FINDING GOODWILL IN MERGERS

TERRY HARDING OF KPMG EXPLAINS WHAT STEPS ACCOUNTING STANDARD SETTERS WORLDWIDE ARE TAKING TO TIGHTEN REGULATIONS SURROUNDING M&A ACTIVITY.

The acquisitive business world has been grappling with the related issues of merger accounting and goodwill since consolidated accounts first appeared. For some, the debate is conceptual: if I pay more for a firm than its identifiable assets are worth, what have I paid for? Market position, a workforce or brands, perhaps? But are these assets in an accounting sense or simply a 'debit' that should be lost in reserves? Does the value of goodwill decline over time, and should that decline be reflected in earnings? When two similar-sized firms merge, should the value of goodwill of one or both merging companies be brought onto the balance sheet? Or is a merger truly different from an acquisition?

For shareholders, analysts and financiers, the issues are no less significant. But surely mergers and acquisitions are about creating value through market share, integration, synergies and cost savings, about future cashflows, rather than debits and credits? Well yes, and no. The markets still react to profit announcements, despite trends towards more sophisticated measures of performance. If, as under existing standards in the UK, the US and IAS, goodwill is recognised as an asset and amortised through income, EPS is inevitably affected. The impact of goodwill amortisation on the bottom line has been a deal-breaker in more than one case, as well as being the subject of 'competitive disadvantage' claims.

MOVING ON. Accounting standard setters and regulators have become increasingly concerned about the ability to structure deals as mergers and have tightened their rules, mainly around the relative sizes of the merging groups. The relative size trigger for a merger has varied – broadly 60:40 in the UK, 55:45 under IAS and 50:50 for any US foreign registrant regulated by the SEC – but it has remained largely arbitrary. Things are changing, however. The FASB led the way last year with SFAS 141 and 142 and the IASB's proposals are in the pipeline. In short, every business combination is an acquisition. In each deal, an acquirer must be identified, the value paid by the acquirer must be compared with the fair values of the identifiable assets and liabilities acquired, and the difference (goodwill) is recognised as an asset. Rights under separable, identifiable intangible assets, such as trademarks and patents, are shown separately on the balance sheet and will generally be amortised over their lives. Goodwill itself is not amortised but is subject to regular and rigorous impairment tests.

The proposals are helpful in that they remove the arbitrariness from the accounting for mergers and goodwill. Generally, the larger company will be the acquirer and goodwill will be recognised for the value of the smaller company. Some would argue there are valid mergers of equals and choosing an acquirer in such cases is itself arbitrary. The standard setters' response is that 'fresh-start' accounting would then be more appropriate. Goodwill should be recognised for both companies, but for now at least, that is not part of the proposals. The new rules will remove the opportunity – and therefore the cost – of structuring a deal in order to achieve an accounting result.

WHAT LIES AHEAD? The difficulties in the new model lie in the impairment testing. Both the FASB requirements and the IASB proposals introduce complex rules, for example, around when a detailed test should be performed, the level at which it should be performed, and what 'value measures' should be used. In the US, the emphasis is on finding market-based fair values for the reporting unit itself and for its identifiable assets. The difference is the fair value of goodwill. Under the IASB's proposals, there is more emphasis on company-specific estimates of future cashflows for a cash-generating unit.

Despite best efforts to produce detailed application rules, the extent to which goodwill is impaired will remain open to judgement. The rules are such that expenditure on marketing, training and the like will be expensed, but companies can avoid impairment losses by ensuring they spend enough on a regular basis to increase or maintain the value of goodwill. But there will be times when goodwill impairment is unavoidable. Impairment losses will hit the bottom line now and then and, perhaps inevitably, companies will put off that day until the big bath becomes unavoidable. At least, though, any bottom line impact should reflect economic events and future cashflow expectations, not just the latest whims of the accounting profession.

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