IASB Research Forum

Paper Session 2, Paper 3, Discussant 2

Newly Recognised Goodwill and Intangibles under IFRS –
An Empirical Investigation of Market Values and Analysts' Forecasts

First, thank you for your study and your contribution to the IASB's research phase on its future project on intangibles !

I will group my comments in three categories, and those comments are to enhance the usefulness of your study to the IASB's work.

1) <u>Substantive comments – additional research needed</u>

   a. On numerous occasions throughout the paper, there are discussions on analysts' forecast dispersion; the paper seems to imply that lower analysts' forecast dispersion is better, but without really explaining why; as such on:
      i. Page 4: *It leads to lower analysts' forecast dispersion.*
      ii. Page 10: *Therefore, this study also examines the analysts' forecast dispersion effects to investigate the corresponding faithful representation of recognised goodwill. Analysts' forecast dispersion is a proxy for uncertainty about future economic benefits and is used in the literature to assess the faithful representation of accounting information.*
      iii. Page 10: *Hence, the prediction is that goodwill recognised apart from other intangible assets is positively associated with analysts' forecast dispersion:*

      Are you referring to analysts' forecast dispersion in appreciating earnings' metrics (such as EPS or multiples) or valuation of a business (fair values based on transactions or comparables) ? in your study, you focus on analysing acquisition-date balance sheet items; so, is it the later ?
      If it is the later, my practical experience on performing the annual impairment test shows that the more forecasts are dispersed to assess the value of a business (when internally using multiple approaches, such as DCF (value in use) or FV (transactions or comparables, including the analysts' consensus)), the more the middle-point of the valuations is relevant.
      This should also lead you to nuance your following conclusion expressed on page 21: *The extant literature provides the first evidence that the recognition of intangible assets is useful for analysts to predict future earnings by showing negative associations between intangible asset recognition and analysts' forecasts dispersion and error.*

   b. Page 9, on the summary you provide, I do not necessarily disagree with your conclusion: *Hence, I expect newly recognised goodwill to be related to the market value but less* *value relevant than intangible assets resulting from the acquisition.*

But I cannot agree as it seems to me that you jump a bit too quickly to this conclusion, for the following reasons:

i. You state: *Those other intangible assets are more concrete information about the extent of future cash flows, as they can be individually identified […]*; in my practical experience, it is because they relate to a contract entailing contractual rights and obligations, whereby goodwill relates to an entire business.
   This should also lead you to nuance your following conclusion expressed on page 21: *While it is widely acknowledged that goodwill from a business combination represents an asset, findings suggest that the future earnings of goodwill are more uncertain and complex to predict than those of other intangible assets.*

ii. You further state: *[…] and valuated at fair value*; in my practical experience, many fair values are derived from cost-based measurement techniques, such as a replacement cost method, and there exists no genuine fair value as no market exists for many, if not most of these assets (your statement in this regard at the bottom of page 9 is to nuance…).

iii. Finally: *[…] theoretically, the market value equals a firm's discounted future economic benefits*; in my practical experience, many fair values are higher than discounted future economic benefits, which is the effect of the rarity of the asset, the quality of the asset relative to others, and the non-tangible benefits provided by the asset (for example, influence).

c. Pages 15 and 16 represent my biggest discomfort with the state of your research, as illustrated by the *following* statements:

   i. Page 15*: However, against expectation, the study cannot provide evidence of a higher coefficient for identifiable intangible assets compared to newly acquired goodwill.*

   ii. Page 16: *Based on the findings that newly recognised goodwill is essential for the firm value from a market-based view, it is even more interesting to investigate whether it is also beneficial for analysts to predict future economic benefits of the firm.*

   I would have liked you to analyse the reverse expectation, i.e., what if the fair values of identifiable intangible assets are not beneficial for analysts to predict future economic benefits of the company, and therefore similarly, if not even more, for goodwill.

   Only then would you be able to state your conclusion expressed on pages 20-21: *It highlights that recognising intangible assets as key value drivers is informative for analysts as market intermediaries. These findings contribute to the debate on the non-recognition of most internally generated intangibles.*

   I also do not see the relation of the first sentence with the second sentence in your conclusion expressed on page 21: *The study provides evidence that higher recognition of residual goodwill apart from intangible assets leads to higher analysts' forecast*

dispersion. It implies that recognising intangible assets leads to more useful information for analysts than the non-recognition of intangible assets, where the purchase price is attributed to residual goodwill.
Moreover, your study focuses on the recognition and measurement of assets in the acquisition balance sheet, and there is no reference to analysing the consequences in the P&L (statement of financial performance) or in the statement of cash-flows; those data seem to me more fundamental for the management of a company and its investors (current and potential).

2) <u>Substantive comments – disagreements</u>

a. Page 5, refer also to IAS 38:
   i. Definition of an intangible asset in IAS 38.9-17: identifiability, control, and future economic benefits (FEBs); and,
   ii. IAS 38.33: in a business combination, presumption that recognition criteria in IAS 38.21 are met (probability that expected FEBs attributable to the intangible will flow to the entity, and cost of the asset can be measured).

b. Page 8, I disagree with the following statement without nuance: *Components (3) and (4) occur when managers misvalue existing assets or fail to identify previously unaccounted intangible assets […]*; in my practical experience, the largest components of those assets are intangible assets that cannot be recognised in the balance sheet at the acquisition date, such as workforce (IFRS 3.B37) or potential contracts with prospective new customers (IFRS 3.B38).
As an illustration, on page 38, example 1: I do not understand why you consider this example as a 'rather poor disclosure'; there is an explicit mention that the goodwill reflects potential growth, i.e., potential contracts with prospective new customers (refer to IFRS 3.B38), being noted that the amount of goodwill seems to be not that material relative to the size of the company.

c. Page 8, I disagree with the following statement without nuance: *Contrastingly, overpayments occur when managers knowingly overpay for targets (managerialism theory). This can happen for empire-building reasons.*; I dispute that the later cannot lead to value creation on a longer term.

d. Page 17, I disagree with the following statement without nuance: *IFRS 3 also requires the acquiring firm to disclose additional information about the goodwill recognised, especially the factors that make up the goodwill. As discussed in section 2, these disclosure requirements are discretionary and vague, and firms are often not compliant with the required disclosures on goodwill*; in my practical experience, it is very often because of the following characteristics of this information: forward-looking, internally confidential and commercially sensitive, including synergies; off course, commercial sensitivity is vis-a-vis competitors; so, to protect the company, its executives and its shareholders, the information is simply not provided to avoid any adverse effects, which could lead in many cases to potential litigation risks.

e. Page 17, I disagree with the following statement without nuance: *In line with disclosure theory (Diamond and Verrecchia, 1991; Verrecchia, 2001; Lambert et al., 2007), firms tend to disclose good information and withhold bad*; in my practical experience, companies have a significant incentive to disclose bad information as it is protective for the company itself, its executives, and ultimately its shareholders, vis-a-vis legal risks.

3) Some editorial comments (to be more nuanced in the expression)

   a. Page 2, to better align with paragraph 2.2 presented on pages 7 and 8, amend the following sentence accordingly: *Under IFRS 3, a portion of goodwill represents hoped-for excess returns from the merger that exceed the future economic benefits (FEBs) of the target firm's individually identifiable balance sheet items.*

   b. Page 6, the following statement is not explained: *Findings generally suggest that goodwill balances in financial statements and impairments are related to market value […]*; to better explain how it is effectively the case; is it through the use of a ROCE ratio (Return on Capital Employed) for example ?

   c. Page 10: in the context of your discussion, the following statement should be nuanced: *This is considerably difficult since goodwill impairments are subject to earnings management […]*; goodwill impairments are subject to management's estimates, and in some cases to earnings management.

   d. Page 13: equation (1) is not introduced; is it the core Ohlson model ?

   e. The following acronyms should be introduced:
      i. IOA, Impairment-only approach on page 3;
      ii. IIA, Identifiable intangible assets on page 6 ;
      iii. FE and RE on page 19.