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Garth Coppin
4 Avril Crescent
Beverley Gardens
Randburg
South Africa
2194
3 April 2003

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sirs

ED 3 BUSINESS COMBINATIONS

There are many issues in ED 3 Business Combinations with which I have no concerns and am in agreement with, while there are other issues that I am not in agreement with. There are, however, some issues that are of such concern to me, that if I had been given the opportunity to vote on them, would have resulted in me voting against the whole proposed International Financial Reporting Standard. Accordingly this letter does not deal with the issues that I am in agreement with or those with which I am not in agreement with but which are not of such a magnitude that I would have voted against them if I had been given the opportunity, but instead only deals with the issues that I am totally opposed to.

<u>Summary of concerns</u>

The proposals contained in the exposure draft concerning the non-amortisation of goodwill and the accounting treatment of negative goodwill are not supported. I feel that the rationale for the accounting treatment proposed for the non-amortisation of goodwill and the reasons for the inconsistent treatment of goodwill and negative goodwill are poorly supported by the arguments in the exposure draft, including the basis of conclusion.

I feel that the arguments in support of the proposed accounting treatment for these issues in the exposure draft:

- Have little support in terms of the Framework for Preparation and Presentation of Financial Statements;
- Will result in an inconsistent treatment with how similar issues are dealt with in terms of other International Accounting Standards;
- Will result in goodwill and negative goodwill being treated in an inconsistent manner; and
- Are based on some assumptions that are not necessarily valid.

The reasons for these comments are given below.

<u>Reasons not contained in exposure draft</u>

In addition, I feel that the proposals on the above issues contained in the exposure draft are not being truly honest, by not dealing with what I consider to be some of the main reasons for the proposed changes. If these reasons had been given they could have probably undermined further the already weak arguments in support of the accounting treatment for these issues, in that they are based on political and pragmatic arguments and not technical arguments. The omitted reasons for the proposed changes are considered to be as follows:

- The proposals are in line with those adopted in the US (which is not of itself a concern), where the changes are reported to have been driven more by political reasons than technical reasons. In order to get acceptance by preparers of financial statements of the proposal to stop the uniting of interests/pooling method of accounting for business combinations, the standard setters had to come up with a method of accounting which would minimize the effect of fair value accounting and the related goodwill. This was achieved by preventing entities from amortising goodwill, which they obviously had to justify. The justification they provided for this treatment is not considered to be convincing. In addition, the US standard setters have introduced a treatment of accounting of goodwill that is different from that which until then was becoming the internationally accepted method of accounting for goodwill. Accordingly there is a question as to whether the proposed treatment for goodwill is more an effort to achieve international harmonisation than to produce high quality, technically robust accounting standards.
- With comments that analysts ignore goodwill amortisation in their assessment of enterprises, it seems the standard setters are therefore accepting that there is less need for goodwill amortisation to be included in the income statement of enterprises. This approach is doubtful seeing that while analysts are still focusing on the income statement in their assessment of companies, the standard setters have consciously in recent years taken a different approach and focused instead on assets and liabilities, which is producing more volatile profits than if an income statement approach was adopted. Therefore, to be consistent, the standard setters should not be changing their views to accommodate analysts.

<u>Compliance with the Framework</u>

Paragraph 83 of the Framework for the Preparation and Presentation of Financial Statements ("Framework") requires that "an item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise, and
(b) the item has a cost or value that can be measured with reliability."

It is felt that the proposals contained in paragraphs 36 and 43 of ED 3 as well as the consequential changes to paragraphs 29-32 of IAS 38 are aimed at identifying as many as possible of those assets that could produce future economic benefits to an enterprise. Therefore any remaining unallocated amounts, which would comprise goodwill, are of doubtful economic benefit. In this respect the following paragraphs of the Framework should be considered:

- Paragraph 59 which states that expenditure which aims at future economic benefits is not conclusive proof that the definition of an asset has been met;
- Paragraph 90 which states that the expenditure which does not meet the definition of an asset does not imply that management was misguided or that the intention was not to generate future economic benefits; and
- Paragraph 97 which states that an expense should be recognised immediately in the income statement when the expenditure does not meet the definition of an asset.

Accordingly it is suggested that goodwill might be more likely to be an expense than an asset. If there is doubt that future economic benefits will be received, then in terms of the Framework, the amount should be written off, whereas the exposure draft does not appear to acknowledge this. Accordingly the proposed treatment of the capitalisation of goodwill is not strongly supported by the Framework.

Comparison with other assets and expenses

The various International Accounting Standards (IAS) have provided guidance that indicates a certain hierarchy regarding assets and expenses:

- Tangible assets – including property, plant and equipment which can be shown at cost or revaluation, inventories which are shown at the lower of cost and net realisable value and monetary assets which are shown at fair value;
- Intangible assets which can be shown at cost or valuation, but where the criteria for revaluation is unlikely to be met;
- Goodwill which can be recognised as an asset if acquired in a business combination, but only at cost, but not recognised if internally generated;
- Amounts not recognised as assets even though future economic benefits may arise from expenditure (e.g. start-up costs, pre-opening costs, training expenditure and advertising and promotional activities); and
- Amounts expensed when incurred because no future economic benefits will be received.

This can be illustrated diagrammatically as follows:

Record as assets on balance sheet			Expenditure recorded in income statement		
Tangible assets	Intangible assets	Acquired goodwill	Internally generated goodwill	Non recognised assets	Expenses

This again illustrates that acquired goodwill is close in nature to internally generated goodwill and accordingly suggests that its treatment should be similar (i.e. expensed) as opposed to being diametrically opposed (i.e. no income statement expense unless impaired) to that of internally generated goodwill.

Double counting of expenses

In ED 2 Share-based Payments one of the arguments not accepted for the non-expensing of the fair value of options was the argument that the income statement would be affected twice. While that argument was not supported in that case, it seems it has been accepted in this exposure draft, when it should not have been accepted.

This argument is based on the assumption that if goodwill is amortised it will cause the income statement to be impacted by both purchased goodwill and internally created goodwill. If no acquisitions were made an enterprise would, in determining its net profit, be expensing the costs of internally generated goodwill. If it then made an acquisition it should be earning increased profits. These increased profits could include an element of the synergy benefits that were expected to arise from the acquisition, so it would be appropriate to reduce these profits by the amount paid for the benefits expected, in that these additional profits would not have been earned if the additional payment had not been made. If these additional profits were further reduced by internally generated goodwill, this is no different from the situation before the acquisition was made, namely that "normal profits" (in this case profits earned from the acquisition excluding synergy benefits) are impacted by internally generated goodwill. Accordingly the argument that profits are doubly impacted if goodwill is amortised is not accepted.

How assets are recovered

The accounting for assets should reflect the manner of how an enterprise expects to recover the assets. I would argue that in the case of goodwill it is realised from utilising the assets and liabilities acquired and accordingly, in line with other IASs, goodwill should be accounted for over the period over which it is realised. In terms of paragraph 96 of the Framework, "when economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures." It is believed that amortisation of goodwill over a period achieves this objective. Accordingly the arguments contained in paragraphs BC 107-108 for the non-amortisation of goodwill are not accepted.

Furthermore, the more likely an item is an expense as opposed to an asset, the shorter the period over which it should be amortised, whereas the proposals take an opposite position and do not allow for amortisation or immediate expense of goodwill acquired in a business combination.

Separate accounting for assets

One of the fundamental principles of IAS is that each asset should be separated and accounted for individually. This is illustrated further by the proposed Improvements to International Accounting Standards, where, for example, the changes to IAS16.22A would require components of property, plant and equipment to be accounted for as a separate asset. The proposed treatment for goodwill in ED 3 is in conflict with this approach. Paragraph BC98 of the Basis for Conclusion in ED 3 recognizes two components of "core goodwill", namely the going concern element and expected synergies. It is argued that these components will quickly disappear if action is not taken to deal with them. Accordingly if expected synergies are realised then that part of goodwill should be derecognised as the synergies are realised. Secondly, many of the components of the going concern element would also be realised over time, with the remaining components more likely to reflect actions taken since acquiring the goodwill than the components acquired. Furthermore, paragraph BC98 acknowledges the other two components identified in BC97 that are included in goodwill as not being assets.

This means that the goodwill tested for impairment in any subsequent period in terms of the proposed paragraph 8A of IAS 36 is unlikely to comprise the same components as the goodwill acquired in the prior business combination. Accordingly internally generated goodwill subsequent to acquisition is being valued and used to justify the carrying amount of purchased goodwill. This is contrary to paragraph 40 of the proposed revision to IAS 38, which does not provide for internally generated goodwill to be recognised as an asset, as well as being contrary to the principle that each asset should be accounted for separately.

Assumptions made in exposure draft and comparison of treatments proposed for goodwill and negative goodwill

The exposure draft seems to make an assumption that when entities make an acquisition that the purchase price is determined from the fair value of the individual assets and liabilities acquired, when this might not be the case. The purchase price might be dependent more on what future profits can be achieved or the current market price of the entity than the fair value of the individual assets and liabilities. This being the case, market sentiment or the existence or absence of competitors can significantly influence the final purchase price, which could be different from the expected purchase price. These factors can determine whether a likely negative goodwill changes to positive goodwill or whether expected positive goodwill increases.

This suggests that positive and negative goodwill should be accounted for in a similar manner and not in diametrically opposed manners as proposed in the exposure draft. For example, if the market sentiment towards a particular sector is unfavourable an entity may make an acquisition resulting in negative goodwill. This negative goodwill will be included in the income statement immediately in terms of ED 3, while the existence of a competitor who pushes up the price, or a change in market sentiment by the time the acquisition is recorded could result in goodwill being recorded that does not impact on the income statement. This treatment is regarded as being inconsistent. Therefore it is suggested that goodwill and negative goodwill should be accounted for in a similar manner, seeing that small changes in certain factors that could occur after the acquisition process is started can determine whether goodwill or negative goodwill is recorded.

Assessments of acquisitions

The proposals will also make it more difficult to assess whether the acquirer has overpaid for an acquisition. BC97 recognises this is one of the possible components of goodwill. If an acquisition is contended this increases the possibility of overpayment. With amortisation of goodwill it is more likely that it can be determined whether returns achieved exceed the cost of the acquisition than in the method proposed in ED3. As stated above this can be disguised by subsequent internally generated goodwill or alternatively by existing internally generated goodwill where the acquisition is incorporated into an existing cash-generating unit.

Particularly where the purchase price of acquisitions is large I believe it is important to assess whether (1) the amount paid was excessive or not and (2) whether the returns achieved from an acquisition exceed the cost. While this might not always be easy to assess, any approach that makes this assessment more difficult or assumes it is not important to make such an assessment should be resisted.

Business practices

With statistics suggesting that a high number of business combinations do not achieve their desired goals, this supports goodwill being expensed immediately or over a period as opposed to be shown as an unamortised indefinite life asset.

In addition, the proposals contained in ED 3 could affect business practice, which might not be desirable. For example, if an entity is in a development stage most of its expenditure might have to be expensed in terms of IAS 38. However, if another entity acquires that entity at a later stage, its income statement could be impacted differently; either not at all by not requiring goodwill to be amortised, or over a period by requiring intangibles to be amortised over a period. This could discourage entities from carrying out their own development, which is not considered desirable.

Conclusion

Accordingly, based on the above, the proposals contained in ED 3 for the accounting of goodwill, particularly subsequent to acquisition, are not supported.

Based on the above I would support the following:

- While as noted above there might be doubt as to whether goodwill meets the criteria of an asset, I accept that there might be future economic benefits which could arise, even if the nature is difficult to specify, and accordingly I believe that goodwill should be amortised over a relatively short period; and
- Negative goodwill being accounted for in a manner similar to that of goodwill, namely being taken to the income statement immediately or over a relatively short period. In this regard the negative goodwill can be included in equity before being taken to the income statement in the same way as fair value adjustments for available-for-sale investments can be taken to equity before being included in the income statement.

If you wish any of the above comments to be expanded upon or clarified please do not hesitate to contact me.

Yours faithfully

G Coppin