Spotlight on Accounting Errors

Business Combinations – Overpayment on Acquisition

A material accounting error can arise when an entity acquires another business and pays too much on acquisition. The acquisition was not a good deal on the day it was made, and it never will be.

The commercial reality is that an acquirer may pay too much for an acquiree and therefore, at the date of acquisition the acquired assets are impaired. In accounting for the acquisition an entity needs to reflect that impairment loss and not rely upon the purchase price paid as being indicative of the 'fair value' of the acquiree for the purposes of complying with Australian and IFRS Accounting Standards.

Why entities pay too much?

Failure to make the right acquisition at the right price can arise from a range of reasons which include the following:

- Irrational exuberance about the strategic importance of the acquiree;
- Getting too attached to the deal, leading to the acquirer to overpay;
- A rival is also in pursuit and the desire to "win" leads to a bidding war;
- Failure to perform adequate due diligence;
- The due diligence and the purchase price being based on inaccurate information;
- Limitations of financial and other information used to determine the purchase price by the acquirer;
- Failure to consider the costs of integrating the acquired business and thus overstating the synergistic benefit of the combined entities;
- Appreciation of the acquirer's share price from the time of making the offer to purchase the business and the date the business was acquired (if consideration is in the acquirer's shares);
- Appreciation of the currency used to acquirer the business compared with the functional currency of the acquired business; and
- The business underperforming from the date of due diligence and determination of the purchase price to the date of acquisition.

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Accounting for acquisitions

Key accounting principles

AASB 3 / IFRS 3 *Business Combinations* paragraph 18 states:

> *The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.*

When an entity overpays for an acquiree, the business combination will give rise to goodwill. Goodwill represents the difference between a purchase price and the net identifiable assets acquired on a business acquisition. Such goodwill is required to be tested for impairment.

AASB 136 / IAS 36 Impairment of Assets paragraph 8 states:

> *An asset is impaired when its carrying amount exceeds its recoverable amount.*

AASB 136 / IAS 36 Impairment of Assets paragraph 10(b) states:

> *Irrespective of whether there is any indication of impairment, an entity shall also: … test goodwill acquired in a business combination for impairment annually in accordance with paragraphs 80–99.*

AASB 136 / IAS 36 Impairment of Assets paragraph 96 states:

> *The annual impairment test for a cash-generating unit to which goodwill has been allocated may be performed at any time during an annual period, provided the test is performed at the same time every year. Different cash-generating units may be tested for impairment at different times. However, if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period.*

AASB 136 / IAS 36 paragraph 96's requirement to test goodwill for impairment on a business combination that occurred in the current year addresses the risk that an acquirer could 'overpay' when acquiring another entity. The International Accounting Standards Board in the Basis of Conclusions of IAS 36 note at BC172 and 173 the following:

> *The Board observed that acquirers can sometimes 'overpay' for an acquiree, resulting in the amount initially recognised for the business combination and the resulting goodwill exceeding the recoverable amount of the investment. The Board concluded that the users of an entity's financial statements are provided with representationally faithful, and therefore useful, information about a business combination if such an impairment loss is recognised by the acquirer in the annual period in which the business combination occurs.*

> *The Board was concerned that it might be possible for entities to delay recognising such an impairment loss until the annual period after the business combination if the*

Standard included only a requirement to impairment test cash-generating units (groups of units) to which goodwill has been allocated on an annual basis at any time during a period. Therefore, the Board decided to include in the Standard the added requirement that if some or all of the goodwill allocated to a unit (group of units) was acquired in a business combination during the current annual period, the unit (group of units) should be tested for impairment before the end of that period.

Provisional accounting

AASB 3 / IFRS 3 Business Combinations paragraph 45 permits a business combination to be accounting for on a provisional basis. However, provisional accounting does not mean that impairment issues with acquired assets may be ignored within the first 12 months of a business acquisition. AASB 136 / IAS 36 paragraph 96 specifically requires that goodwill on a newly acquired business be tested for impairment before the end of the current financial reporting period, and, where such an asset is impaired, provisional accounting under AASB 3 / IFRS 3 does not permit a company to fail to recognise and/or misstate the impairment loss.

Provisional accounting only applies to the determination of the fair value of assets and liabilities acquired at the date of acquisition, if an event has occurred post the acquisition that has caused an asset or liability to change (examples include: a bad debt becoming impaired, a decision being made to not use an acquired tangible or intangible asset, a pollution event, an unforeseen event such as a pandemic/ war/ sanctions) this is not subject to provisional accounting and instead should be reflected in the income statement.

It should also be recognised that acquired financial assets are measured using AASB 9 /IFRS 9, again an entity needs to apply the impairment provisions of that standard to financial assets (e.g., trade receivables) rather than relying on the provisions of provisional accounting.

Other considerations when impairment is identified

If impairment is identified in respect of acquired goodwill such that all the recognized goodwill is impaired, careful consideration is required of the fair values assigned to the identified assets and liabilities as any overvaluation of assts or undervaluation of liabilities will directly increase the impairment charge.

Determining recoverable amount

The recoverable amount of an asset or a cash generating unit (CGU) is the higher of its fair value less cost of disposal and its value in use. There are issues entities that need to be considered for determining the recoverable amount of newly acquired goodwill when applying either impairment model.

Value in use impairment model

The requirements of AASB 136 / IAS 36 to utilize the VIU model to determine the recoverable amount of the newly acquired goodwill are very strict and need to be considered when assessing whether the newly acquired goodwill is impaired.

Common errors in application of the VIU model to determine the recoverable amount of the newly acquired goodwill include:

- The assumptions in the cashflow model are not reasonable or supportable because the acquirer lacks the appropriate knowledge of the historic performance of the acquired entity and / or internal forecasts and budgets are unrealistic being inflated to attract a buyer or not factoring disruptions arising from the change in ownership.
- The cashflows in the cashflow model do not represent the cashflows from the asset in its current state and condition, but rather factor in planned improvements/enhancements and restructurings by the new owner.
- The discount rate used in the VIU model does not represent the risk that the forecast cashflows will not be achieved (it does not follow that the discount rate for the newly acquired business is the same as that used by the acquirer).

AASB 136 / IAS 36 provides detailed guidance on how to calculate a CGU's value in use (VIU) providing guidance on:

- The basis for estimating future cash flows;
- The composition of estimates of future cash flows;
- Foreign currency future cash flows; and
- The discount rate to be applied.

VIU model assumptions

AASB 136 paragraph 33(a) requires that a VIU model is to base cash flow projections on **reasonable and supportable assumptions** that represent managements best estimate of the range of economic conditions that will exist over the useful life of the asset.

AASB 136 / IAS 36 paragraph 34 states:

> *Management assesses the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows. Management shall ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.*

ASIC reported in INFO 203[1] the failure to ensure that cash flow assumptions applied are 'reasonable and supportable' is a common issue with impairment calculations stating:

> *In our experience, common issues with impairment calculations performed by companies include:*
>
> - *cash flows and assumptions are not reasonable, having regard to matters such as historical cash flows, economic and market conditions, and funding costs*
> - *value in use calculations:*
>   - *do not use sufficiently reliable cash flow estimates*
>   - *use increasing cash flows after five years that exceed long-term average growth rates, and without taking into account offsetting impacts on discount rates, and*
>   - *include cash flows from restructurings and improving or enhancing asset performance.*

Fair value less cost of disposal model

Fair value less cost of disposal (FVLCD) is an exit price for an asset. When measuring FVLCD, fair value is measured in accordance with AASB 13 / IFRS 13 *Fair Value Measurement*, costs of disposal are calculated in accordance with AASB 136 / IAS 36.

Common errors in application of the FVLCD model to determine the recoverable amount of the newly centers on the adoption of the incorrect premise that the fair value of the newly acquired goodwill at the year end is the value the acquirer actually paid for it. This premise is flawed for a number of reasons, including:

- It simply ignores the possibility that the acquirer overpaid for the acquired business.
- It ignores that the fair value is what the market would place on the acquired business, this value is not always the value the acquirer placed on the business
- It ignores the possibility that the fair value has changed from the date the acquirer valued the acquired business.

AASB 136 / IAS 36 paragraph 53A notes the important distinction that needs to be made when applying a fair value less cost to sell impairment model:

> *Fair value differs from value in use.* ***Fair value reflects the assumptions market participants would use when pricing the asset****. In contrast, value in use reflects the effects of factors that may be specific to the entity and not applicable to entities in*

[1] Australian Securities and Investments Commission Information Sheet 203 Impairment of non-financial assets: Materials for directors reissued August 2019.

general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to market participants:

(a) additional value derived from the grouping of assets (such as the creation of a portfolio of investment properties in different locations);

(b) synergies between the asset being measured and other assets;

(c) legal rights or legal restrictions that are specific only to the current owner of the asset; and

(d) tax benefits or tax burdens that are specific to the current owner of the asset.

FVLCD model assumptions

A critical distinction between the application of a VIU and FVLCD model is that the FVLCD model is not an entity specific measurement but is focused om market participants' assumptions for a particular asset or liability. For non-financial assets, fair value must take to account the highest and best use by a market participant to which the asset could be put.

AASB 13 / IFRS 13 does not limit the types of valuation techniques an entity may use to measure fair value, focusing on the inputs to be used. The standard requires the use of a valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. The objective is that the best available inputs should be used in valuing the assets using one of the three valuation approaches in the standard:

- The market approach;
- The cost approach; and
- The income approach.

AASB 13 / IFRS 13 allows an entity to use unobservable inputs to calculate fair value as long as the objectives, an exit price from the perspective of a market participant, and assumptions about risk are met. A discounted cash flow model may be used to estimate the fair value of an acquired entity, but must reflect cash flows that market participants would take into account when assessing fair value. It is not permissible to include assumptions about cash flows or benefits (such as cost savings arising from integrating the acquired entity into the acquiror's business) from the entity that would not be available to or considered by a typical market participant.

When performing a FVLCD impairment model, external evidence cannot be ignored. The acquiror must use the best information that is available to it and adjust its own data if reasonably available information indicates that other market participants would use different data or there is something particular to the acquiror that is not available to other market participants such as entity-specific synergy.

ASIC raise the following concerns regarding the use of a FVLCD model:

> *Are fair values less costs of disposal based on available market prices or observable market data? If not, it may be necessary to use value in use to determine the recoverable amount.*
>
> *Have valuations been checked by using different valuation methods, particularly where a market value is not available?*
>
> *Is the range of possible fair values too broad to determine a reliable estimate?*
>
> *Is the value chosen in a range of possible fair values representative of the fair value? This may not be the midpoint.*
>
> *Have maximum observable market inputs been used?*

Cash flow assumptions – what to look out for

ASIC note the following issues that Directors should consider regarding the forecasting of cash flows that are applied in an impairment model:

> *Are cash flow forecasts reasonable and supportable?*
>
> *If cash flows are predicted to increase significantly after year end, is there a strong basis for this prediction? Have any risks been considered? Is the growth consistent with past growth achieved and is it sustainable? Have predictions been met in the months since year end to the completion of the financial report?*
>
> *If cash flows are based on an internal budget, is the budget realistic or based on stretch goals?*
>
> *Have past cash flow forecasts been met? If not:*
>
> - *Has careful consideration been given to whether current forecasts and assumptions are reasonable and supportable?*
> - *Have the reasons been analysed and addressed in current forecasts and assumptions?*
>
> *Are management's forecasted cash flows consistent with your understanding of the business and its future prospects?*
>
> *Has the cyclical nature of a business over time been properly recognised, rather than assuming cash flows at the top of a cycle will continue?*
>
> *Are nominal cash flows discounted using discount rates that include the effect of inflation?*

When performing an impairment test for a newly acquired entity, this risk of using cash flow forecasts that are not reasonable or supportable is increased because the acquiror has less knowledge about whether past cash flow forecasts were met and management's accuracy in growth assessments.

In addition, a significant risk when performing a VIU impairment test in relation to a newly acquired entity is that often the data used to determine the purchase price may be out of date and/or unaudited and therefore cannot be considered reliable for the purposes of performing a VIU impairment test.

Assessing the recoverable amount of a newly acquired entity

The recoverable amount of a newly acquired goodwill can be difficult to assess, given the acquiror's management have less knowledge regarding the historical performance of the entity and its accuracy of its budgeting and accounting systems.

Example of difficulties passing the supportable requirement of the VIU model

For example, consider Company A who has a 31 December year end and acquires Company B on 1 November 2022. Company B is unlisted and had a 30 June year end. Information provided to Company A in a data room in January 2022 included:

- Internal Company B management accounts from 30 June 2021 to 31 December 2021
- Company B unaudited accounts as at 30 June 2021
- Company B audited accounts as at 30 June 2020
- Company B budget for the financial year ended 30 June 2022

There is the very real risk that the actual financial performance of Company B could be materially different from that reflected in Company B's management accounts, forecasts and unaudited accounts due to:

- Lack of accuracy in the unaudited financial information provided to Company A; and
- As at 31 December 2022, the financial information of Company B is out of date and not the most current financial information.

The fact that the last audited accounts for Company B relates to the financial year ended 30 June 2020 means that there is a heightened risk that the financial information used by Company A to assess the financial performance of Company B is materially misstated and increases the risk that Company A has overpaid for Company B.

For the purpose of Company A's audit of the consolidated group, only the November and December 2022 results and assets of Company B will be subject to audit.

ASIC notes the following matters for directors to consider in relation to key assumptions applied in an impairment model:

> *Have key assumptions such as growth or discount rates been adequately supported?*
>
> *Is the discount rate appropriate, having regard to funding costs, and an appropriate weighted average cost of capital or other appropriate rate?*
>
> *Is there a reasonable and supportable basis for use of different or similar discount rates for different CGUs?*
>
> *Has the impact of risks associated with matters such as market changes, climate change, technological change, or possible changes in business models due to digital initiatives of the company or its competitors, been considered?*

And

> *Are forecast cash flows and other assumptions consistent with other information, such as:*
>
> - *realistic budgets and sales predictions*
> - *the operating and financial review, market announcements, and presentations to investors and analysts*
> - *commentary in other board papers and reports, and*
> - *external commentary on, and your understanding of, the market and economy?*

Indicators of impairment

When considering whether an acquired entity is impaired, there are red flags that must seriously be assessed by management to ensure that the newly acquired entity's goodwill is not impaired. ASIC have outlined the following possible indicators of impairment:

> *If the company is listed, is its market capitalisation less than the net assets shown by the company's statement of financial position?*
>
> *Are there indicators that the overall value of any of the company's CGUs may be less than the value attributed to the related assets?*
>
> *Has the financial performance of any CGU declined in recent years or in the last year?*
>
> *Has performance declined since the end of the financial year, or is it projected to decline in the future?*
>
> *Have past forecasts used in impairment calculations been met?*

Are there significant changes in the business or its environment now or in the future? Examples may include the following matters if significant:

- *a decline in the market or price for products or services*
- *oversupply in markets for products or services*
- *problems in sourcing raw materials or services*
- *increases in the costs of production or delivering services*
- *changes in exchange rates affecting costs or sales*
- *new competitors*
- *new products or services from competitors*
- *technological change*
- *changes in law or regulations*
- *changes in economic conditions*
- *changes in interest rates (this may affect discount rates used in calculating an asset's value)*
- *physical damage to assets*
- *plans to dispose of assets earlier than expected*
- *plans to discontinue or restructure operations, and*
- *other changes in the activities of the business.*

Basford Consulting – The Accounting and Audit Experts

The team at Basford Consulting provide independent expert evidence drawing from our considerable experience in providing technical accounting, audit and governance solutions for clients.

Our Team

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Wayne is the Managing Director of Basford Consulting. Wayne is highly qualified and experienced in delivering both technical expertise and thought leadership to a national and international audience. Wayne has worked with major global accountancy firms across three continents, developing extensive experience with large, multinational audits. Wayne is a specialist in International Financial Reporting Standards (IFRS). He regularly authors technical papers and newsletters on application of IFRS and Auditing Standards, as well as consulting on application of IFRS and corporate governance.

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