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Ms Annette Kimmitt
Senior Project Manager
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By Email

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Dear Ms Kimmitt

I should like to comment on the Board's proposals on Business Combinations. Many Board Members will have heard me before on the point I wish to raise and the matter was covered in rather more detail several years ago by my paper "On the Valuation of Assets". In this note I emphasise only the major point which I wish to put forward.

In my view, there is a gap in the theoretical analysis which is used by the IASB in considering the questions of financial reporting. The question of "goodwill" is not correctly analysed from the conceptual point of view. This is fundamentally due to a failure to make a certain distinction in the Framework. I cannot emphasise too much how important the matter is - without a correct appreciation of goodwill, the outcome of the deliberations on Business Combinations, and some aspects of accounting for Intangible Assets, will not be correctly handled.

Consider a company of international dimensions which has developed all its subsidiaries internally, on a green field site basis. Thus a UK group has a German subsidiary which is very profitable. At a certain point, 49% of the shares in the German subsidiary are floated on the Frankfurt Stock Exchange. The resulting valuation of these shares is greatly in excess of the assets employed in the German subsidiary.

The parent company, or from another point of view the group, owns 51% of the shares in this very successful German subsidiary. I would like to ask the Board whether they consider that those shares (51%) meet the definition of an asset. In my view, as the Framework at present drafted, they do. Why therefore are they not recognised and valued in the balance sheet?

They are not valued in the balance sheet for the same reason as the Stock Exchange valuation of the whole group is not valued in the balance sheet. We do not want to represent, on the balance sheet, the value of the future cash-flows generated by the operations of the group or company. The future cash-flows generated by the group, or a company within the group, are indeed assets of the shareholders (at whatever level they are defined). But those future cash-flows, as measured by the discounted present value of their future worth, are not assets employed in the business.

Indeed, since the purpose of financial statements is to enable the user to make decisions on the basis of forecasted cash-flows, it would be logically circular to show an asset in the balance sheet valued at the discounted present value of those same cash-flows.
Possibly the definition of an asset in the Conceptual Framework of the FASB is defective in this way. The definition of assets according to the IASB Framework contains the word "resource" which was inserted (if I may say so) at my insistence. The Framework definition of an asset should be modified to deal with this matter.

Unless this matter of the definition of an asset is sorted out, there will continue to be confusion as to the relationship between the assets employed in the business and the future cash-flows generated by the business and their value.

When a company is acquired (as opposed to internally generated on a green field site basis as mentioned above) then, by force, the group acquires a subsidiary at a price which reflects the future cash-flows which are generated by the subsidiary or which the group believes it can generate. In other words we have on the balance sheet something which we do not want - we do not want it in the same way as we do not want the valuation of the group to be on the balance sheet. Thus, I would argue, the whole of the purchase price (not just goodwill) is an item which, although it is relevant to the analysis of the financial statements in the sense that the purchase has been financed (in one way or another), is not an asset employed in the business.

The logic of this matter is further confused by the fact that the total value of the purchase is split into two: the assets employed in the business, and the "goodwill". According to my analysis, the goodwill is simply a consolidation difference. Yet there is a tremendous feeling in many places that in some way it is an asset in the same way as a factory is an asset or a patent (intangible) is an asset. We even have the phrase "identifiable intangibles", in that there is a kind of feeling that if only all the intangibles could be identified the goodwill would be used up. But this logic is absolutely against the idea that the balance sheet is not there to reflect the value of a company. One might as well say that a simple company - maybe Coca Cola - could be represented on the balance sheet at the value of its market capitalization if only all the "identifiable intangibles" of Coca Cola could be discovered. This is a delusion of the first order.

If it is recognised, as I would argue is correct, that the total value of the purchase of the subsidiary is an asset of the shareholders and not an operating asset, then one can see that there are two balance sheets. I have some years ago been in correspondence with the SEC in Washington who rejected this argument on the grounds that the SEC could conceive of only one balance sheet. This insistence on the answer before the analysis is made is in my view completely incorrect. If there are two balance sheets there are two balance sheets. If the acquired subsidiary is placed in the parent company balance sheet (or the holding company, or whatever it might be called), then these problems are dissolved. First, if the acquired company (the whole purchase price) is seen as an acquisition by the parent company, it can be assessed for impairment (so as to check management responsibility) on a well defined basis. So long as the acquired subsidiary remains as an entity, that entity is clearly displayed at its original price and an attempt to decide whether a part of it (called the goodwill) is impaired ceases to be relevant. The Income Generating Unit is the acquired company as a whole - which is much more sensible. If on the other hand the acquired company is dissolved into some other parts of the group, a problem will arise - but no more so than the problem arises if goodwill is seen as a separate item as in the present literature of the IASB and elsewhere, and at any rate the start point - the acquired company as a whole - is coherent and logical.

It can be seen that the 51% group holding in the self-generated German subsidiary could (if it was thought worthwhile, which I rather doubt) be valued in the parent company balance sheet. This would parallel the value of the acquired company. The difference between an acquired company and a self-generated company would therefore disappear, except on the financing side.

Goodwill should not be artificially depreciated. On the above argument it would be not only wrong but in fact non-sensible to depreciate it. The discounted present value of future incomes is not something which can be depreciated. The argument for impairment is to judge whether the original purchase by the management was justifiable or not.

The above analysis puts the matter in logical context. Also, the idea that in some way goodwill could be broken up into its identifiable intangibles is set aside and the pressure to try and identify such intangibles goes away. This latter point is not trivial since many people around the world will suggest and indeed have suggested that if it is so important to break up acquired goodwill into identifiable intangibles, why is it against the rules of the Framework to show on the balance sheet the self-generated identifiable intangibles?

This analysis also resolves the matter of negative goodwill. On the one hand, the negative goodwill could remain in the same way as positive goodwill. Or, rather, we would be dealing not with goodwill (whether negative or positive) but with the whole value of the company purchased. That is, there would be an item in the parent company balance sheet showing the value at purchase of the new subsidiary, something which would have to be justified on the arguments above: and in fact it would turn out (in the case of negative goodwill) that the purchase was a cheap one. When we come to consider what should be done with the "cheapness" (after the mirror image of an impairment text) the matter is resolved by other considerations. Whereas in the past items such as this (government grants are another example) would be spread over the life of a relevant asset (in this case, the operations of the new subsidiary over the years, presumably at a loss), now the government grant (or the negative goodwill) would be taken as income immediately. This is of course as proposed in the Exposure Draft. But the logic which I put forward to obtain the same answer is different. The Board is in difficulties (Basis of Conclusions paragraph 117) because if the components of negative goodwill do not meet the definition of a liability, one must suspect that some or all of the elements of positive goodwill do not meet the definition of an asset. And indeed they do not, on the analysis above, meet the definition of an asset in the operating balance sheet, only an asset of the shareholders.

Yours sincerely

DAVID DAMANT