The South African Institute of Chartered Accountants
Die Suid-Afrikaanse Instituut van Geoktrooieerde Rekenmeesters

CL 45

4 April 2003

Sir David Tweedie
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Dear Sir David

EXPOSURE DRAFT 3 ON BUSINESS COMBINATIONS

In response to your request for comments on the exposure draft on business combinations, I attach the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not just a professional body, but also secretariat for the Accounting Practices Board (APB), which is the official standard setting body in South Africa.

We would like to thank you for the opportunity to provide comments on this document as we believe there is an urgent need for global harmonisation of accounting standards on business combinations given the effect these transactions have on the reported results of entities.

We have, in addition to our response to the questions raised, also included a summary of the main points addressed in the questions.

Please do not hesitate to contact me should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director - Technical

cc: Peter Wilmot (Chairman of the Accounting Practices Board)
Pat Smit (Chairman of the Accounting Practices Committee)

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SUMMARY OF THE MAIN POINTS ADDRESSED IN THE QUESTIONS

In order to assist the reader, we have highlighted below a summary of our main areas of disagreement with the proposed statement on Business Combinations and subsequent amendments to IAS 36 and IAS 38.

Combining phase I and II into one final standard

We note that there are several areas where the IASB proposes guidance in ED 3, but then plans to revisit those areas in its current joint project with the US FASB on the application of the purchase method in phase II. These areas include accounting for "true" mergers and the possible use of fresh start accounting, common control transactions, contingent consideration, contingent liabilities, acquisitions achieved in stages and classification of minority interest.

Currently, the Board intends to finalise ED 3 in the fourth quarter of 2003, while issuing an exposure draft on phase II in the second quarter of 2003 and a final IFRS on phase II in 2004. However, we believe it is unwise to issue two major standards in less than twelve months addressing many of the same topics, but with different transitional provisions and effective dates.

We are concerned that if the guidance is issued as planned currently, i.e. in a relatively short timeframe but at two different dates, inconsistencies introduced in phase I and amended in phase II will only cause confusion for preparers and users of financial statements and will not contribute to the acceptance of IFRS. We therefore strongly recommend that the Board consider combining the proposals in phase I and II in one final standard to be issued early in 2004.

Goodwill

We understand that one of the driving factors behind issuing the proposals in ED 3 in their current form is the Board's desire to converge with other major standard setters, especially with the recent US standards on business combinations and intangible assets. In general, we support the Board's objective of convergence. However, in the case of ED 3, we are not convinced that the proposed new accounting model for goodwill – the impairment-only model – is preferable to the existing model whereby goodwill is amortised systematically over its useful life and impairment tested only if an indication of impairment exists.

We therefore do not support the proposal in ED 3 to cease amortisation of goodwill and to rely entirely on an annual impairment test. Instead, we believe that if goodwill can be determined to have a finite life, then a systematic and rational amortisation method must be used. Just like any other finite life intangible asset, goodwill would be tested for impairment when triggered. If goodwill has an indefinite life, amortisation should be prohibited with goodwill stated at cost less any accumulated impairment losses, i.e. an "impairment only model". We want to stress that we do not believe the method used should be a choice, but a method that reflects the economic substance of the goodwill recorded.

Negative goodwill

We agree with the Board that the current presentation of negative goodwill, as a negative asset, should be revised. We also agree that a liability presentation would be incorrect, as there is no income to be deferred. A different basis is therefore required. However, we disagree with ED 3 that, after having adjusted any imprecision in the fair value measurement of identifiable assets and liabilities or the purchase consideration, negative goodwill presents an immediate profit.

We believe that an exchange between informed and willing parties, other than in a forced or liquidation sale, must by definition be at fair value and that therefore no party can obtain an immediate profit. Even if a bargain purchase apparently occurs, in the shape of a surplus of non-monetary assets, in our view the benefits do not materialise immediately but as those assets are used.

Our view therefore is that any excess initial valuation which merely results from the cost allocation process applied in purchase accounting, should be reduced against non-monetary assets and the additional amount, if any, should be taken directly to equity.

Inconsistencies

We are concerned about the various inconsistencies introduced by ED 3 and amendments to IAS 36 and IAS 38. We urge the Board to reconsider the guidance proposed in the following areas:

Intangible assets

Inconsistencies are created by the different recognition and measurement criteria for intangible assets, depending on whether they are acquired or internally generated. Purchased goodwill gets replaced with internally generated goodwill over time, and if this goodwill is subject to an impairment test only, (as proposed in ED 3) it could result in a smaller write-off than the depreciation/amortisation charge on the assets in an entity where organic growth, instead of growth by acquisition, occurred.

In addition, the Board has changed the recognition criteria for intangibles acquired in a business combination in such a way that it is no longer necessary to prove that the benefits derived from the intangible asset are probable. It is assumed that probability is reflected in the fair value measurement and therefore always will be satisfied for intangibles acquired in a business combination. A fundamental change, leading to an inconsistency with the Framework, is introduced through ED 3.

Contingent liabilities

We disagree with the proposal to recognise contingent liabilities acquired in a business combination at fair value. Both the initial recognition and the re-measurement at fair value are inconsistent with IAS 37 and the Framework. The arguments supporting the proposals do not warrant such inconsistency without a further debate about the broader conceptual issues involved.

Fair valuing

If the IASB intends to increase the use of fair value measurements in this and other projects, we suggest the Framework be revisited. Such a change and the resultant due process should enable the necessary debate around fair value measurement, in general, in the light of the various difficulties such measurement creates in terms of reliability of information.

Disclosure

We find many of the proposed disclosure requirements in both ED 3 and in the revisions to IAS 36 to be excessive and believe that they fail to meet a cost-benefit test. We anticipate that compliance with these requirements will be extremely onerous and do not believe the Board has demonstrated the need of financial statement users for this disclosure.

COMMENTS ON BUSINESS COMBINATIONS (ED 3)

Question 1 - Scope

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?

We agree with the scope exclusions, subject to our comments below.

Both accounting for transactions under common control and accounting for business combinations resulting in joint ventures are areas where practice issues frequently arise. We agree with the definition of business combinations involving entities under common control and find it helpful in identifying such transactions. However, most practice issues revolve around the accounting for such transactions. We would prefer to see a final standard being issued combining both the definition of and accounting for common control transactions. We propose that the guidance with regard to entities under common control be expanded to provide a practical example of the interpretation of the definition of "common control", in the same way as the other illustrative examples.

As to the definition of common control, we note that the term "transitory" has not been defined in ED 3. We presume that the requirement for control not to be transitory is to deal with temporary arrangements in connection with deal structuring. We agree that this term should not be defined and that judgment should be used to determine the substance of specific transactions. However, we anticipate that the absence of additional guidance in this area will lead to many discussions in practice and, therefore, we would welcome an example of a situation where the Board considers control to be transitory.

We are in general agreement with the proposed definition of a business combination in the Exposure Draft. However, we have concern as to the application of the current guidance in distinguishing an exchange of assets from a purchase of a business or operations. We note the importance of this distinction in IAS 12.15, 12.24 and IAS 39.19.

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?

We agree with the decision that one method of accounting for a business combination is preferable to two or more methods and that the purchase method is the best and most widely used method available at this time. However, we are of the opinion that true mergers do in fact exist in some circumstances.

We understand that the Board is contemplating fresh-start accounting for true mergers. If guidance from Phase II is issued shortly after Phase I as planned, users could be confused by two changes in accounting to be applied to true mergers within a relatively short period. This supports our view that the IASB should not address accounting for business combinations in two phases, but should instead wait and issue all guidance at once in one standard.

Regardless of whether the uniting-of-interests method is eliminated in respect of mergers, we suggest that the definition be maintained in IFRS. We believe that a different method of accounting is required for business combinations in which a new entity is formed as a result of a true merger. We anticipate that this method, replacing the uniting-of-interests method, will be required for certain common control transactions once they are addressed in Phase II of the business combinations project.

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?

We agree that a business combination should be accounted for according to its substance. The entity with the power to govern the financial and operating policies of the other entity so as to obtain benefits from its activities is the true acquirer and should be treated as such. Therefore we agree with the proposals.

We have some concern, however, over the loss of the shareholders' perspective that is used in IAS 22.13, SIC 9 paragraph 4 and paragraph 8. Although IAS 22.13 relates to the case in which there is no acquirer, SIC 9 clarifies that the shareholder perspective should be applied to all acquisitions. The concept is that an acquirer is identified when one of the shareholder groups obtains control over the combined entity. Ultimately, in the accounting entries, one of the entities has to take the role of the acquirer but this flows from the identification at the shareholder level. The proposition in ED 3 is that one of the entities is the acquirer itself, rather than inheriting this status from its pre-combination shareholders. We recommend that the Board include the shareholders' perspective in the discussion of determining the substance of a business combination.

In addition, while we find the proposed additional guidance in Appendix B to be useful, we suggest a clarification in respect of the reporting of consolidated equity. We understand that the first part of paragraph B 79(c) requires the value of total equity issued to represent the legal subsidiary's equity. However, the Board's intention in respect of the second sentence, where the entity is required to reflect the legal parent's equity structure, is unclear. In the illustrative example, this is demonstrated as simply showing that the number of issued equity instruments is equal to the legal parent's issued equity, while the value is reflective of that of the legal subsidiary. While this example appears to satisfy the wording of the guidance in paragraph B 7, we believe that the disclosure should be different. The issued equity value should reflect that of the legal parent and the difference between that value and the value of the issued equity of the legal subsidiary should be recorded as a separate reserve. Regardless of whether the Board agrees with this presentation, more guidance in the application of this paragraph should be provided.

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

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?

We agree with the proposal to identify one of the combining entities that existed before the combination as the acquirer, as this treatment will reflect the substance of the transaction regardless of its legal form. However, the Board should include guidance as to how the acquirer is brought into the new entity.

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

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?

We agree with the conclusion that the recognition of a provision should be accounted for in accordance with IAS 37 regardless of whether the provision arises out of a business combination. We request that the final standard provide guidance that will specifically clarify the difference in recognition between restructuring costs considered to be post acquisition events and restructuring costs that are considered liabilities of the acquiree.

Question 6 – Contingent liabilities

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?

We strongly disagree with the above proposals of accounting for contingent liabilities in a business combination. The proposed accounting treatment would create unjustifiable inconsistencies with both the Framework and with IAS 37, as well as significant practical application issues. While we appreciate the relevance of recognising a contingent liability in certain circumstances, in order to prevent negative goodwill, the inconsistency between the recognition of acquired and non-acquired contingent liabilities is of greater concern. We believe there is an urgent need to address the conceptual merits of fair value measurements in accounting as part of a project on the Framework. We are concerned that by setting a precedent of choosing when and when not to follow the Framework, the IASB is setting a dangerous precedent. We note that the Board states its intention to revisit the role of probability in the Framework and we suggest that recognition of contingent liabilities in a business combination be deferred to this wider discussion. At present, we do not see the merit of incorporating recognition criteria in this proposed IFRS that represents a departure from both the Framework and IAS 37.

Furthermore, we are concerned that the recognition of contingent liabilities at acquisition date can be manipulated. It creates an opportunity for a subsequent gain being recognised in the income statement as a result of the reversal of the provision when the contingent liability fails to materialise. The subjectivity in valuing such contingent liabilities and the incentive of recognising a subsequent gain in the income statement is a recipe for abuse.

We also disagree with the proposal to continue to re-measure contingent liabilities recognised as a result of a business combination. If the Board decides to move forward as proposed in respect of contingent liabilities, we recommend that the original value be retained until such time as the liability qualifies for recognition under IAS 37, or until the provision is no longer needed and released. The reason that a contingent liability would be recorded at fair value originally is because this would represent its cost. Furthermore, if the contingency reaches the liability recognition criteria under IAS 37, it should be treated in accordance with IAS 37, which is not necessarily at fair value.

We also note that further inconsistency would be introduced if contingent liabilities are addressed in Phase I and contingent assets are left for Phase II. This inconsistency supports our argument that the Board should complete Phase II of the business combinations project in advance of finalising the IFRS so that all guidance can be issued at once.

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

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?

We agree in principle with the proposal to require minority interest in the acquired net assets to be recorded at fair value. However, we prefer that this change is made after having finalised the wider debate on minority interests, addressed in Phase II of the project. This is another example in support of our recommendation to issue all guidance resulting from both phases at once.

Furthermore, the guidance should also be expanded to address the instance where control already exists, but the percentage holding is increased (e.g. 49% to 51% holding versus 51% to 55% holding). This is currently not within the ambit of the definition of a business combination.

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?

We agree that goodwill acquired in a business combination should be recognised as an asset.

Even though the principle is conceptually correct, we do not support the Board's proposal to require non-amortisation of goodwill and have annual impairment testing instead in all circumstances.

We are not convinced that an annual impairment test in all cases, as opposed to the amortisation method, meets the cost benefit test. We are concerned that the proposed impairment test is not robust enough to provide relevant and reliable information that is more of a benefit than a net goodwill amount (see our comments to the revisions to IAS 36). In addition, we are not convinced that ruling out amortisation due to its arbitrary results is any more conceptually accurate than requiring an impairment test based on arbitrary fair value allocations. The IASB should reconsider whether convergence with US GAAP in this area is desireable and provides any more reliable and relevant information.

Goodwill may, in some cases, have a finite useful life and a method of systematic amortisation may be preferable to an annual impairment test both in reliability and relevance. As a result, we propose the following:

- If goodwill can be determined to have a finite life, then it should be amortised over its expected useful life as determined, similar to property, plant and equipment. Just like any other finite life intangible asset, goodwill would be tested for impairment when triggered.

- If goodwill has an indefinite life, amortisation should be prohibited and the impairment model used.

We want to stress that we do not believe he method used should be a choice, but a method that reflects the economic substance of the goodwill recorded.

Further arguments to support the amortising of goodwill are:

- The accounting for assets should reflect the manner of how an entity expects to recover the assets. It is argued that in the case of goodwill it is realised from utilising the assets and liabilities acquired and accordingly, in line with other IFRSs, goodwill should be accounted for over the period over which it is realised. In terms of paragraph 96 of the Framework, "when economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures." It is believed that amortisation of goodwill over a period achieves this objective.
- One of the fundamental principles of IFRS is that each asset should be separated and accounted for individually. This is illustrated further by the proposed Improvements to International Accounting Standards, where, for example, the changes to IAS 16.22A would require components of property, plant and equipment to be accounted for as a separate asset. The proposed

treatment for goodwill in ED 3 is in conflict with this approach. Paragraph BC 98 of the Basis for Conclusion in ED 3 recognises two components of "core goodwill", namely the going concern element and expected synergies. It is argued that these components will quickly disappear if action is not taken to deal with them. Accordingly if expected synergies are realised, then in theory, that part of goodwill should be derecognised as the synergies are realised. Secondly, many of the components of the going concern element would also be realised over time, with the remaining components more likely to reflect actions taken since acquiring the goodwill than the components acquired.

This means that goodwill tested for impairment in any subsequent period in terms of the proposed paragraph 8A of IAS 36 is unlikely to comprise the same components as the goodwill acquired in the prior business combination. Accordingly internally generated goodwill subsequent to acquisition is being valued and used to justify the carrying amount of purchased goodwill.

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

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 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?

We do not agree with the proposed treatment in the Exposure Draft.

Please note that we continue to use the term "negative goodwill" as it is the only term broadly understood in practice.

We believe that purchase accounting is a cost allocation process and thus no more than the cost of the acquisition should be allocated to the acquired net assets. We do not believe that negative goodwill represents instant profit. An exchange between informed and willing parties must be, by definition, at fair value. Even if the case of a bargain purchase exists, the benefits are realised as the assets are used and not immediately. Based on these arguments, we recommend that negative goodwill should be used to reduce non-monetary assets and the additional amount, if any, should be taken directly to equity.

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

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?

We agree with the twelve-month limitation for adjustments to the initial accounting for a business combination. We also agree that any adjustments beyond the twelve-month period following the acquisition should be recognised only to correct an error.

We suggest that final purchase accounting adjustments should be recorded in the financial statements if these adjustments are finalised after the balance sheet date, but before issuance of the financial statements. Therefore, we would suggest the appropriate change to paragraph 61, which appears to state that such an adjustment would be a non-adjusting event after the balance sheet date under IAS 10.

Consistent with current guidance under IAS 22, we understand paragraph 64 to apply at any time after the acquisition date, and therefore see it as an exception to the twelve-month limit on the adjustment period. We agree with this exception, however, we suggest that the Board explicitly state that there is no limit to the adjustment period in respect of deferred taxes. We understand the rationale for having the exception is to avoid accounting arbitrage. Since recognition of deferred tax assets is somewhat judgmental, there may be a tendency to postpone recognition until after the hindsight period, so that a credit to income (rather than to goodwill) can be recorded. We recommend that the Board include this rationale in the Basis for Conclusions of the final IFRS.

Additional comments on Business Combinations (ED 3)

Disclosure

We believe that certain of the proposed disclosure requirements are excessive and do not meet the cost-benefit test. Specifically, we believe the following proposed disclosures to be unnecessary.

Paragraphs 65 and 76

Paragraph 65 is a guidance paragraph and sets out the objective of the disclosures. Paragraph 76 then requires anything to be disclosed that helps achieve the objectives. While we find the objectives to be appropriate, we do not support this approach as we anticipate that it will lead to endless second-guessing in hindsight where good faith efforts to comply have been made. We also note that any disclosures not specifically mandated, but required for a true and fair view are required under IAS 1.91(c).

Paragraph 65 also requires that the disclosures be made for business combinations effected in the post-balance sheet period. This requirement is covered by IAS 10 and does not need to be repeated here.

Paragraph 66 (f)

We consider the requirement to disclose the amounts recognised for each class of assets, liabilities and contingent liabilities, and their carrying amounts directly before the acquisition to be excessive. We find it hard to see how this information would add value to the financial statements and we believe that it could be difficult and very costly to obtain in circumstances where the acquiree did not comply with IFRS before the business combination. We recommend that this requirement be deleted.

Paragraph 66 (i)

This paragraph requires the disclosure of the amount of the acquiree’s profit or loss since the acquisition date included in the acquirer’s profit or loss for the period. We doubt whether this requirement is practicable as the acquiree’s profit or loss may no longer be available when its operations have been integrated with those of the acquirer.

Paragraph 69

We disagree with the requirement to disclose such pro forma information about what the results would have been had the acquisitions been made at the start of the period. The disclosure required by this paragraph do not reflect the reality and they appear to question the concept of the purchase method of accounting for business combinations.

Paragraphs 69 and 70

We believe that the IFRS should include a requirement to disclose not only that the undue cost and effort exemption is used, but also the reasons why. Adding this requirement will deter unreasonable use of the exemption, and will make the IFRS consistent with the proposed standard on first-time application of IFRS.

Paragraph 73

We note that this paragraph is inconsistent with the proposed improvements to IAS 16 and IAS 38 as it does not required disclosures of comparative information.

COMMENTS ON IMPAIRMENT OF ASSETS (IAS 36)

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?

We agree with the proposal that indefinite lived intangible assets be tested for impairment at least annually or when certain indicators exist that question the current value of the intangible assets. As noted in our response to Question 8 of ED 3, we believe there may be a situation where goodwill has a finite life and therefore amortisation may be appropriate. In that situation we would recommend that an impairment test be conducted only when certain indicators exist that question the current value of the intangible asset.

It should be noted that it is not always practical to perform an impairment test at year end. Impairment tests could be performed at any time during the year. However, events subsequent to the impairment test should be reviewed and adjustments made, when indicators exist.

We disagree with the requirement in paragraph 93 that where goodwill has been allocated to a cash-generating unit during the current period, that unit must be assessed for impairment after the acquisition and before the end of the year. If goodwill has been established in an arms length transaction subsequent to the impairment test for the current year, we do not think an impairment test should be required unless there is a further indicator of impairment.

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?

We agree with the IASB's proposal. However, we request additional guidance be provided on how to project cash flows for assets with an indefinite life.

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?

We find the additional guidance provided in proposed paragraphs 25A and 27 to be useful and appropriate. We also agree that an entity should be permitted to reflect the elements listed in paragraph 25A either as adjustments to future cash flows or as adjustments to the discount rate.

The additional guidance provided in proposed Appendix B is useful, but only to a certain extent. The IASB could increase its usefulness by including guidance in respect of a number of other areas of difficulty that are experienced with the current standard. We strongly encourage the IASB to provide additional guidance and/or illustrative examples in the following area:

Capital expenditures and restructuring costs

More guidance is required in determining whether certain future expenditures for capital purchases and restructuring costs should be included in the cash flow forecasts. We have noted that preparers experience difficulty in identifying whether or not the management commitment test is met, as well as in identifying whether certain capital expenditures are considered to maintain or enhance a level of performance.

Difficulty also is encountered when impairment testing is done shortly after an acquisition where the transaction included considerations in respect of synergy, capital expenditure, restructuring or other items that may be disallowed in the impairment test. Testing in this case could lead to an impairment charge immediately after an acquisition. We find this to be inappropriate and believe that changes are required in this regard.

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?

We agree that goodwill should be allocated to cash-generating units (CGUs) in order for impairment testing to be performed at a level consistent with management monitoring of return on investment.

Paragraph 74 requires allocation of goodwill to cash-generating units only when a reasonable and consistent basis can be determined. This would seem to require certain cash generating units to be aggregated to test some goodwill amounts, but disaggregated to test other goodwill amounts. We are not sure the benefits of such an approach outweigh the cost of implementing these tests annually.

Therefore, we recommend the addition of a maximum level of disaggregation at one level below the primary reporting segment level. Not only is this consistent with US GAAP, it provides practical guidance that balances the cost and benefits of an impairment approach.

We also agree with the proposal to allocate the appropriate portion of goodwill in determining the gain or loss on the disposal of an operation. The allocation based on relative values is a reasonable approach unless there is another allocation method that is apparent and more meaningful to a particular entity. For instance, the substance or contractual arrangements underlying the original transaction may indicate a different allocation. We suggest that the IASB include such a provision in the standard so that an entity may use a different approach if there is in fact a more meaningful split. In addition we suggest that the reference to "relative values" be changed to "relative recoverable amounts" to add clarity.

Consistently with the case of a disposal, we find that the allocation of goodwill on the basis of relative values is reasonable in the case of a reorganisation in which the composition of the CGUs is altered. We also believe that guidance should be added in respect of cases where a more relevant allocation is apparent.

We agree with the guidance provided in paragraph 81 for the disposal of an operation within a cash-generating unit that contains goodwill. We also agree with the proposal in paragraph 82 on the reallocation of goodwill as a result of a restructuring of cash-generating units. However, we request clarification of whether "value" in these paragraphs shall mean carrying value, fair value or both.

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?

We agree that the recoverable amount of a CGU to which goodwill has been allocated should be the higher of the value in use and the net selling price. This guidance is consistent with the current IAS 36 and the extension to cover CGUs to which goodwill has been allocated is logical.

We also agree with the use of a screening mechanism for identifying potential goodwill impairments and support the two-phased approach.

Our agreement is based on the principle referred to in our comments on ED 3 Question 8, that goodwill is only impaired where it has an indefinite useful life, otherwise it should be amortised over its useful life.

Question 6 – Reversals of impairment losses for goodwill

The Exposure Draft proposes that reversals of impairment losses recognized 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 recognized?

If the IASB moves forward with the proposals to not amortise goodwill but to test it annually for impairment, we agree that an entity should not be permitted to reverse an impairment loss recorded in respect of goodwill. Allowing such a reversal would be inconsistent with the prohibition to record internally generated goodwill under IAS 38.

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?*

We are of the opinion that the proposed disclosure requirements are excessive. Requesting such extensive disclosure suggests that the proposed approach of not amortising goodwill but instead testing it annually for impairment may be unreliable. While we understand the argument that such disclosures are designed to ensure that the impairment testing is done correctly, we argue that the cost involved in meeting some of the requirements far outweighs the benefit.

We expect the application of these proposals to be a significant undertaking for companies and we anticipate that many will argue that the costs and efforts are undue in relation to the benefit.

COMMENTS ON INTANGIBLE ASSETS (IAS 38)

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?

We find the separability and contractual/other legal rights criteria appropriate. However the interaction between these criteria, as set out in paragraph 11, and the control criterion discussed in paragraphs 12 to 15 need further clarification. Under current IAS 22 and IAS 38, intangible assets are not recognised if they are not controlled by the entity acquiring them. For instance, a customer list would not normally meet the current recognition criteria as it cannot be controlled. This notion seems to be retained in the new paragraph 15. However, the illustrative guidance indicates that items such as customer lists and non-contractual customer relationships can be capitalised if they meet the criteria in paragraph 11, that is, based on these items being separable.

We are of the opinion that the recognition criteria need to be consistent for intangibles acquired in a business combination and those acquired separately, and therefore, that the control requirement be emphasised in the proposals.

In addition, we are concerned about the potential for intangible assets to be separated excessively to the point where the recognition loses its meaning and utility. For example, an intangible item such as a brand should be recorded as such and not separated into individually identifiable components.

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.

We have some doubts about the IASB's presumption that fair values of all intangible assets can be reliably measured. There are certainly intangible items that may carry an intellectual property right but that are not easily assigned a fair value. For example, a slogan is likely to be protected by a legal right but a fair value would be difficult, if not impossible to determine. We expect that difficulties would also often be encountered in separating and assigning separate values to items such as a customer list, non-contractual customer relationships or trade dress.

In addition, we have experienced some difficulty in practice in determining the fair value of intangibles that do not have an observable market. In certain cases, when an intangible asset is not traded in an observable market, its fair value is estimated based on cash flows. However, in practice, we have noted that there are certain intangibles that only generate cash flows when used with a collection of other assets, both tangible and intangible. Difficulty also has been experienced in identifying and measuring the value of customer relationship assets. There are significant differences in professional opinion amongst valuation specialists regarding the factors that should be considered in determining such values. These issues affect both the recording of intangibles acquired in a business combination and subsequent impairment testing under [revised] IAS 36. In light of these practice issues, we recommend that the IASB consider limiting separate recognition of intangibles to those that can be sold individually or with a group of similar intangibles.

We also note that proposed paragraph 30 states that "sufficient information should always exist to measure reliably the fair value…" The use of the word "should" leads us to question the Board's proposal in a case where such information is not available. According to the proposals for revisions to IAS 38, we presume that if the intangible asset cannot be reliably measured, it should not be recognised separately from goodwill. However, ED 3 proposes to drop the reliable measurement criterion assuming that if an intangible is identifiable, it can be measured reliably.

Paragraph 32 discusses the recognition of intangible assets separately from goodwill in a business combination, including specific mention of in-process research and development. We have concerns about the inconsistency introduced by this paragraph. Even if the probability recognition criterion is assumed to be met, the capitalisation of research acquired in a business combination is in direct conflict with the requirements for internally generated research. We do not support such inconsistency with the Framework and with the requirements for internally generated research. In the Basis of Conclusion, paragraph B 13, the Board sets out that it will consider the role of probability in the Framework more generally as part of a later "Concepts projects" and that it may also revisit IAS 38 at a later stage to determine whether it should make the recognition criteria for internally developed research consistent with acquired in-process research.

We disagree with this approach. We would find it strongly preferable for the Board not to move ahead with introducing significant inconsistencies before these issues are addressed more broadly within the context of the future concepts and intangible assets projects.

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?

We agree with the proposal to remove the rebuttable presumption from IAS 38 as we agree that some intangible assets will have useful lives that are indefinite. We have some concern, however, that companies may inappropriately assign the useful life of an intangible asset to be so long that it is effectively indefinite. However avoiding the requirement to test indefinite intangibles for impairment. Therefore, we suggest that the revised IAS 38 include a requirement that useful lives over a certain threshold be subject to the same impairment testing as those with indefinite useful lives. This recommendation is consistent with our response to Question 1 on IAS 36, which addresses the frequency of impairment tests under revised IAS 36.

However, we are concerned that without a rebuttable presumption, an indefinite useful life will be used without proper analysis of relevant facts. While we do not believe that the revised IAS 38 should require a definite useful life for all intangibles assets, we encourage the IASB to emphasise in the final standard that substantial support should be gathered in respect of a useful life that is determined to be indefinite.

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)?

We agree with the above, but would like further guidance.

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?

In our response to Question 3 above, we have noted that we agree that there are certain intangible assets that have indefinite useful lives. In such cases, we find it appropriate that the intangible assets are not subject to amortisation.

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