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By MASB Secretariat

AN OPPORTUNITY TO RECONSIDER AMORTISATION OF GOODWILL AND BETTER INFORMATION IN RELATION TO MERGERS AND ACQUISITIONS (BUSINESS COMBINATIONS)

One of the possible economic outcomes of the COVID 19 pandemic is an increase in merger and acquisition activity as companies seek to raise cash to reduce debt through the disposal of business units, or leverage financial strength to take advantage of acquisition opportunities which may arise.

Consequently, it is timely that the International Accounting Standards Board ("IASB") has issued a Discussion Paper, DP/2020/1, "Business Combinations-Disclosures, Goodwill and Impairment" (the DP).

The DP reflects the IASB's preliminary views on improvements which could be made in response to concerns expressed by stakeholders during a post-implementation review of IFRS 3 (= MFRS 3) Business Combinations about better disclosure, accounting for goodwill and presentation.

Disclosure

At present, MFRS 3 (which is word-for-word IFRS 3) does not require any specific disclosure of the performance of an acquisition in subsequent periods against management's objectives for the acquisition. Consequently, investors are unable to assess the effectiveness of management in identifying suitable businesses to acquire, negotiating a purchase price and subsequently integrating the acquisition into the existing business to realise the benefits expected.

The IASB's preliminary view is that it should require companies to disclose in the year of acquisition the strategic rationale and the key objectives for the business combination and the metrics the company will use to measure whether the objectives are being achieved. In subsequent periods, a company would need to disclose the actual performance of the business combination using those metrics.

Given the objectives in making an acquisition are company specific, the DP suggests that the information disclosed be based on that used by management internally, specifically by the chief operating decision maker.

The information would be required to be disclosed for as long as the performance of the acquisition is monitored internally, with an expectation that this would be for at least two years after the year of acquisition or an explanation provided where monitoring was not occurring.

The IASB's preliminary views also include some targeted improvements to the information provided in the year of acquisition including the amount and range of expected synergies, and the value of any defined benefit pensions and debt liabilities taken on in the acquired business, with these liabilities being separately disclosed to facilitate investors determining the return on capital employed.

Goodwill

Since 2004, business combinations have been accounted for by MFRS 3 which introduced an impairment-only approach for goodwill. An impairment test assesses whether the value (recoverable amount) of an asset is lower than the amount recorded for it on the balance sheet (carrying amount). If the recoverable amount of an asset is lower than its carrying amount, the company would recognise an impairment loss as an expense in profit and loss for the period. Goodwill cannot generate cash on its own, it can only do this in combination with other assets and so goodwill is tested for impairment in this group of assets (or cash-generating unit). If the recoverable amount of the unit's assets is below their carrying value, then an impairment is required with the loss first being allocated against any goodwill included in the unit.

Given the narrow vote, the IASB welcomes feedback on this topic from stakeholders, however just repeating well known arguments will not necessarily move the debate forward, instead, the IASB welcomes feedback that provides new evidence or arguments.

The case for amortisation

Supporters of amortisation maintain that goodwill has a limited life which diminishes over time and that it is possible to estimate useful life and a pattern over which it diminishes.

They consider that the impairment test does not recognise impairment losses on goodwill on a timely basis due to over optimistic assumptions by management in cash flow models. There is some evidence to suggest that impairment losses are recognised relatively infrequently despite many acquisitions failing to meet expectations.

A further reason that impairment losses may not be recognised on a timely basis is “shielding”. This may arise, for example, where the recoverable amount of the business unit, with which the acquired business and goodwill is combined, exceeds its carrying amount prior to the acquisition. As a result, the pre-existing “headroom” shields the acquired goodwill from subsequent impairment even if the acquired business is not performing as management expected.

Both of these issues can lead to impairment losses on goodwill not being recognised on a timely basis or even being avoided with the result that management is not held accountable for the poor performance of the acquired business.

Supporters of amortisation assert that amortisation would better hold management to account because it would show that the acquisition is not successful if it does not generate economic benefits in excess of the amortisation expense. Additionally, amortisation prevents internally generated goodwill being recognised, replacing acquired goodwill as it is consumed.

The case for impairment-only

Supporters of retaining the impairment-only approach maintain that the impairment test provides more useful information than an arbitrary amortisation expense. Although often only confirmatory they say it is more useful than an amortisation expense that most investors would ignore.

Although not perfect and although cash flow forecasts will always be judgemental, applied well the impairment test should meet its objective of ensuring that the carrying amount of the cash-generating unit as a whole is recoverable.

Supporters of retaining the impairment-only approach argue that goodwill is not a wasting asset with a determinable finite life (hence amortisation would only ever be arbitrary) and companies acquire businesses with an expectation that the acquired goodwill is maintained indefinitely.

Supporters of retaining the impairment-only approach also point out that even if amortisation was reintroduced, there would still be a requirement to perform an impairment test of goodwill and therefore amortisation would not significantly reduce cost.

Can the impairment test be improved?

Although the outcomes of testing under IAS 36 (= MFRS 136) Impairment of Assets are inherently subjective, in the IASB's view sufficient safeguards are included to minimise the risk of management's cash flow forecasts being too optimistic.

MFRS 136 requires companies to use reasonable and supportable assumptions for the range of economic conditions that could exist over the remaining useful life of the asset, with most reliance being placed on external evidence.

Assumptions are required to be based on the most recent financial budgets or forecasts approved by management, and are also required to be considered in the light of the reasons for differences between actual and forecast cash flows in previous years.

The IASB therefore considered that if cash flow forecasts are too optimistic in practice, that this is best addressed by auditors and regulators, rather than by changing IFRS Standards.

The IASB also sought to address the problem of "shielding" through a "headroom approach" that incorporates the headroom in the test, reducing the "shielding effect" of the headroom on the acquired goodwill. Nevertheless, the approach would require an arbitrary allocation of any impairment identified between the acquired goodwill and the unrecognised headroom.

After considering various allocation methods such as a pro rata allocation between the goodwill and the headroom, the IASB concluded that redesigning the impairment test in MFRS 136 would not cause sufficient improvement in the information provided to investors to warrant the additional time and cost involved for stakeholders.

Reducing the cost and complexity of impairment testing

MFRS 136 currently requires impairment testing of cash-generating units containing goodwill to be conducted annually even when there is no reason to suspect that an impairment may have occurred. It also requires value in use to be estimated on a pre-tax basis and the exclusion from estimates of value in use of cash flows of future uncommitted restructurings or asset enhancements.

The IASB considers that where there is no evidence (or indication) that an impairment of goodwill within a cash-generating unit has occurred, then an annual test of impairment should not be required. Companies would however still be required to assess whether there are indications of impairment each reporting period and perform the impairment test if there is an indication of impairment. It is also proposed to remove restrictions on the inclusion of uncommitted cash flows from a restructuring and from asset enhancements, and permit the use of post-tax discount rates in estimates of value in use.

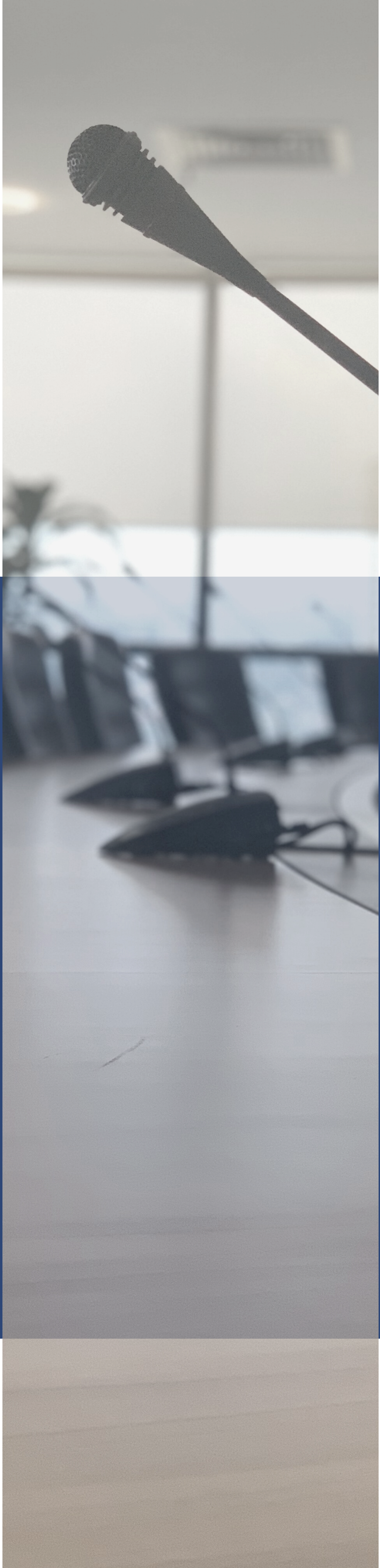
These changes are proposed on the basis that the current requirement for an annual quantitative test does not solve the problem of "shielding" and is unlikely to detect a material impairment where there is no obvious indication of impairment, and the changes to value in use estimates better align the cash flows and discount rates used with internal forecasts and industry practice.

As a consequence, these changes should reduce the cost and complexity of impairment testing without compromising the robustness of the test and the quality of the information provided to investors.

Other improvements

In order to highlight the significance of goodwill in certain companies, an asset which cannot by its nature be physically separated from the other assets of a business, the DP suggests that an amount of total equity excluding goodwill be presented on the balance sheet.

After considering the costs and potential benefits, the DP concludes that no change is warranted to the range of intangible assets already recognised in a business combination.



Conclusion

Younger members of the director community may not recall the controversy and opposition from many directors some 16 years ago when amortisation of goodwill ceased to be permitted.

However, the experience of all directors since that time in an environment in which growth through merger and acquisition has been a major strategy of senior management, places directors in a unique position to consider the adequacy of existing accounting and disclosure requirements for business combinations.

The Discussion Paper, DP/2020/1 "Business Combinations – Disclosures, Goodwill and Impairment" provides directors with the opportunity of sharing their experience in the interests of improving the information provided to the investors and other stakeholders in their companies.

This is a crucial topic for directors – the IASB's preliminary views are based on bringing more transparency for investors to hold boards and managements accountable for their merger and acquisition decisions.

The MASB strongly encourages directors to have their say!