To present the headroom and acquired goodwill as separate compartments in the post-acquisition period run counter to the concept of the cash-generating unit where cash flows among units are largely interdependent. One would expect a symbiotic relationship to take effect after acquisition.

(2) The initial headroom is combined with the acquired goodwill to be "total goodwill". The assumption is that the headroom is all goodwill. However, the headroom includes identifiable elements (refer items (2) and (3) above). For example, unrecognized intangible assets of the existing businesses or the excess of fair value over carrying amount of identifiable net assets would be included in the initial headroom. If the recoverable amount of the combined business falls, it may be due to identifiable elements and not necessarily "total goodwill".

(3) The assumption is that if recoverable amount falls below carrying amount, it is the acquired goodwill that is impaired rather than the initial headroom.

While the headroom approach is expedient, further consideration should be made to evaluate the validity of these assumptions.

The Board may also wish to consider if the headroom should be analysed further into the three components as explained above, with the identifiable elements separated from the goodwill. Preferably, the fair value of identifiable net assets could be separated from the fair value of goodwill. Impairment could then be determined separately for goodwill and identifiable net assets, without having to assume that all impairment is attributed to goodwill.

4. *Should total equity be presented after excluding goodwill?*

This exclusion approximates the net tangible asset concept. I do not agree with this exclusion. As the world moves into a digital era, the most important asset in many balance sheets will be intangible assets. While these assets are subjective in measurement, they are depositories of economic value that must be meaningful to the investor. With the strengthening of the impairment process, the carrying amount of goodwill should be reliable and relevant. The audit process should be recognized for its contribution to the meaning of these numbers. To exclude goodwill from total equity would effectively be reinstating IAS 22's method of writing goodwill against shareholders' equity. There is no conceptual or economic merit in this accounting treatment. The concerns with reliability and uncertainty should be reflected in the footnotes but the reader should be allowed to make his/her own judgement on the nature and meaning of this typically significant asset.

I trust that the above feedback is useful for your purposes and wish the Board well in its ongoing efforts to improve reporting on goodwill and impairment.

Yours sincerely,

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