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March 4, 2003

Re : Organismo Italiano di Contabilità (OIC): Comments on "ED 3 – Business Combinations" and on "Proposed Amendments to IAS 36 *Impairment of Assets*, and IAS 38 *Intangible Assets*".

Dear Sir,

We have the pleasure to inform you that the Executive Committee of the OIC ("Comitato Esecutivo") has adopted its comments on the "ED 3 – Business Combinations" and on "Proposed Amendments to IAS 36 *Impairment of Assets*, and IAS 38 *Intangible Assets*".

Yours Sincerely,

Prof. Angelo Provasoli
(OIC – Chairman)

cc: Kevin Stevenson

Attachments

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EXPOSURE DRAFT 3

BUSINESS COMBINATIONS

<u>Question 1 – Scope</u>

The Exposure Draft proposes:

(a) to exclude from the scope of the IFRS business combinations in which separate entities or operations of entities are brought together to form a joint venture, and business combinations involving entities under common control (see proposed paragraphs 2 and 3 and paragraphs BC9-BC11 of the Basis for Conclusions).

Are these scope exclusions appropriate? If not, why not?

(b) to include in the IFRS a definition of business combinations involving entities under common control, and additional guidance on identifying such transactions (see proposed paragraphs 9-12 and Appendix A, and paragraphs BC12-BC15 of the Basis for Conclusions).

Are the definition and additional guidance helpful in identifying transactions within the scope exclusion? If not, what additional guidance would you suggest, and why?

<u>Draft Response</u>

(a) We agree with the Board's proposal that these scope exclusions are appropriate for phase I of the project, but we believe that phase II of the Business Combinations project should deal with these issues which is in line with our understanding of IASB's intention.

(b) We regard the definition of business combinations involving entities under common control and additional guidance on identifying such transactions helpful. We believe that the proposed revision to the definition of joint control in IAS *28 Accounting for Investments in Associates* and IAS 31 *Financial Reporting of Interests in Joint Ventures* is an over-simplification. Although joint control requires unanimous consent on strategic decisions, it is compatible with the use of majority voting for lesser issues.

<u>OIC Comments</u>

(a) We agree with EFRAG. However, we take the opportunity to emphasyze the need that "*business combinations involving entities under common control"* should be addressed in this IFRS, without waiting phase II of the project.

(b) The definition of entities under common control is clear, but we would advise the Board to specify that the condition of common control before the business combination occurs can not have been only for a short period.

Question 2 – Method of accounting for business combinations

The Exposure Draft proposes to eliminate the use of the pooling of interests method and require all business combinations within its scope to be accounted for by applying the purchase method (see proposed paragraphs 13-15 and paragraphs BC18-BC35 of the Basis for Conclusions).

Is this appropriate? If not, why not? If you believe the pooling of interests method should be applied to a particular class of transactions, what criteria should be used to distinguish those transactions from other business combinations, and why?

Draft Response

We agree with the IASB proposal and believe that purchase accounting is the appropriate method for business combinations which are real acquisitions. Purchase accounting should replace pooling of interests accounting because in our view the reality is that it is only rarely that an acquirer cannot be identified in business combinations.
Nevertheless, we would like the IASB to consider the new fresh start method as a possible alternative when there may be more than one view as to who is really the acquirer. Our view is that the definition of criteria for the application of that method needs to be determined as soon as possible. Since both parties would revalue their assets and liabilities to fair market value, there is less scope for distortion.

OIC Comments

We agree with EFRAG. We encourage the Board to deal, as soon as possible, with those circumstances, although rare in practice, for which it is not virtually possible to identify an acquirer (merger of equals). In our view, in these rare circumstances the fresh start approach could be adopted.

Question 3 – Reverse acquisitions

Under IAS 22 Business Combinations, a business combination is accounted for as a reverse acquisition when an entity (the legal parent) obtains ownership of the equity of another entity (the legal subsidiary) but, as part of the exchange transaction, issues enough voting equity as consideration for control of the combined entity to pass to the owners of the legal subsidiary. In such circumstances, the legal subsidiary is deemed to be the acquirer. The Exposure Draft:

(a) proposes to modify the circumstances in which a business combination could be regarded as a reverse acquisition by clarifying that for all business combinations effected through an exchange of equity interests, the acquirer is the combining entity that has the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. As a result, a reverse acquisition occurs when the legal subsidiary has the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities (see proposed paragraph 21 and paragraphs BC37-BC41 of the Basis for Conclusions).

Is this an appropriate description of the circumstances in which a business combination should be accounted for as a reverse acquisition? If not, under what circumstances, if any, should a business combination be accounted for as a reverse acquisition?

(b) proposes additional guidance on the accounting for reverse acquisitions (see proposed paragraphs B1-B14 of Appendix B).

Is this additional guidance appropriate? If not, why not? Should any additional guidance be included? If so, what specific guidance should be added?

Draft Response

(a) We agree with the proposed description of the circumstances in which a business combination should be accounted for as a reverse acquisition. We believe that even though the majority of the instigating group of shareholders may be from the acquired entity the acquirer should be the entity whose shareholders have obtained the power to govern the financial and operating policies of the other entity.

(b) We regard the proposed additional guidance together with the illustrative examples as appropriate. Nevertheless, we think it would be helpful if IASB added guidance in the standard making it clear that the comparative figures presented should be those of the legal subsidiary and not those of the legal parent.

OIC Comments

We agree with EFRAG.

Question 4 – Identifying the acquirer when a new entity is formed to effect a business combination

The Exposure Draft proposes that when a new entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination should be adjudged the acquirer on the evidence available (see proposed paragraph 22 and paragraphs BC42-BC46 of the Basis for Conclusions).

Is this appropriate? If not, why not?

Draft Response

We agree with the general principle that in business combinations an acquirer has to be identified based on the evidence available. The newly formed entity individually has little economic substance and can therefore not be considered as the acquirer. The legal form of the transaction should not change the general principle and consequently, we support the Board's proposal that one of the combining entities that existed before the combination should be determined to be the acquirer on the evidence available.

OIC Comments

We agree, as EFRAG, with the IASB proposal, because the substance of the transaction has to be over the legal form adopted to effect the combination.

<u>Question 5 – Provisions for terminating or reducing the activities of the acquiree</u>

Under IAS 22, an acquirer must recognise as part of allocating the cost of a business combination a provision for terminating or reducing the activities of the acquiree (a 'restructuring provision') that was not a liability of the acquiree at the acquisition date, provided the acquirer has satisfied specified criteria. The Exposure Draft proposes that an acquirer should recognise a restructuring provision as part of allocating the cost of a business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets (see proposed paragraph 40 and paragraphs BC55-BC66 of the Basis for Conclusions).

Is this appropriate? If not, what criteria should an acquirer be required to satisfy to recognise a restructuring provision that was not a liability of the acquiree as part of allocating the cost of a combination, and why?

<u>Draft Response</u>

We agree with the IASB proposal not to apply recognition criteria different from IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for a restructuring provision in the case of a business combination.

<u>OIC Comments</u>

We agree that these expenses are treated in compliance with IAS 37 in order to avoid that similar circumstances are accounted for in a combination differently than the way they would be accounted for in ordinary circumstances.

<u>Question 6 – Contingent liabilities</u>

The Exposure Draft proposes that an acquirer should recognise separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably (see proposed paragraphs 36 and 45 and paragraphs BC80-BC85 of the Basis for Conclusions).

Is this appropriate? If not, why not?

<u>Draft Response</u>

No, we do not believe that the proposal is appropriate. We believe that contingent liabilities should be recognised separately only if they satisfy the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Our main concerns with the proposal are:

- non compliance with the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- unreliable measurement
- potential recognition of contingent liabilities with high amounts but low probability of becoming an actual liability

We do think it illogical to recognise contingent liabilities in an acquisition, if it is not possible to recognise them under the current requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* The nature of a contingent liability does not change as a result of an acquisition and we believe the IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* criteria should still be applied. Although the purchase price of the acquired entity may include an allowance for contingent liabilities (and for contingent assets), we are not convinced that their fair values can be measured reliably.
Many contingent liabilities arise from legal claims (for example for tobacco or fast food industries) and can result in very large figures according to Appendix B15 (l), which requires the amount of the contingent liability to "reflect all expectations about possible cash flows and not the single most likely or the expected maximum or minimum cash flow". The resulting number does not reflect the potential future cash outflow because it is based on an average expectation covering a wide spectrum of possible outcomes. It is very difficult in reality, sometimes impossible, to quantify the possible outcome of contingent matters such as legal proceedings.
Once contingent liabilities are recognised separately, the acquirer must measure them at their fair values with changes in fair value recognised in profit or loss (paragraph 46). Such contingent liabilities are explicitly excluded from the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* We disagree with the proposal, because it results in inconsistent treatment between contingent liabilities acquired in a business combination and other contingent liabilities of the same or a different entity.
In addition, we understand from BC74 that the Board agreed that the role of probability in the Framework should be considered more generally as part of a later Concepts project. While we welcome this initiative, we believe that meanwhile the recognition criteria for assets and liabilities should not be altered in the case of a business combination.

<u>OIC Comments</u>

In line with the EFRAG approach, we don't believe that with the Board's proposal is appropriate. We support the reasoning exposed by EFRAG to justify its dissent. Particularly, we underline the need that, as in other cases, the accounting treatments should always be consistent among the existing IASs. A business combination can not cause, in our opinion, inconsistencies with other Standards (and with the Framework).

OIC welcomes that the initial orientation to consider the contingent assets has not been implemented in the ED3.

<u>Question 7 – Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed</u>

IAS 22 includes a benchmark and an allowed alternative treatment for the initial measurement of the identifiable net assets acquired in a business combination, and therefore for the initial measurement of any minority interests. The Exposure Draft proposes requiring the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost to be measured initially by the acquirer at their fair values at the acquisition date. Therefore, any minority interest in the acquiree will be stated at the minority's proportion of the net fair values of those items. This proposal is consistent with the allowed alternative treatment in IAS 22 (see proposed paragraphs 35 and 39 and paragraphs BC88-BC95 of the Basis for Conclusions).

Is this appropriate? If not, how should the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of a business combination be measured when there is a minority interest in the acquiree, and why?

Draft Response

In principle we agree with the proposal of the Board requiring the acquiree's identifiable assets and liabilities to be recognised as part of the cost allocation to be measured initially by the acquirer at their fair values at the acquisition date. However, while we acknowledge that the purchase price in general is affected by contingent liabilities and in-process research and development, we believe that assets and liabilities that do not meet the recognition criteria of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 38 *Intangible Assets* should not be recognised as assets and liabilities in a business combination.
We refer to our answer to Question 6 that for reasons of comparability and understandability the recognition criteria of the Framework should be applied consistently when accounting for business combinations.

OIC Comments

We agree with accounting for the minority interest at the fair value. The elimination of the alternative proposed in the IAS 22 is appropriate in order to increase the comparability.

Question 8 – Goodwill

The Exposure Draft proposes that goodwill acquired in a business combination should be recognised as an asset and should not be amortised. Instead, it should be accounted for after initial recognition at cost less any accumulated impairment losses (see proposed paragraphs 50-54 and paragraphs BC96-BC108 of the Basis for Conclusions).

Do you agree that goodwill acquired in a business combination should be recognised as an asset? If not, how should it be accounted for initially, and why? Should goodwill be accounted for after initial recognition at cost less any accumulated impairment losses? If not, how should it be accounted for after initial recognition, and why?

Draft Response

We agree that goodwill acquired in a business combination should be recognised as an asset, although we consider that goodwill represents a prepaid premium rather than an identifiable asset.

We considered the two alternative methods of accounting for goodwill after initial recognition i.e. testing for impairment and amortisation over the useful life.
The first method has as significant advantages that in cases of indefinite useful life of goodwill with no indication of diminution in value of the acquired entity, no amortisation or impairment has to be recognised so that no charge to income has to be made. In addition,

this method has been adopted in the U.S.A. and inclusion in IFRS will therefore bring about worldwide convergence.
On the other hand the impairment test as proposed has conceptual and practical weaknesses, for example:

- in applying the impairment test acquired goodwill and internally generated goodwill will be intermingled
- no reversal of the carrying amount of goodwill will take place when the factors that caused the impairment reverse
- annual impairment testing is an onerous and very judgemental process.

The second method of systematic amortisation with additional impairment testing (as currently mandated by IAS 22 *Business Combinations*) acknowledges that the factors that constitute the goodwill paid at acquisition generally diminish in value over time and that the ensuing costs are charged to income systematically over its useful life. In practice this method is easy to apply, which makes it particularly attractive for small and medium sized companies and those entities that have no cross-border listings in the U.S.A.

Although we are generally not in favour of options in accounting standards, we strongly recommend the Board in this case to retain the current IAS 22 *Business Combinations* treatment as an allowed alternative, in addition to non-amortisation and impairment testing, the latter regarded as the benchmark treatment.

(N.B. While EFRAG is seeking comments on all the points raised in this letter, as well as any other concerns commentators might have, we explicitly ask commentators to let us know which method they prefer for the accounting of goodwill, including the arguments supporting such preference. Generally we prefer not to seek options in accounting standards but we also ask commentators to comment on the retention of amortisation of goodwill as an alternative for the impairment approach as currently proposed by the Board.)

OIC Comments

We agree with EFRAG and recommend too that the amortisation method on a systematic basis could be kept as allowed treatment in order to take account of those for the circumstances in which the application of impairment test mechanism has significant practical problems. We believe, for instance, that it is necessary to use the systematic amortisation of the goodwill whereas it is not possible to estimate the future cash flows in a reasonable way.

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

In some business combinations, the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of the combination exceeds that cost. The Exposure Draft proposes that when such an excess exists, the acquirer should:

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

(See proposed paragraphs 55 and 56 and paragraphs BC109-BC120 of the Basis for Conclusions.)

Is this treatment appropriate? If not, how should any such excess be accounted for, and why?

<u>Draft Response</u>

We do not believe that the proposed treatment is appropriate and therefore disagree with the Board's proposal. Although we agree that "negative goodwill" does not meet the definition of a liability, we believe that its treatment should be consistent with the treatment of positive goodwill. In a business combination an entity should be required to recognise assets and liabilities according to current standards and recognition criteria. The remaining difference between the purchase price and the separately recognised identifiable assets and liabilities can either be a positive or negative premium, called goodwill. The remainder is economically justified either by future profits or future losses. The reference to expected future losses in the case of negative goodwill is clearly expressed in the current IAS 22 *Business Combinations* in paragraph 61. Accordingly, negative goodwill should only be recognised immediately as income to the extent that it does not relate to identified expected future losses and expenses that can be measured reliably at the date of acquisition. Therefore, we prefer to retain the present requirements for negative goodwill (IAS 22 *Business Combinations* paragraphs 59 to 63) particularly the treatment in paragraphs 61 and 62.

<u>OIC Comments</u>

We disagree with the IASB proposal and, in line with EFRAG, we believe that if the negative goodwill represents a "premium" against future losses, this negative goodwill has to be deferred in order to offset expected future losses, to the extent these losses are effectively incurred.

OIC is aware that the creation of a provision could not be consistent with the existing definition of liability included in the framework ("a present obligation"). However, this inconsistency is already included in the IAS 22. Therefore, we recommend the Board to re-consider and enlarge this definition to consider the "expected outflow of resources" case as well.

<u>Question 10 – Completing the initial accounting for a business combination and subsequent adjustments to that accounting</u>

The Exposure Draft proposes that:

(a) if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer should account for the combination using those provisional values. Any

adjustment to those values as a result of completing the initial accounting is to be recognised within twelve months of the acquisition date (see proposed paragraphs 60 and 61 and paragraphs BC123-BC126 of the Basis for Conclusions).

Is twelve months from the acquisition date sufficient time for completing the accounting for a business combination? If not, what period would be sufficient, and why?

(b) with some exceptions carried forward as an interim measure from IAS 22, adjustments to the initial accounting for a business combination after that accounting is complete should be recognised only to correct an error (see proposed paragraphs 62 and 63 and paragraphs BC127-BC132 of the Basis for Conclusions).

Is this appropriate? If not, under what other circumstances should the initial accounting be amended after it is complete, and why?

Draft Response

Yes, we believe that adjustments to estimates of the total cost of the combination should normally be made within 12 months of the acquisition date. Thereafter adjustments should only be made to correct an error (as proposed).

OIC Comments

As EFRAG, we agree that twelve months are a reasonable period to review the initial estimates; after this period any change has to be accounted for as an error correction.

On contrary, we do not share the opinion exposed in the paragraph 64, which seems to allow the future recognition of deferred tax assets against the goodwill without time limit. We do not see, in fact, logical reasons to justify the use of a different accounting treatment.

Other comments

1. Disclosure requirements of paragraphs 73 to 76

Paragraphs 65 to 76 of ED 3 require certain disclosures for past business combinations and business combinations effected during the reporting period or after the balance sheet date but before the issue date of the financial statements.
Although paragraphs 65, 71 and 73 are not explicit as to whether comparative figures are required or not, we believe that paragraph 65 (covering current and future business combinations) as well as paragraph 71 (asking for cumulative information) do not require comparative figures for the information requested. However, paragraph 73 and the following paragraphs are not clear in that respect.
We ask the Board to clarify whether paragraphs 73 to 76 require comparative information or not.

OIC Other comments

It should be clarified that the fair value of the acquired assets and liabilities has to require a discounting process whereas it is expected that they result in a cash outflow over a long term period. We believe that the time value has to be taken into consideration, also with reference to the deferred taxes, anytime it is possible to reliably forecast the reversal timing. In relation thereto, we suggest that the IAS 12 be consequently modified.

The definition of business combination includes also cases in which a SPE is acquired without business activity and which owns only an asset or a group of assets (for instance, an equipment). The Standard should clarify that, in these circumstances, it is not possible to generate a goodwill.

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Proposed Amendments to IAS 36

IMPAIRMENT OF ASSETS

Question 1 – Frequency of impairment tests

Are the proposals relating to the frequency of impairment testing intangible assets with indefinite useful lives and acquired goodwill appropriate (see proposed paragraphs 8 and 8A and paragraphs C6, C7 and C41 of the Basis for Conclusions)? If not, how often should such assets be tested for impairment, and why?

Draft Response

We disagree with the Board's proposal that:

(a) indefinite useful life intangibles shall be tested for impairment annually at the end of each annual reporting period; and whenever there is an indication of possible impairment;
(b) acquired goodwill shall be tested for impairment annually at any time during an annual reporting period, provided the test is performed at the same time every year; and whenever there is an indication of possible impairment.

We believe that permitting annual impairment tests at different dates for indefinite useful life intangibles (at the end of each annual reporting period) and for acquired goodwill (at any time during an annual reporting period) is impractical. Testing other intangible assets for impairment is conceptually related to testing goodwill for impairment. Therefore, all annual impairment tests should be performed at the same date at any time during an annual reporting period provided the test is performed at the same time every year. For reasons of comparability and relevance of interim and annual financial reports testing in the fourth quarter should be recommended.

OIC comments

We agree with the EFRAG approach.

Question 2 – Intangible assets with indefinite useful lives

The Exposure Draft proposes that the recoverable amount of an intangible asset with an indefinite useful life should be measured, and impairment losses (and reversals of impairment losses) for such assets accounted for, in accordance with the requirements in IAS 36 for assets other than goodwill (see paragraphs C10-C11 of the Basis for Conclusions).

Is this appropriate? If not, how should the recoverable amount be measured, and impairment losses (and reversals of impairment losses) be accounted for?

Draft Response

We generally support the Board's proposal, since there is no conceptual reason to make a distinction between intangible assets with indefinite useful life – like trademarks – and acquired goodwill. For the same reason we disagree with the different treatment of intangible assets with indefinite useful life and goodwill in respect of reversals of impairment losses (paragraph 118 requires reversals of impairment losses only for assets other than goodwill (paragraph 123 makes it even clearer)). We recommend the same treatment for goodwill and intangible assets with indefinite useful life in order to avoid arbitrage.

OIC comments

We agree with the IASB approach according to the methodology proposed to measure a recoverable amount. Furthermore, we agree that it is appropriate to keep separate the impairment criteria concerning intangible assets and goodwill.

Question 3 – Measuring value in use

The Exposure Draft proposes additional guidance on measuring the value in use of an asset. Is this additional guidance appropriate? In particular:

(a) should an asset's value in use reflect the elements listed in proposed paragraph 25A? If not, which elements should be excluded or should any additional elements be included? Also, should an entity be permitted to reflect those elements either as adjustments to the future cash flows or adjustments to the discount rate (see proposed paragraph 26A and paragraphs C66 and C67 of the Basis for Conclusions)? If not, which approach should be required?

(b) should the assumptions on which cash flow projections are based take into account both past actual cash flows and management's past ability to forecast cash flows accurately (see proposed paragraph 27(a)(ii) and paragraphs C66 and C67 of the Basis for Conclusions)? If not, why not?

(c) is the additional guidance in proposed Appendix B to [draft] IAS 36 on using present value techniques in measuring an asset's value in use appropriate? If not, why not? Is it sufficient? If not, what should be added?

Draft Response

We agree with the Board's proposal in (a) and (c), but we believe that it is unclear how to take past actual cash flows and management's past ability (or inability) to forecast cash flows accurately into account, as described in (b). This is a very theoretical requirement and we ask the Board to clarify how this can be done in practice.

OIC comments

We agree with the EFRAG opinion.

Question 4 – Allocating goodwill to cash-generating units

The Exposure Draft proposes that for the purpose of impairment testing, acquired goodwill should be allocated to one or more cash-generating units.

(a) Should the allocation of goodwill to one or more cash-generating units result in the goodwill being tested for impairment at a level that is consistent with the lowest level at which management monitors the return on the investment in that goodwill, provided such monitoring is conducted at or below the segment level based on an entity's primary reporting format (see proposed paragraphs 73-77 and paragraphs C18-C20 of the Basis for Conclusions)? If not, at what level should the goodwill be tested for impairment, and why?

(b) If an entity disposes of an operation within a cash-generating unit to which goodwill has been allocated, should the goodwill associated with that operation be included in the carrying amount of the operation when determining the gain or loss on disposal (see proposed paragraph 81 and paragraphs C21-C23 of the Basis for Conclusions)? If not, why not? If so, should the amount of the goodwill be measured on the basis of the relative values of the operation disposed of and the portion of the unit retained or on some other basis?

(c) If an entity reorganises its reporting structure in a manner that changes the composition of one or more cash-generating units to which goodwill has been allocated, should the goodwill be reallocated to the units affected using a relative value approach (see proposed paragraph 82 and paragraphs C24 and C25 of the Basis for Conclusions)? If not, what approach should be used?

Draft Response

We agree with the IASB proposal in point (a), (b) and (c). The cash generating unit (CGU) is the lowest level at which management monitors the return on the investment in that goodwill, provided such monitoring is conducted at or below the segment level based on an entity's primary reporting format. We acknowledge that it is likely to be a lower level than the Reporting Unit as defined by US GAAP in SFAS 142 paragraph 30.

OIC comments

a) We fully agree with the proposal that the segment has to represent the highest level of combination, beyond which it is not possible to refer the impairment test; on the other hand, we believe that the CGU is the lowest level at which the management conducts its impairment monitoring. Significant application problems could arise for the entities where more CGUs are jointly reported to management for operational and economic control (for instance, the management have interest on the performance of more CGUs linked together).

b) e c) We agree with the position expressed from IASB and shared by EFRAG.

Question 5 – Determining whether goodwill is impaired

The Exposure Draft proposes:

(a) *that the recoverable amount of a cash-generating unit to which goodwill has been allocated should be measured as the higher of the unit's value in use and net selling price (see proposed paragraphs 5 (definition of recoverable amount) and 85 and paragraph C17 of the Basis for Conclusions).*
Is this appropriate? If not, how should the recoverable amount of the unit be measured?

(b) *the use of a screening mechanism for identifying potential goodwill impairments, whereby goodwill allocated to a cash-generating unit would be identified as potentially impaired only when the carrying amount of the unit exceeds its recoverable amount (see proposed paragraph 85 and paragraphs C42-C51 of the Basis for Conclusions).*
Is this an appropriate method for identifying potential goodwill impairments? If not, what other method should be used?

(c) *that if an entity identifies goodwill allocated to a cash-generating unit as potentially impaired, the amount of any impairment loss for that goodwill should be measured as the excess of the goodwill's carrying amount over its implied value measured in accordance with proposed paragraph 86 (see proposed paragraphs 85 and 86 and paragraphs C28-C40 of the Basis for Conclusions).*

Is this an appropriate method for measuring impairment losses for goodwill? If not, what method should be used, and why?

Draft Response

We disagree with the proposal. In order not to result in a lack of reliability and objectivity, the impairment test needs to be a robust test. Therefore, the testing criteria need to be very strong.

We believe – as argued in our answer to Question 8 of ED 3 - that the impairment test as proposed is conceptually imperfect, because pre-existing internally generated goodwill of the acquirer is not separated from the measurement of acquired goodwill. Therefore 'cushions' of internally generated goodwill will avoid the recognition of impairment losses in certain cases. On the other hand, paragraph 124 (Reversal of an Impairment Loss for Goodwill), which refers to IAS 38 *Intangible Assets*, illustrates that the Board has the clear position that recognition of internally generated goodwill is prohibited, which is not consistent with the proposed impairment test.
Nevertheless, we recognise the Board's difficulty (expressed in the Basis for Conclusions C65) in devising an impairment test for acquired goodwill that removes the cushion against the recognition of impairment losses provided by goodwill generated internally after a business combination, but we believe that the Board should make it clear that its conceptual rationale does not require such a distinction to be made. However, we do believe that the Board could do more to identify and eliminate from the calculation the pre-existing goodwill of the acquirer.

We support the use of a screening mechanism whereby if the carrying amount of a cash-generating unit does not exceed its recoverable amount, no further assessment of impairment needs to be made. However, we recognise that this can mask a situation where the goodwill has been impaired, but the impairment is more than offset by gains in other assets or intangibles which may or may not be recognised on the balance sheet (e.g. internally generated goodwill). At the borderline anomalous results may appear such that no impairment of goodwill is recognised if the screening test is passed but a significant write down must be made if the full impairment test is performed. Nevertheless, the complexity is reduced if a screening test is applied and we regard that as a practical solution.

OIC comments

We agree with the position expressed by EFRAG in relation to the points a), b) and c).

Question 6 – Reversals of impairment losses for goodwill

The Exposure Draft proposes that reversals of impairment losses recognised for goodwill should be prohibited (see proposed paragraph 123 and paragraphs C62-C65 of the Basis for Conclusions).

Is this appropriate? If not, what are the circumstances in which reversals of impairment losses for goodwill should be recognised?

Draft Response

Yes, we agree that reversal of goodwill impairment should not be treated as any other reversal of impairment. Taking into account the way the impairment test for goodwill is structured it is accepted that no distinction can be made between originally acquired goodwill and additional internally generated goodwill, so that in these situations reversal of impairment losses is not appropriate.

OIC comments

We agree with the approach for which the goodwill reversal has to be prohibited. This would be consistent also with the FAS 142. Furthermore (see Q5), suggested accounting has to be adopted if we accept the position that no distinction can be made of acquired goodwill and internally generated goodwill. In other words, the goodwill reversal could not apply in all the cases in which a same amount of positive goodwill is internally generated.

Question 7 – Estimates used to measure recoverable amounts of cash-generating units containing goodwill or intangible assets with indefinite useful lives

The Exposure Draft proposes requiring a variety of information to be disclosed for each segment, based on an entity's primary reporting format, that includes within its carrying amount goodwill or intangible assets with indefinite useful lives (see proposed paragraph 134 and paragraphs C69-C82 of the Basis for Conclusions).

(a) Should an entity be required to disclose each of the items in proposed paragraph 134? If not, which items should be removed from the disclosure requirements, and why?

(b) Should the information to be disclosed under proposed paragraph 134 be disclosed separately for a cash-generating unit within a segment when one or more of the criteria in proposed paragraph 137 are satisfied? If not, why not?

Draft Response

(a) No, we believe that disclosed information should be useful for users of financial statements in drawing conclusions on the financial position and financial performance of entities. Therefore, we believe the list of required items given in paragraph 134 should be reduced. Some of the required information seems to us being excessive and having no value in meeting the criterion of understandability of financial statements. For example, we believe it is likely that a segment may include different cash-generating units where for some the recoverable amount is net selling price and for others where it is value in use. The information required by paragraph 134 (e) and (f) then may become unwieldy and of little benefit to the reader.

(b) We agree with the principle as proposed in paragraph 137 but once again have concerns about the very extensive disclosure requirements in paragraph 134 (e) and (f).

(N.B. While EFRAG is seeking comments on all the points raised in this letter, as well as any other concerns commentators might have, we explicitly ask the EFRAG commentators to provide us with examples of particular items required to be disclosed (listed in paragraph 134) which is not information necessary for users of financial statements and should be removed from the disclosure requirements.)

OIC comments

a) We agree with EFRAG opinion exposed in (a), because.

- the required disclosure, particularly with reference to the points e) and f), is excessive and could be reduced by a brief description concerning the period to which the future cash flows are referred, the related uncertainty and the main “assumptions” taken into consideration;
- the related disclosure, required at segment level and not at cash generating unit, could be not significant.

b) Disclosure at CGU level could be necessary regardless of the requirements included in paragraph 137 (see previous point). The number of CGU for which it is necessary to provide the required disclosure has to be limited taking into account cost involved and lack of clearness due to an excessive amount of information.

PROPOSED AMENDMENTS TO IAS 38

INTANGIBLE ASSETS

Question 1 – Identifiability

The Exposure Draft proposes that an asset should be treated as meeting the identifiability criterion in the definition of an intangible asset when it is separable or arises from contractual or other legal rights (see proposed paragraphs 10 and 11 and paragraphs B6-B10 of the Basis for Conclusions).

Are the separability and contractual/other legal rights criteria appropriate for determining whether an asset meets the identifiability criterion in the definition of an intangible asset? If not, what criteria are appropriate, and why?

Draft Response

We agree that the separability and contractual or other legal rights criteria are appropriate for determining whether an asset meets the identifiability criterion in the definition of an intangible asset as prescribed in paragraph 11.

OIC Comments

We agree with EFRAG.

Question 2 – Criteria for recognising intangible assets acquired in a business combination separately from goodwill

This Exposure Draft proposes clarifying that for an intangible asset acquired in a business combination, the probability recognition criterion will always be satisfied and, with the exception of an assembled workforce, sufficient information should always exist to measure its fair value reliably (see proposed paragraphs 29-32 and paragraphs B11-B15 of the Basis for Conclusions). Therefore, as proposed in ED 3, an Exposure Draft of a proposed International Financial Reporting Standard Business Combinations, an acquirer should recognise, at the acquisition date and separately from goodwill, all of the acquiree's intangible assets, excluding an assembled workforce, that meet the definition of an intangible asset (see proposed paragraphs 36, 43 and 44 of ED 3).

Do you agree that, with the exception of an assembled workforce, sufficient information can reasonably be expected to exist to measure reliably the fair value of an intangible asset acquired in a business combination? If not, why not? The Board would appreciate respondents outlining the specific circumstances in which the fair value of an intangible asset acquired in a business combination could not be measured reliably.

Draft Response

We disagree with the Board's proposal. Paragraph 89 of the Framework requires an asset to meet the criteria of the probability test in order to be recognised. The general principle that an asset is recognised when (i) future economic benefits will probably flow to the entity and (ii) the cost or value can be measured reliably, should be consistently applied in all situations including business combinations. The current proposal results in an inconsistent treatment of internally generated and externally acquired intangible assets, because the probability criterion for recognition of an asset as defined in the Framework is now presumed to be fulfilled in the case of a business combination or separate acquisition. We regard the Board's proposal as a major change which should not be introduced in the context of the newly proposed consequential amendments to IAS 38 *Intangible Assets* but instead be considered more generally as part of a separate Concepts project.

We further believe that the proposed amendments are not clear enough in respect of how to account for in-process research and development projects (paragraph 36(c) of ED3). The Basis for Conclusions clarifies in BC67 that any item must first meet the definition of an asset to be recognised on the balance sheet. We disagree that an acquired in-process research and development project meets the criterion of "control over a resource" and we fail to see why such acquired in-process research and development would qualify as an asset while internally generated in-process research and development would not. Therefore we ask the Board to investigate these issues in a separate "Concepts" project.

OIC Comments

We agree with the first EFRAG observation and we believe that it is not always possible to acquire enough information to measure the fair value of all the "intangible assets".

We further agree that further consideration be given to the issue related to the "in-process research and developement projects" in presence of a business combination.

Question 3 – Indefinite useful life

The Exposure Draft proposes to remove from IAS 38 the rebuttable presumption that an intangible asset's useful life cannot exceed twenty years, and to require its useful life to be regarded as indefinite when, based on an analysis of all of the relevant factors, there is no foreseeable limit on the period of time over which the asset is expected to generate net cash inflows for the entity (see proposed paragraphs 85-88 and paragraphs B29-B32 of the Basis for Conclusions).

Is this appropriate? If not, under what circumstances, if any, should an intangible asset be regarded as having an indefinite useful life?

Draft Response

We support the useful life requirements in paragraphs 85 – 90. The existing 20 year useful life presumption is arbitrary and often unrealistic. Although we agree that an indefinite life is usually dependent on future maintenance expenditure, it is difficult to determine how much is required to maintain the asset at its present level of performance (see paragraph 88). This approach therefore introduces another arbitrary element.

OIC Comments

We agree with EFRAG.

Question 4 – Useful life of intangible asset arising from contractual or other legal rights

The Exposure Draft proposes that if an intangible asset arises from contractual or other legal rights that are conveyed for a limited term that can be renewed, the useful life shall *include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost (see proposed paragraphs 91 and 92 and paragraphs B33-B35 of the Basis for Conclusions).*

Is this an appropriate basis for determining the useful life of an intangible asset arising from contractual or other legal rights that are conveyed for a limited term that can be renewed? If not, under what circumstances should the useful life include the renewal period(s)?

Draft Response

We support the useful life requirements in paragraphs 91 and 92. It may be the case that after a limited time of a patent that cannot be renewed, there is still an intangible asset – e.g. unpatented know how – which already existed at the time of the business combination. However, we find it too difficult to apply an "economic renewal concept" and furthermore it may lead to discretionary interpretations.

OIC Comments

We believe that IASB proposals are appropriate basis to determine the useful life of an intangible asset.

Question 5 – Non-amortisation of intangible assets with indefinite useful lives

The Exposure Draft proposes that an intangible asset with an indefinite useful life should not be amortised (see proposed paragraphs 103 and 104 and paragraphs B36-B38 of the Basis for Conclusions).

Is this appropriate? If not, how should such assets be accounted for after their initial recognition?

Draft Response

We support the proposal not to amortise an intangible asset with an indefinite life according to paragraphs 103 and 104 in general, although we believe the impairment test based on future recoverable amount of, say, a brand name will often be highly subjective.

OIC Comments

We agree with EFRAG.

Consistently with what exposed in the Q8 of ED3, we believe that it shall be considered the possibility to amortise the intangible assets whereas it is not possible to estimate the future cash flows.

Other comments

1. Directly attributable expenditures

The deletion of item (d) in paragraph 58 (old paragraph 54), regarding overheads that can be allocated, seems to be a consequential amendment of the improvements proposed to IAS 16 *Property, Plant and Equipment* as published by the Board in its Exposure Draft of May 2002. The Board confirmed in its November 2002 deliberations that administration and general overhead costs are excluded from the cost of an item of property, plant and equipment. However, we believe that the overheads referred to in the old paragraph 54 (d) should be regarded as directly attributable costs to generate the asset, for example in the case of Research and Development, and should be reinstated.