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Friday, March 28, 2003

Dear Ms Kimmitt

Re.: **ED 3 Business Combinations and Revised IAS 38**

May I comment on three aspects of the current exposure draft on Business Combinations, two of which affect the exposure draft on the revised IAS 38, and which can be categorized with regard to the "Invitation to Comment" under the following headings:

1. ED 3 Business Combinations
   Question 9 – Excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities:

   *We recommend strengthening of the standard in regard to the recognition of this excess over the cost of a business combination, otherwise referred to as **Negative Goodwill**.*

2. Exposure Draft of Revised IAS 38
   Question 2 - Criteria for recognizing intangible assets acquired in a business combination separately from goodwill:
   ED 3 Business Combinations
   (Question 7 – Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed)

   Definition of Intangible Assets :

   Although IAS 38 deals adequately with the issue of "Control" (see paragraphs 12 - 15), we consider that an explicit reference to the **concept of "Control"** in ED 3 Business Combinations, paragraphs 36 and 43, would avoid confusion and mis-understanding.

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3. Exposure Draft of Revised IAS 38
Question 1 – Identifiability:
ED3 Business Combinations
(Question 7 - also, as above)

In-Process Research & Development Projects (Technology under development):

Although the proposed treatment of in-process research and development under IAS 38 is only addressed under "Internally Generated Intangible Assets", we recommend that the accounting treatment of research and development projects in acquired business combinations should also be consistent with this treatment as proposed in paragraphs 43 – 51.

ED 3 Business Combinations itself need to be amended to avoid confusion by specifically stating that research and development projects, if classified as still "in-process" and with no alternative future use, should be identified, valued and charged to expense in accordance with previously accepted normal accounting principles

Note: The subject under 3. above could of course be considered to be a sub-set of 2., though we have deliberately addressed it as a separate sub-category. The reason is that the action I recommend to be taken by the IASB in regard to the treatment of in-process research & development projects is diametrically opposite to that being made for the definition of intangible assets (though, interestingly enough, consistent with this definition).

1. Negative Goodwill (ED3: Question 9 in "Invitation to Comment")

In my view, the Exposure Draft does not adequately address the reasons why it is undesirable to allow negative goodwill to be reported in financial statements except under the most restrictive circumstances.

Owing to the weak UK standard on the matter, lax and inadequate practices and methodologies in the valuation of real estate have been allowed to continue unchecked over many years. It is only the recent radical change in the taxation of intangible assets in the UK that has, for the first time, introduced any real sanction against such practices (i.e. by treating the amortization of negative goodwill as taxable income).

In my view the International Accounting Standards should be specific about the treatment of negative goodwill, as currently not all countries have adopted similar treatments of negative goodwill for taxation purposes (i.e. treating the amortization of it as taxable income).

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While I agree in principle with the proposed standard, as per paragraphs 55 and 56 of ED3, nevertheless we feel that it should be strengthened to address the known weaknesses of existing standards. I recommend, therefore, that the IASB's own standard in regard to Negative Goodwill should also reflect similar requirements to those set out in the US's FASB requirements under SFAS 141 relating to "**bargain purchases**" (refer to paragraphs 44 to 46). While the concept of a bargain purchase is recognized in paragraph 56 (c) of the proposed IASB standard, this appears to be really only by way of a passing reference.

In the Basis for Conclusions, paragraph BC114, however, the IASB considered the above recommendation, which reflects the view that recognizing an excess by reducing the values attributed to the acquiree's identifiable net assets is appropriate. But the IASB rejected this view, noting that the reduction in values allocated to each of the acquiree's identifiable net assets would inevitably be arbitrary and therefore not representationally faithful.

While I agree with the IASB's observation above, however, I believe that its consideration of the problem was itself based upon a misconception. This misconception is rooted in the implicit assumption that the acquirer's reassessment of the net fair values attributed to some of the acquiree's identifiable net assets would itself be subject to appropriate valuation methodologies for the fixed assets. Inappropriate valuation practices have been allowed to develop in the UK as a result of accounting standards which have not previously adequately addressed the problem of negative goodwill.

Included at the end of this section is a more formal statement of my recommendation.

Background

To provide more support for why it is necessary to amend the suggested standard, we feel that it may be helpful to first provide a description of some of the real estate valuation problems that have been encountered in the UK over the past few years. These problems are, I believe, directly attributable to the current very weak position adopted in the UK accounting standard on negative goodwill.

A particular problem I, as an international valuation consultant, has encountered is the effective overvaluation of fixed assets where a depreciated replacement cost approach is adopted. Under the Royal Institution of Chartered Surveyor's (RICS's) guidelines, evaluations undertaken on this basis are included assuming earnings are adequate to support the reported values, i.e. no economic obsolescence is quantified or applied to the values reported. The depreciated replacement cost approach is generally used for specialized assets, notably non-general purpose real estate, and the resulting valuations, without adequate care and understanding, can be out of step with economic reality.

The above comment is not to say such an approach does not have its place in the valuation of specialized assets. For example, in the USA, the "cost approach" as it is known is probably more commonly used than in the UK, though the sophistication of the appraisal techniques is often greater, including a more quantitative methodology in penalizing the assets for any economic obsolescence.

The blanket acceptance of cost approaches to the valuation of certain assets which assume adequate earnings, will continue to contribute to their overvaluation and hence result in the creation of what may be claimed to be negative goodwill.

A second issue concerning the potential overvaluation of assets, specifically real estate, is where properties are valued as "buildings with trading potential". The RICS correctly recognizes that certain properties such as hotels, nursing homes, etc. may need to be valued effectively as a business, as this cannot realistically be separated from the real estate's "bricks and mortar". There are two principal issues here:

1. This approach should be applied only to certain types of assets (as specified in the RICS Appraisal and Valuation Manual)

2. In undertaking such an approach the valuers need to be fully conversant with business appraisal to avoid such problems as inclusion of brand names and other intangible assets within the values ascribed to the property.

Within 1., we have recently seen part of the Safeway real estate portfolio valued on an earnings basis as opposed to the more usual open market approach using comparative rental or sales evidence of similar real estate assets. It is clear these assets were valued as individual businesses, not as pure real estate properties, although the more accepted open market basis assuming a vacant property would most likely have yielded materially different results.

Within point 2., above, there are numerous issues of methodology and competence of the firms to undertake "business valuations" and to recognize what particular assets they are valuing.

Major areas of concern are the multipliers applied to earnings streams such as EBITDA which are very sensitive to relatively minor variations and for which, appropriate expertise is required in the derivation of these rates. Notably any misguided use of real estate yields applied to such income streams would have catastrophic consequences. Additionally, what actually is being valued is very pertinent. We feel strongly that additional earnings attributable to factors such as brand names and other associated intangible assets (as opposed to the generic real estate) are probably being included in the concluded real estate values at an individual property level. Where a dominant factor is the brand (e.g. for a hotel chain), it is incongruous to have a situation whereby the sum of the parts can materially exceed the value of the whole. Should the brand name and other associated intangible assets have been separately identified and valued, any element of double-counting would clearly exacerbate the problem.

The valuation of assets on a trading potential basis is therefore an issue of understanding and governance by the professional bodies concerned, as well as appropriate expertise in the area of business valuation by those undertaking such engagements. Overriding the above is what is being valued and how this is being represented.

The View of the UK's ASB in the Preface to its Consultation Paper on ED3

In paragraph 25 of its Preface to its Consultation Paper on ED3, the ASB states that the IASB's proposal to recognize negative goodwill as a profit in the performance statements may lead to problems with companies legislation based on EU Directives. We understand from this statement that the ASB may consider it better to retain its treatment of negative goodwill under its existing standards on the matter, i.e. as embodied within FRS 10.

It is my opinion that, on the contrary, any negative goodwill arising as a result of a business combination can only be considered as "realized" and, as such, therefore wholly in accordance with the EU Directives which permit only "realized" profits to be credited to the profit and loss account.

Recommendation for amendment of the proposed ED 3 standard per Question 9:

I recommend that ED 3 Business Combinations paragraphs 55 and 56 include the following insertions, indicated in red and italics:

55. If the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognized under paragraph 35 exceeds the cost of the business combination, the acquirer shall:

(a) reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination, and

(b) recognize immediately in profit or loss any excess remaining after that reassessment.

Under (a) above, specific attention should be directed to the question of whether adequate consideration had previously been given to the assessment of functional and economic obsolescence in the determination of the fair values attributed to the identified assets (and liabilities).

56. A gain recognised under paragraph 55 could comprise one or more of the following components:

(a) errors in measuring the fair value of either the cost of the combination or the acquiree's identifiable assets, liabilities, or contingent liabilities. Possible future costs arising in respect of the acquiree that have not been reflected correctly in the fair value of the acquiree;s identifiable assets, liabilities or contingent liabilities are potential causes of such errors.

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(b) a requirement in an accounting standard to measure identifiable net assets acquired at an amount that is not fair value, but is treated as though it is fair value for the purpose of allocating the cost of the combination. For example, the guidance on determining the fair value of the acquiree's identifiable assets and liabilities, in Appendix B requires the amount assigned to tax assets and liabilities to be undiscounted.

(c) a bargain purchase.

Note that a bargain purchase should be regarded, in general, as an extraordinary event – and therefore its recognition needs to satisfy the same tests and criteria as are applied to the recognition of other extraordinary items in the financial statements of an accounting entity.

Comment on above in context of Convergence with US GAAP

The US viewpoint is likely to be that their standard dealing with bargain purchases, namely paragraphs 44 to 46 of SFAS 141, is more effective in ensuring that any over-valuation of designated assets, both tangible and intangible, is curtailed – even though this may result in a less theoretically elegant proposal.

The US recommendation is that any excess of the amounts assigned to assets acquired and liabilities assumed is allocated as a pro rata reduction of the amounts that would have been assigned to all of the acquired assets, with some specified exclusions. (The value of the assets under consideration also includes any research and development assets acquired and charged to expense, which aspect we address in a later section.) The US standard does, however, provide for a bargain purchase to be recognized, by providing for any excess remaining after reducing to zero the amounts that otherwise would have been assigned to those assets, to be booked as an extraordinary gain.

In my view, the US's FASB may well accept the IASB standard as modified above, as the basis for a revision to their own standard SFAS 141.

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2. Definition of Intangible Assets (Question 2 in IAS 38 in "Invitation to Comment" [and Subset of Question 7 re. ED 3])

I do not disagree with the definition of intangible assets as set out in ED 3 Business Combinations paragraph 36 (c) and the need to satisfy the identifiability criterion set out in paragraph 43. The definition of "an asset" as set out in the Exposure Draft of the Revised IAS 38 has retained the reference to the concept of "Control". Nevertheless the revised standard for the criteria necessary for the recognition of an intangible asset is in danger of weakening this concept of "Control" as one of the key criteria which needs to be satisfied in order to define and value an "identifiable" intangible asset.

For example, as set out in paragraph 43 of ED3, referring to paragraph 36, the definition of an intangible asset has now been aligned with the definition set out in the US standard as contained in Paragraph 39 of SFAS 141.

I would recommend, therefore, that paragraph 43 of ED3 Business Combinations should include explicit reference to "Control" – i.e. in addition to the reference to IAS 38 Intangible Assets (revised 200X) which does indeed retain this reference to the need for control. (See Exposure Draft of Revised IAS 38 paragraphs 12 through 15)

In the context of this comment, however, it may be worth observing that in the "Basis for Conclusions on Exposure Draft 3, December 2002", paragraphs BC90-through-BC95, the IASB considers the issue of "control" but in a different context, namely the use of 'control' to define the boundaries of a group. Note, however, that the meaning ascribed to "control" in IAS 38, paragraphs 12 – 15, is consistent with the meaning set out above.

Included at the end of this section is a more formal statement of my recommendation.

Background

The IAS 38 (together with the associated UK standard FRS 10) has previously provided a superior standard for the recognition of intangible assets to that recently introduced by the US's Financial Accounting Standards Board under SFAS 141. This has been particularly relevant in the context of the argument previously advanced as to why one should not recognize an Assembled and Trained Workforce as an intangible asset apart from Goodwill, but was also relevant in regard to Customer Relationships.

As set out in Appendix B to the SFAS 141, paragraph B169, the logic for the treatment in the US standard was because FASB believed that the methodologies used to measure the value of an assembled workforce and the related intellectual property was likely to be replacement cost. FASB believes that replacement cost is not a representationally faithful measurement of the fair value of the intellectual capital acquired in a business combination, and concluded that the techniques to measure the value of an assembled workforce and the related intellectual capital with sufficient reliability are not currently available. Consequently FASB decided to make an exception to the recognition criteria and require the value of an assembled workforce to be included in the amount recorded as goodwill.

Neither a portfolio of clients nor a team of skilled staff would be recognised under IAS 38 nor under the UK's Financial Reporting Standard FRS 10, according to the following argument. "There may be an expectation that the clients within the portfolio will continue to seek professional services from the entity, or that the team of staff will continue to make their expert skills available to the entity. However, in the absence of custody or legal rights to retain the clients or staff, the entity has insufficient control over the expected future benefits to recognise them as assets."

In US GAAP, under SFAS 141, I understand that a customer base defined as a group of customers that are not known or identifiable to the entity (such as customers of a fast-food franchise), would not meet the criteria for recognition apart from goodwill. On the other hand, per §B159: while a non-contractual customer relationship is only recognised apart from goodwill if it meets the separability criterion, it would meet the separability criterion if it can be sold in combination with a related contract, asset or liability. Per §B160: there is no requirement that the relationship itself be traded in observable exchange transactions; and per §B161: there is no requirement that management intends to sell the asset, only the capability of being sold.

By way of contrast, the team of skilled staff or assembled work force ("AWF") is not recognised under US accounting standards, but based upon a different argument. Apparently the Financial Accounting Standards Board ("FASB") have chosen to consider AWF as an element of goodwill because they feel the replacement cost method typically employed overlooks the embedded know-how in the AWF. FASB concluded that techniques to measure the value of an assembled workforce and the related intellectual capital with sufficient reliability are not currently available. Consequently, per §B169, it decided to make an exception to the recognition criteria and require that the fair value of an assembled workforce acquired be included in the amount initially recorded as goodwill, regardless of whether it meets the recognition criteria. In effect, this treatment appears to hang on the argument that the current replacement cost techniques used to value an assembled workforce may significantly under-value this intangible asset.

Not reporting the value of an asset because it is considered to be under-valued represents a new and somewhat risky development for the accountancy profession in general.

Note that in the Basis for Conclusion on ED3, in paragraphs BC93 and BC94, the IASB does address an issue of "control" in the context of defining the boundaries of a group, but this reference is in an entirely different sense to that addressed in connection with this recommendation. Note, however, that the meaning ascribed to "control" in IAS 38, paragraphs 12 – 15, is consistent with the meaning assumed above.

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The View of the UK's ASB in the Preface to its Consultation Paper on ED3

The ASB observes in paragraph 28 of its Preface to its Consultation Paper on ED3 that the IASB proposes both to change the definition of an intangible asset (the separability criterion) and to make presumptions in favour of acquired intangibles meeting the 'probability of inflow of benefits' test of the recognition criteria. It goes on to say that the proposals would result in the recognition of many more intangible assets with the only asset proposed to be prohibited from recognition being the assembled workforce. The ASB expresses its concern that widening of the scope of recognition of intangible assets may not improve the usefulness of information for users because of problems in reliability measuring the fair value of such assets.

In my view, explicit retention of the requirement for control of the intangible asset by the entity involved will serve to substantially meet the concerns expressed by the ASB and to limit, sensibly, the number of intangible assets that are to be separately recognised under the revised standard.

Recommendation for amendment of the proposed ED3 standard per Question 7:

I recommend re-writing ED 3 Business Combinations paragraphs 36 and 43 to include the following insertions, indicated in red and italics:

36 The acquirer shall recognize separately the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date only if they satisfy the following criteria at that date:

(a) in the case of an asset other than an intangible asset, it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably;

(b) in the case of a liability other than a contingent liability, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and its fair value can be measured reliably;

(c) it is an intangible asset as defined in IAS 38 *Intangible Assets* (revised 200X)***, meets the associated requirements for control of the asset by the entity***, and it is not an assembled workforce; and

(d) in the case of a contingent liability, its fair value can be measured reliably.

43 Under paragraph 36, the acquirer recognizes separately an intangible asset of the acquiree at the acquisition date only if it meets the definition of an intangible asset in IAS 38 (revised 200X)***, meets the associated requirements for control of the asset by the entity***, and is not an assembled workforce. A non-monetary assets without physical substance must be identifiable to meet the definition of an intangible assets and thus be recognized by the acquirer separately from

goodwill. In accordance with IAS 38 (revised 200X), an asset meets the identifiability criterion in the definition of an intangible asset only if it:

(a) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations; or

(b) is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability.

Note that we are not advocating that paragraph 44 be dropped, though with the above amendment to paragraph 43, it may be viewed as superfluous. Note also the omission from paragraph 36 relating to an in-process research and development project, which is addressed in the following section.

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3. Treatment of In-Process Research & Development Projects (Question 1 in IAS 38 "Invitation to Comment"[and Subset of Question 7 re. ED3])

In my view, the reference to in-process research and development projects as currently contained in paragraph 36 of ED3 to be unclear and confusing.

Reference is made to an in-process research and development project that "meets the definition of an intangible asset" when, by definition, the very term "in-process research and development project" cannot meet the definition of an intangible asset (see reference to IAS 38, below). Confusion obviously exists with respect to the intangible asset(s) which reasonably could be expected to emanate from an in-process research and development project, and the concept of what an in-process research and development project represents in the first place.

Typically, the intangible asset being created during the course of an in-process research and development project is "technology", while during the time this technology is being created, i.e. until such time as the point of "technical feasibility" is reached, it is perhaps better referred to as "technology under development". The other point worth making, moreover, is that an in-process research and development project may well be aimed at enhancing "existing technology", or at least utilizing previously developed technology in the creation of "new" technology. Owing to the potential confusion created, moreover, it is our opinion that it would be unwise to even refer to an intangible asset called "research and development project" (i.e. even after dropping the term "in-process" once the project had proceeded beyond the point of "technical feasibility").

IAS 38 (at paragraph 46, revised) does indeed rule that no intangible asset arising from research (or from the research phase of an internal project) shall be recognized. Similarly, in paragraph 49 (revised), it specifies that an intangible asset arising from development (or from the development phase of an internal project) shall be recognized only if an entity can demonstrate the technical feasibility of completing the intangible asset so that it will be available for use or sale.

The above requirements therefore reflect essentially the same requirements as embodied within the US's SFAS 141. Paragraph 42 of SFAS 141 does, however, emphasize the requirement that the amounts assigned to both tangible and intangible assets that *have no alternative future use* shall be charged to expense at the acquisition date. Similarly, in a footnote to paragraph 44, in addressing the excess of amounts assigned to assets acquired and liabilities assumed, it is emphasized that the acquired assets include research and development assets acquired and charged to expense in accordance with the requirement described above.

The proposed standard per ED3 could, however, usefully be enhanced by including a similar requirement to that included in SFAS 141, namely that amounts assigned to both tangible and intangible assets that have no alternative future use should be charged to expense.

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Background

Under US GAAP, significant problems had previously been encountered by the Securities and Exchange Commission in policing the identification and valuation of technology associated with In-Process Research and Development Projects. These ranged from the problem of having very low or even zero values assigned to the whole drugs development pipeline belonging to large, viable pharmaceutical companies, to having unacceptably high percentages of the total acquisition values of computer software companies being assigned to in-process research and development projects.

To address and control the worst excesses of such variations in the conclusions of value, stringent practice guidelines have been developed by the American Institute of Certified Public Accountants in cooperation with the SEC, covering the methodologies to be used in the valuation of in-process research and development projects. There was such a practice guideline issued by the AICPA with specific reference to the pharmaceutical, electronic devises and software industries in 2001.

Needless to say, one of the key objectives in preparing the above guidelines on in-process research and development projects was to ensure that the value associated with existing technology employed or otherwise used in the research and development projects was recognized and valued as “Existing Technology”. This applied, in particular, to all technology that was patented or the subject of a patent application.

Similarly, a second key objective of the guidelines was that economic benefits arising from further development of the technology currently under development, i.e. in future research and development projects, should be attributed to Goodwill and not to the current research and development projects.

Recommendation for amendment of the proposed ED3 and IAS 38 standards:

I recommend re-writing **ED 3 Business Combinations** paragraph 36 to exclude the explicit reference to in-process research and development projects under sub-section (c) and, at the end of the paragraph, making a further insertion to clarify the need to write-off any value attributed to “in-process research and development projects”. In addition, I recommend leaving the previously recommended insertion relating to the proposal to introduce the concept of “control” into the definition of intangible assets. See the indicated insertions, below, in red and italics,:

36 The acquirer shall recognize separately the acquiree’s identifiable assets, liabilities and contingent liabilities at the acquisition date only if they satisfy the following criteria at that date:

(a) in the case of an asset other than an intangible asset, it is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably;

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(b) in the case of a liability other than a contingent liability, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and its fair value can be measured reliably;

(c) it is an intangible asset as defined in IAS 38 *Intangible Assets* (revised 200X)***, meets the associated requirements for control of the asset by the entity***, and it is not an assembled workforce; and

(d) in the case of a contingent liability, its fair value can be measured reliably.

***Note*: Any value attributed to in-process research and development projects, i.e. those that have not yet reached that stage defined as "the point of technical feasibility" and have no alternative future use, should be written off and reduce the value attributed to Goodwill by an equivalent amount. Any existing technology being utilized by "in-process research and development projects" should be identified and valued as "technology", and be included among the identified intangible assets. Any value to be attributed to future extensions of existing research and development projects, i.e. the creation and/or development of technology not yet under development, should be included in the identified value of Goodwill.**

With regard to the **Revised IAS 38** standard, I recommend that under the section "**Acquisition as Part of a Business Combination**", a new paragraph should be inserted, perhaps at number 31, with subsequent paragraphs re-numbered accordingly. This paragraph will make specific reference to the treatment of in-process research and development projects as follows:

31. With regard to technology under development, there is the need to recognize and value this as an asset associated with in-process research and development projects. For those in-process research and development projects that have no alternative future use, the associated value of the technology under development should be charged to expense in accordance with normal accounting practice as set out in paragraphs 43 – 51 (Note: following insertion of this paragraph: revised numbers 44-52)

With the acquisition of an on-going programme of research and development projects, any value ascribed to future research and development projects forms part of the Goodwill of the entity. In other words, the value of any technology not yet developed as part of an existing research and development project, forms part of the value ascribed to Goodwill.

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I trust that my comments and recommendations, above, concerning amendments to be made to the Exposure Drafts on Business Combinations and the Revised IAS 38 will contribute helpfully to the IASB's consideration of further amendments prior to finalisation of the proposed accounting standards.

As a professional valuation consultant, I have limited my comments to those aspects impinging upon the concepts of "fair value" and which, in my experience, can have a profound impact upon both professional appraisal practice and valuation standards themselves.

Yours sincerely,

Hugh J Osburn, FCMA, ASA, ASIP