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Business combinations – Disclosures, Goodwill and Impairment

I welcome this opportunity to comment upon the Discussion Paper, and have a particular interest in the issues of recognizing goodwill or identifiable intangible assets, and whether amortization is mandated.

I believe that this is relevant to this discussion as I believe the recognition of identifiable intangible assets would contribute significantly to transparency in business combinations and facilitate discussion and evaluation of acquisitions. I also think that this will necessitate further consideration of intangible assets.

I will base my comments on findings in the academic literature that I consider relevant.

In Australia a range of accounting practices have been applied to goodwill and identifiable intangible assets, and this potentially provides insights relevant to the Discussion Paper Business Combinations—Disclosures, Goodwill and Impairment. These divergent accounting practices can often be attributed to particular regulatory changes, and the impacts include first and second order impacts.

The voluntary recognition of identifiable intangible assets by Australian firms can be traced back to the 1970s (or earlier). However, this became increasingly common subsequent to the issue of AAS 18 Accounting for Goodwill in 1984. This required the mandatory amortization of goodwill over a period not exceeding 20 years and a strategy to avoid this was the recognition of an identifiable intangible asset with an infinite life (Wines & Ferguson, 1993).

In the absence of regulation specifically addressing identifiable intangible assets, the regulations relating to assets generally at that time applied. These included AASB1015 Accounting for the Acquisition of Assets, AASB1010 Accounting for the Revaluation of Non-

Current Assets and AASB1021 Depreciation of Non-Current Assets. There was however a constraint on the values attributed to identifiable intangible assets through AASB1010 Accounting for the Revaluation of Non-Current Assets. This limited the carrying value of non-current assets to their 'recoverable amount'. There is evidence of amounts recognized as being relevant to users of financial statements, with this being evidenced by positive and significant associations of identifiable intangible assets with stock price and earnings in future periods (Ritter & Wells, 2006). An interesting question that is as yet not fully addressed is whether this result is attributable identifiable intangibles recognized at cost or revaluation, and this is salient to recognition of goodwill and identifiable intangible assets at cost and the effective prohibition on the revaluation of intangible assets.

However, some insights are provided into this in the period surrounding transition to IFRS. Distinguishing periods pre and post transition to IFRS Su and Wells (2015) find no evidence that identifiable intangible assets acquired and recognized in business combinations are associated with post acquisition performance or changes in post acquisition performance. While this suggests persistent overpayment and raises doubts about the recognitionof identifiable intangible assets, a challenge in interpreting this result are differences in the recognition of identifiable intangible assets and goodwill with transition to IFRS. Subsequent to transition to IFRS the requirement for mandatory amortization of goodwill was removed, and hence greater recognition of goodwill occurred. Addressing this Su and Wells (2018) find evidence of an association between higher acquisition premiums (and likely overpayment) with the recognition of identifiable intangible assets in the pre transition period. In contrast, in the post transition period where the more opaque treatment was the recognition of goodwill, there was no such association. This identifies the recognition of goodwill as contributing to opacity, and not mandating amortization reduces the 'cost' of this accounting practice.

Implications:

1. Divergent treatments being applied to goodwill and identifiable intangible assets leads to regulatory arbitrage. This may be intentional and used to encourage recognition of identifiable intangible assets if this considered preferable and enhancing transparency.
2. If the more transparent accounting practice in business combinations is the recognition of identifiable intangible assets then this can be encouraged by mandating the amortisation of goodwill.
3. There is evidence of overpayment of in business combinations and to the extent that this occurs it will lead to an excess of book value over recoverable amount for both goodwill and identifiable intangible assets. Consequent issue are whether these assets recognized at cost are necessarily relevant and whether asset impairment are being appropriately recognized.

If there is evidence that firms are overpaying in business combinations, this would necessitate the impairment of goodwill and identifiable intangible assets. This is addressed in a significant literature considering impairment of goodwill (e.g., Ramanna, 2008). A challenge when interpreting the results in such papers is that they make assumptions about allocation of goodwill across cash generating units, and this forms the basis for conclusions that impairment of goodwill is particularly problematic. However, caution is suggested and Bond, Govendir, and Wells (2016) find evidence of firms with goodwill recognizing impairments of assets other than goodwill. Furthermore, issues with the impairment of assets are not limited to firms recognizing goodwill. This suggests issues with the recognition of asset impairments are not confined to goodwill.

Implications:

1. Issues with impairment require address generally, and consideration of goodwill separately may give rise to unintended consequences, including the recognition of assets other than goodwill.

In essence, I believe that satisfactory resolution of the accounting issues here requires consideration of whether the preferred practice in business combinations is the recognition of goodwill or identifiable intangible assets.

Yours faithfully

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Discussion Paper: Business Combinations—Disclosures, Goodwill and Impairment

AGL welcomes this opportunity to make a submission on the Business Combinations Discussion Paper and would like to comment on the specific matters as follows:

2. whether the proposals create any auditing or assurance challenges;

The paper proposes to enhance the disclosure objectives and requirements in AASB 3 *Business Combinations* to improve the information provided to investors about an acquisition and its subsequent performance. This includes strategic rationale and financial and non-financial metrics. Whilst of the opinion that financial metrics may be monitored and audited as required, the nature of non-financial metrics is such that this may significantly extend the scope of assurance required and not align with current auditing practice. The feasibility of the auditing requirements of such metrics would need to be considered in implementing any changes.

3. whether, overall, the proposals would result in financial statements that would be useful to users;

AGL concurs that the proposals would result in financial statements that would be useful to users however AGL also supports the reintroduction of the amortisation of goodwill on the following basis:

- The economic benefits of acquisitions, whether those be increased cash inflows or reduced cash outflows, are mostly modelled as finite life.
- This would provide users with additional information regarding the expected realisation of the benefits (including timeframe) of the acquisition as opposed to the current proposal which focuses solely on internally specified management metrics and which are more likely to be short-term in nature.
- Potential impairments of identifiable goodwill may be shielded by existing or unrelated headroom in the cash-generating unit. The overperformance of certain assets within a single cash-generating-unit may sufficiently offset the underperformance of other assets acquired as part of a business combination.
- Amortisation reduces potential exposure to point in time impairments which are often unexpected for users and not recorded in a timely manner.
- Impairments may suggest that the business did not achieve management's original acquisition objectives however this may be misleading as return on investment is usually finite.
- Amortisation of goodwill is consistent with the AASB 116 *Property, Plant and Equipment* and AASB 138 *Intangible Assets* concepts and principles regarding the consumption of economic benefits over time. For example, "synergies" which generate goodwill are normally expected to be realised in the short to medium term. This may ultimately mean that the amortisation profile is not straight line.
- Similarly in accordance with AASB 138 *Intangible Assets* an asset's useful life may be deemed indefinite when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. This provides

scope for entities to not amortise goodwill recognised in business combinations where the realisation of benefits is indefinite.
- This will have minimal impact on analyst forecasts and stakeholder information as in our experience non-cash items of this nature are ignored in their analysis and valuations.

Our view is that the reintroduction of the amortisation of goodwill should be applied retrospectively to reflect the benefits previously realised. We recommend the assessment of useful life to be consistent with that of other intangible assets in accordance with AASB 138.

AGL supports that such amortisation should be considered in conjunction with the impairment test as outlined in AASB 136 *Impairment of Assets* and that goodwill should still be tested for impairment on an annual basis at a minimum.

AGL intends to separately respond to the IASB's Discussion Paper further supporting the matters outlined above. We will provide a copy of this to the AASB as part of the submission.

Yours sincerely,

Damien Nicks
Chief Financial Officer