

## UK ACCOUNTING FOR ACQUISITIONS STILL POOR AND SA NO BETTER

Merger and Acquisition (M&A) activity is expected to pick up as economic conditions improve in the year ahead. A study released recently by UK watchdog, the Financial Reporting Council (FRC), on the quality of financial reporting for acquisitions suggests that the International Financial Reporting Standard (IFRS) on business combinations (IFRS 3) has been poorly applied by companies due to unfamiliarity with its requirements and the complexity of valuing intangible assets such as brands and customer relationships.

The study found that companies had provided insufficient or inconsistent information about material acquisitions in their audited accounts when compared to the rationale given for these same acquisitions in their business reviews.

“While the study was limited to UK companies, South Africa’s level of compliance is not much better,” says Andrew Naudé, director at Moore Stephens Corporate Finance. “We definitely find that not all companies are equal when it comes to applying IFRS to acquisitions.”

Naudé points to recent high profile cases, such as micro-lender African Dawn’s write-off of R188m of ‘goodwill’, which slashed its net asset value and triggered a governance storm in the company, as examples of poor application of IFRS regarding acquisitions.

“IFRS has a very practical rationale. Companies often spend hundreds of millions of shareholders’ funds on making acquisitions, which could alternatively have been paid out to those shareholders as dividends. IFRS 3 simply seeks disclosures about what’s been bought and why.” “The objective of IFRS 3 is to reduce so-called ‘goodwill’ to its barest components, by separately recognising (and amortising) all identifiable assets acquired in a business combination.

By combining everything together as ‘goodwill’, non-compliant companies both understate amortisation charges and also reduce the probability of impairment losses by having performing assets obscure non-performing assets when testing for impairment. In African Dawn’s case, this also made its financials less directly comparable to competitors which had applied IFRS 3 correctly.”

Naudé says that shareholders and analysts look closely at M&A disclosures under IFRS as these provide valuable information about acquisition risks and acquisition rationales, and also serve as indicators of management’s commitment to transparency. “If for example I spend R100m buying a company with tangible assets of R10m, a brand worth R60m and a recurring customer base worth R30m, that obviously provides a lot more information than if I simply reflect R10m worth of assets and R90m of some vague thing called goodwill.”

“There is a reason that companies pay significant premiums to tangible net asset values to make acquisitions and correct application of IFRS seeks to explain this to the people whose cash has been spent on such transactions,” concludes Naude.

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