Accounting Standards Board
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Conseil des normes comptables

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Memo

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Dear Ms. Kimmitt:

Exposure Draft – ED3 Business Combinations and Proposed Amendments to IAS 36 and IAS 38.

The following comprises the response of Canadian Accounting Standards Board staff (AcSB staff) to the IASB's exposure draft ED3 Business Combinations and the proposed amendments to IAS 36 and IAS 38.

The Accounting Standards Board (AcSB) issued Handbook Sections 1581, Business Combinations, and 3062, Goodwill and Other Intangible Assets in 2001.These new standards were the outcome of a convergence project with the Financial Accounting Standards Board (FASB) and are harmonized with FAS 141 and 142.

The AcSB is also discussing the issues in the current joint IASB/FASB project on Purchase Method Procedures, in the same time frame as the IASB and FASB. Some of the issues which are included in the current IASB exposure documents are included in the Purchase Method Procedures project by FASB and the AcSB.

The IASB proposals, other than those which the AcSB will include in Purchase Method Procedures, are substantially consistent with Sections 1581 and 3062. The only significant differences relate to items where the IASB proposals are consistent with other IASB standards that are different from Canadian standards (e.g. impairment, revaluation of assets).

Not surprisingly, given the consistency of the IASB proposals with recently developed Canadian standards, the AcSB expressed support for the proposals when they reviewed them and did not raise any significant concerns. The AcSB requested that staff respond to the IASB, raising any detailed issues identified in staff's review of the proposals.

Attached are AcSB staff comments on ED3 and the proposed amendments to IAS 36 and 38. We hope that these comments are useful to the IASB and its staff. We would be pleased to elaborate on these points in more detail if you so require. If so, please contact Ron Salole, Director, at +1 416 204-3277 (e-mail ron.salole@cica.ca), or Mark Walsh, Principal, at +1 416 204 3450 (e-mail mark.walsh@cica.ca).

Yours truly

Ron Salole
Director
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AcSB COMMENTS ON ED3, BUSINESS COMBINATIONS

Question 1 – Scope

We agree that the formation of a joint venture and business combinations involving entities under common control should be excluded from the scope of the IFRS. Canadian GAAP also excludes these from GAAP on Business Combinations.

We agree that the definition of business combinations under common control is helpful.

The definition of a business combination in ED3 is "the bringing together of separate entities or operations of entities into one reporting entity". It is not clear whether an entity involved in a business combination has to be a business since "entity" is not defined. Paragraph 21 contemplates a business combination where one entity is "a non-operating or dormant public entity". This would seem to include a listed "shell" company, which would not constitute a business. Under U.S. and Canadian GAAP a business combination only exists when the acquiree is a business. We suggest that this point be clarified.

Question 2 – Method of accounting for business combinations

We support the elimination of the pooling of interests method for the reasons stated in the Basis for Conclusions. We also agree that, if "true mergers" were to warrant a different accounting, the fresh start method should be fully considered.

Question 3 – Reverse acquisitions

We agree with the proposals for reverse acquisitions. The accounting for reverse acquisitions in proposed paragraphs B1-B14 is consistent with existing Canadian GAAP. However, we found the discussion on identifying the acquirer in paragraphs BC 37 – 39 would have been clearer if examples were provided of situations where the entity whose shareholders own a majority of the combined entity's shares is not the acquirer.

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

We agree that when a new entity is formed to effect a business combination, one of the combining entities that existed before the combination should be determined to be the acquirer. Substance should rule over form.

Question 5 – Provisions for terminating or reducing the activities of the acquiree

We agree that these provisions should only be recognized when the acquiree has, at the acquisition date, an existing liability that meets the criteria for recognition.

Question 6 – Contingent liabilities

We agree that contingent liabilities, like other liabilities and assets, should be recognized separately and measured at their fair value.

Question 7 – Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

We agree that these should all be initially measured at their fair value at the acquisition date and that the minority interest should be initially stated at the minority's proportion of the net fair value of those items.

Question 8 – Goodwill

We agree that goodwill should be recognized as an asset and subsequently measured at cost less accumulated impairment losses. We also support the definition of goodwill and the requirement to disclose a description of the factors that contribute to the recognition of goodwill. These have the potential to help demystify goodwill, provided that preparers can and do provide meaningful disclosures rather than boilerplate. Some fieldwork may be appropriate on how these disclosures can be developed. Examples of appropriate disclosure would be useful.

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 agree with the proposals for "negative goodwill". We also support the required disclosure of the nature of any excess recognized in income by the acquirer. The fieldwork and examples suggested for goodwill would be also be appropriate.

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

We agree that twelve months is sufficient time to complete the purchase equation. In many cases this can be completed sooner. Depending on how close to the period end the acquisition occurs, it may be realistic to complete the purchase equation in time to include the initial accounting in that period's results. As written, ED3 may be read to imply that the purchase price equation does not need to be completed before twelve months.

We also agree that, other than the exceptions noted, further adjustments to the initial accounting after it is complete should be limited to corrections of an error.

AcSB COMMENTS ON PROPOSED AMENDMENTS TO IAS 36, IMPAIRMENT OF ASSETS

General

IAS 36 bases impairment on recoverable amount, which is defined as the higher of net selling price and value in use. Canadian and U.S. impairment standards are based on fair value. The scope of the proposed amendments to IAS 36 did not include a re-examination of whether recoverable amount or fair value should be used. The comments below also do not address this issue and any reference to the use of recoverable amount is in the context of the IASB general impairment approach. No view is intended on whether this approach is preferable to the fair value approach. It is hoped that the separate project on Measurement will resolve this difference.

Question 1 – Frequency of impairment tests

We agree that intangible assets with indefinite useful lives, including acquired goodwill, should be tested for impairment at least annually, as well as whenever there are indications of impairment.
The two sentences added to the beginning of paragraph 12 made the paragraph less easy to understand. It is suggested that they be deleted and replaced with specific references to paragraphs 20A and 96, which are the specific application of materiality to identifying whether it is necessary to estimate the recoverable amount of an intangible asset with an indefinite life (paragraph 20A) or of goodwill (paragraph 96).

Question 2 – Intangible assets with indefinite useful lives

We agree that an impaired intangible asset with an indefinite useful life should be remeasured in accordance with the requirements in IAS 36 for other assets. There is no conceptual reason for a different basis of measurement for these impaired assets.

Question 3 – Measuring value in use

a) Should value in use reflect the elements in paragraph 25A?

Value in use is defined as "the present value of the future cash flows expected to be derived from an asset or cash-generating unit". It is not clear how element (e) "other factors that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset" fits into this definition. This element refers to market pricing of an asset and not to the value to the owner of the asset of the cash flows that will result from the use of the asset.

Should elements (b), (d) and (e) be permitted to be adjustments to either future cash flows or to the discount rate?

Conceptually either alternative, done correctly, leads to the same measurement amount. The choice therefore needs to be made on practical grounds. Since there are practical difficulties with both approaches, our preference is to permit both so that in any specific situation the approach with less difficulty can be used.

b) Should the assumptions on which cash flow projections are based take into account past cash flows and management's past ability to forecast cash flow accurately?

Paragraph 27 (a) (ii) is confusing. The existing IAS 36 wording requires the use of reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Presumably the added words are intended to help ensure management's best estimate is a good estimate.

Management should have reasonable and supportable assumptions as to <u>why future cash flows will be different from those in the immediate past</u>. The proposed wording does not clearly require this. ("Take into account" can be interpreted many different ways.)

Management's <u>best</u> estimate should exclude any tendency to be optimistic or pessimistic and this would be a useful observation, although it is not clear that this is consistent with paragraph 27 (b) since any bias to be optimistic / pessimistic may be in approved budgets / forecasts. The proposed wording implies an adjustment to management's best estimate. If management estimates are consistently higher / lower than the actual results then should management's estimates be adjusted down / up even if they are fully reasonable? (Perhaps management is learning how to estimate better). How is the amount of the adjustment determined? What if the estimation error is random?

c) Is the additional guidance in Appendix B appropriate (on using present value techniques in measuring an asset's value in use).

This guidance draws heavily from FASB Concepts Statement 7. However it does not include the guidance on incorporating risk into the present value measurement, even though paragraph B1 includes "the price for bearing the uncertainty inherent in the asset" as one of the elements to be included in a present value measurement.

The expected cash flow approach uses the risk-free rate of interest as the discount rate while paragraph B15 implies that the discount rate used in this approach might include some risks. Paragraphs B16 – B19 apply only to the use of the traditional approach, but do not say so.

The guidance on using an entity rate (paragraph B17) is inappropriate as the risks of the asset being tested for impairment will rarely be the same as that of the entity. Paragraph B18 goes on to say that the entity rate must be adjusted to reflect asset specific risks – this assumes the difference in risk can be quantified and expressed as an interest rate differential. It would normally be easier to directly identify the appropriate discount rate for the risks and uncertainties inherent in the asset. (Normally a difference in risk between two items can only be measured by measuring the risk in each item.) There is also the concern that preparers will simply assume the risk inherent in the entity rate is "close enough" to that of the asset and not make an adjustment.

Paragraphs 48-50 would be clearer if rewritten to:

a) identify that an entity may use the traditional or expected cash flow approach;

b) specify that the expected cash flow approach uses the risk-free rate of interest as the discount rate;

c) explain that the traditional approach uses a discount rate that reflects the risk inherent in the asset; and

d) refer to Appendix B for any further detail.

In paragraph 48 we suggest that adding the words "represented by the risk-free rate of interest" after "the time value of money" (see FASB Concepts Statement 7, paragraph 39) would be a useful clarification.

Question 4 – Allocating goodwill to cash-generating units

a) Is the level to which goodwill is allocated appropriate?

We agree with the proposals for allocating goodwill. However, we note that these are not fully consistent with the definition of a reporting unit in FAS 142. Since this is a pragmatic rather than conceptual issue, we would hope that the IASB and FASB could converge on a single approach.

b) Is the treatment of goodwill appropriate when an operation in a cash-generating unit that includes goodwill is disposed of?.

We agree with the proposal. However, for clarity, the "value" to be used should be defined – presumably it is value in use, rather than book value.

c) Is the treatment of goodwill appropriate when an entity reorganizes its reporting structure?

We agree with the proposal. However, for clarity, the "value" to be used should be defined – presumably it is value in use, rather than book value.

Question 5 – Determining whether goodwill is impaired

a) Is it appropriate to measure the recoverable amount of a cash-generating unit with goodwill at the higher of net selling price and value in use?

It is appropriate that the recoverable amount of a cash-generating unit with goodwill be measured consistently with other assets.

b) Is it appropriate to use the proposed screening mechanism to identify potential goodwill impairments?

We agree with the proposed screening mechanism and consider it important in making the proposed amendments operational.

c) Should goodwill impairment be measured as the excess of its carrying amount over its implied value (the excess of the recoverable amount of the cash-generating unit over the net fair value of its net identifiable assets, excluding from that net fair value any asset acquired in a business combination but not recognized separately from goodwill at the acquisition date)?

We agree with the measurement proposals.

Question 6 – Reversals of impairment losses for goodwill

We agree that goodwill impairment write-downs should not be reversed.

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

We agree with the rationale for these disclosures provided in Appendix C. The sensitivity information may require some additional effort to calculate and there may be some "competitive harm" concerns.

While we agree that the disclosures should be made at a segment level, this may provide a misleading impression. A segment in total may have a significant "cushion", implying no immediate likelihood of goodwill impairment, but one or more cash generating units might have recoverable amounts only marginally greater than carrying amount. In the next period there could be goodwill impairment write-downs in those units.

Paragraph 137 requires separate disclosures for cash-generating units in certain circumstances. The interpretation of this paragraph will be important and is likely to be contentious. Examples of circumstances when this level of disclosure is required should be considered.

AcSB COMMENTS ON PROPOSED AMENDMENTS TO IAS 38, INTANGIBLE ASSETS

Question 1 – Identifiability.

We agree that the separability and contractual/other legal rights criteria are appropriate for determining whether an intangible asset meets the identifiability criterion.

Question 2 – Criteria for recognition separate from goodwill.

We 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.

Question 3 – Indefinite useful life

We agree that an intangible asset should be regarded as having an indefinite useful life when there is no foreseeable limit on the period of time over which the asset is expected to generate cash inflows.

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

We agree that when 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.
However paragraph 91 may be confusing. The first sentence limits the useful life to the period of the contractual or legal rights. The second sentence seems to contradict this by identifying circumstances where the useful life may be longer than this (but does not identify this as an exception).

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

We agree that intangible assets with indefinite lives should not be amortized (but should be subject to an annual impairment test).