



Letter of Comment No: 199  
File Reference: 1204-001

Wednesday 26, October 2005

Alan Teixeira  
Project Manager  
International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

Dear Mr Teixeira

Please find accompanying this letter, my comments on the IFRS 3 exposure draft *Business Combinations*.

Yours Sincerely

A handwritten signature in black ink, appearing to read "C. Higson".

Dr Chris Higson

## **EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IFRS 3**

### **Comments - Professor Chris Higson, London Business School**

I am pleased to submit my comments on the IFRS 3 exposure draft.

By way of introduction - I am a professor of accounting at London Business School, where I was previously chair of the accounting subject area. I teach and research in the area of financial statement analysis, and have advised many major corporations and investing institutions on financial statement analysis and valuation over a number of years. My perspective in these comments is that of a user of financial statements.

These comments are freeform and do not follow your question structure. They are in two parts:

1. General observations on the form and the timing of the exposure draft.
2. Specific comments, focussing on one issue - the proposal to recognise minority goodwill.

#### **1 The nature and timing of the exposure draft**

**1.1** Proposals of this sort to reform accounting standards should be evidence-based. In some 200 pages, including supporting materials, this exposure draft provides no clear statement of the desired end state or of how the proposed changes fit into the plan. It is devoid of empirical content. There is no attempt to assess the impact of the proposed changes: for instance, the size and incidence of their effects, what proportion of combinations will be affected, and of what sort. There is no review of the problems generated by existing GAAP; in other words, what was bust, that needed fixing.

**1.2** Rather than making a tightly argued case for the proposed changes, the working style is to make broad assertions about relevance and reliability. Of course, these assertions can be tested, but this challenges the audience to collect the empirical data that the IASB has declined to provide. Asking the audience, which is fragmented, to collect the evidence is costly and inefficient.

**1.3** The reforms to accounting for business combinations over recent years have greatly improved transparency and (I suspect, but without evidence) resource allocation. By contrast, I believe the current proposals are generally 'second order'. You could have communicated most of them as having low impact; equally, they could very easily have been postponed. In fact they seem likely to meet a lot of resistance. If so, this is partly a self-inflicted wound by IASB; a consequence of the abstract style, and of the timing of the IFRS 3 exposure draft.

**1.4** European preparers are in the midst of transition to IFRS. Convergence to one system from many is sure to be a very costly transition involving a plethora of seemingly arbitrary changes. During the transition period, even people who are naturally predisposed to the convergence project complain about the costs, and question the purpose of many of the changes they are being asked to make. IASB would have been wise to allow people time to assimilate and to understand the current framework. This is not a smart time to bring forward proposals that provide a focus for dissatisfaction.

#### **2 Comments on the proposals concerning minority goodwill, from a users' perspective**

**2.1** The reason the exposure draft badly needed to be empirically-based, rather than purely abstract, is that there is no 'principled' solution to the question of whether minority goodwill should be recognised. This is because we already use a model that

is a hybrid of equity and entity when we require full consolidation with partial ownership.

- 2.2** There seems to be widespread opposition to the IFRS 3 proposals on the grounds that they are a Trojan horse for full fair-value accounting, and that they threaten to replace the equity model by the entity model. I do not share this anxiety. I believe the users of financial statements will not be much affected either way. What matters, as always, is disclosure.
- 2.2.1** Though consolidated financial statements are prepared primarily for the shareholders in the parent firm, this has no necessary implications for the issue of whether minorities should or should not be shown gross of their goodwill.
- 2.2.2** Equally, much analysis of financial statements is conducted at the entity level nowadays. But you could not conclude from this that accounts should be prepared using the entity model. The equity model seems to have served analysts adequately thus far; they simply need adequate disclosure.
- 2.2.3** In fact, we tend to tell students and practitioners to include goodwill in a return on equity measure, to judge if managers are creating or destroying value for shareholders, but exclude it for comparing and analysing operating (entity) performance. So if they follow that practice, users will be indifferent to the recognition of minority goodwill.
- 2.2.4** One occasion where the reporting of minority goodwill is 'relevant' is in the calculation of the weighted average cost of capital. In principle, the weights in a WACC calculation are based on market values. Analysts know the value of equity, and GAAP now gives them the value of debt, but they are often puzzled what to do about minorities and are tempted to use book value. Of course there is no reason why guidance on the value of minorities should not be in a footnote disclosure.
- 2.3** The bigger problem is how to value minority goodwill. I think that the exposure draft enormously understates this problem, and I concur with the 5 dissenting Board members on this. There are in fact two problems.
- 2.3.1** One issue is how to value a minority relative to a majority. The discount for lack of control will be highly context specific, and we do not have a good understanding of control premia.
- 2.3.2** But I am in any case much less sanguine about how to value the majority. The exposure draft talks as though observed cost is generally a reliable measure of the value of goodwill at the time of purchase, and that overpayment and underpayment are infrequent. There is a large body of evidence from research suggesting that overpayment is the norm.
- 2.3.3** However, I do not conclude that the problem of reliable measurement is a necessarily a knock-out blow for the recognition of minority goodwill, since the valuation of goodwill, at least of the majority, is in any case necessarily addressed in the impairment review.
- 2.4** As to how to account for exchanges between minorities and equity, I do not attach significance to arguments about whether these should be earnings or reserve accounted. Again, it is all about disclosure. Users simply need enough disclosure to pick the appropriate data, to service the particular piece of analysis they are doing. For some purposes, the relevant income construct will be operating profit pre-exceptionals; at other times it might be comprehensive income; or it can be anything in between.