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*For the attention of Ms. Annette Kimmitt, Senior Project Manager*

Vevey, April 4, 2003

**EXPOSURE DRAFT ED 3 BUSINESS COMBINATIONS AND CONSEQUENTIAL CHANGES OF IAS 36 AND IAS 38**

Ladies and Gentlemen,

We welcome very much the work undertaken by the Board and the Staff on this important project of accounting for business combinations. We outline some general comments below and we then answer the specific questions of the exposure draft in the enclosure to this letter.

The Board had to face a real challenge when reviewing the accounting requirements for business combinations since it had to come to a high quality solution that provides reliable information to the users, is acceptable for the preparers in terms of cost effectiveness and, above all, enables accounting harmonisation. These goals have been partly met and we are generally supportive of the exposure draft. Nevertheless there are a couple of areas that raise concern to our Group and that are discussed below.

We are supportive of the impairment only approach for goodwill on grounds of harmonisation with US GAAP. Nevertheless we still believe that goodwill amortisation remains an acceptable solution and we consider that amortisation of goodwill could be maintained if it can be demonstrated that goodwill has a finite life.

Nevertheless, we consider that the two-step procedure established in the exposure draft is very complex and cumbersome. The implied value of goodwill (recoverable amount of a cash generating unit less the fair value of its net assets) is a highly theoretical concept that has very little economic significance. Even worse, the fair values of tangible and intangible assets are not available and should be obtained through a complicated valuation process for which the auditors may require outside appraisals to protect themselves.

We therefore propose that the future IFRS maintains the current approach of IAS 36 whereby the goodwill is impaired when the recoverable amount of a cash generating unit is lower than its carrying amount on the balance sheet. While we appreciate that our proposal creates a divergence with US GAAP, we recommend that the Board addresses this issue in its long term convergence project with the FASB.

Although the Board has adopted the FASB methodology in determining the impairment losses for goodwill, it has departed from US GAAP in the determination of the cash generating units to be used for the impairment of goodwill by requiring that they are established at the lowest level to which management monitors goodwill. While this requirement may be viewed as being helpful to the preparers, it does not recognise the fact that an aggregation of cash generating units with similar characteristics is sometimes more reliable for the users even if internal allocations may sometimes be made. Moreover, the proposed requirement is somewhat restrictive in the sense that it does not address the issue of matrix organisations by restricting the test to the primary segment, while enterprises may have to test goodwill that benefits to a product group segment but that is utilised across several geographical segments.

ED 3 and the consequential changes to IAS 38 on intangible assets have also introduced some substantial changes to the recognition of provisions, contingencies and intangible assets.

We consider that the recognition of contingent liabilities at the date of the acquisition is not consistent with the definition of a liability in accordance with the Framework and that, at such date, only provisions can be recognised, because, if the acquirer and the acquiree have agreed to reduce the price of an acquisition, it means that the contingency qualifies as a provision.

The requirement for the recognition of contingent liabilities at the date of the acquisition is also not consistent with the requirements for the recognition of provisions. The Board wants to prohibit the recognition of provisions for the restructuring of the acquiree with the exception of those that existed at the acquisition date. However, the acquiree and the acquirer may have agreed to adjust the price of the acquisition for a restructuring of the acquiree that will be carried out after the acquisition date. We do not see why the recognition of such a provision would not be justified as a change of the fair value of the acquiree when it is announced within the twelve months deadline after that acquisition.

Finally we consider that the requirement of the revised IAS 38 to recognise intangible assets that are separable, i.e. capable of being re-sold either individually or together with another asset or liability, goes too far. It does not address the issue of enterprises whose intangibles are embedded in goodwill since they will never be resold separately from the tangible assets such as, for example, the trademark of a mineral water spring. The exercise of valuing separately those intangibles would be purely theoretical and would not bring additional benefits to the users.

The attachments to this letter answer the specific questions of the exposure draft and we stay at the disposal of the Staff to give any additional information that it may require.

We thank you for allowing us to comment on this important exposure draft and for your attention to our comments.

Yours very truly,

NESTLE S.A.

H. Wirz
Senior Vice President
Head of Group Accounting and Reporting

Encl.

## ANSWERS TO SPECIFIC QUESTIONS AND OTHER POINTS

**ED 3**

### Question 1 – Scope

a) The scope exclusions are appropriate. Nevertheless, we are concerned about the exclusion of business combinations in which separate entities are brought together to form a joint venture. As these are going to be dealt with in the second phase of the Business Combination project, we consider that such delay will create a vacuum period during which no guidance would exist for the formation of joint ventures and we recommend that advance implementation guidance be submitted in the from of an IFRIC interpretation. Another possibility would be to make the effective dates of the future IFRSs on business combinations 1 and 2 concurrent.

b) The definitions related to the scope are appropriate.

### Question 2 – Method of accounting for business combinations

We agree with the elimination of the pooling of interests.

### Question 3 – Reverse acquisitions

a) We agree with the requirements for reverse acquisitions.

b) We consider that the additional guidance is appropriate.

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

We agree that one of the entities that existed before should be adjudged as being the acquirer. However the future IFRS should make it clear that the new parent should be the company used for the share capital disclosures.

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

We disagree and do not believe that only provisions that the acquiree had at the balance sheet date should be recognised. We consider that the decision of restructuring the acquiree is taken when the acquirer reviews the operation of the acquiree and that the cost of the restructuring is an element that is considered when the acquirer negotiates the price. Therefore, the provision for the restructuring of the acquiree should be viewed as a cost to bring the acquiree in its working condition at the date of the acquisition. Nevertheless, we agree that recognising such provisions at the date of the acquisition would not meet the announcement criterion of IAS 37.

Therefore we propose to include a rebuttable presumption that such provisions should be announced and then implemented within 12 months from the acquisition date. Such presumption could be rebutted when the acquirer is prevented from implementing the restructuring of the acquiree within the previously mentioned 12 months deadline as a result of an agreement with the authorities or with the unions.

**Question 6 - Contingent liabilities**

We disagree with the proposed treatment to recognise contingent liabilities on the acquisition date as a part of allocating the cost of a business combination.

Paragraph 81 of the basis for conclusion says that "an outflow of resources will be requested to settle the possible or present obligation". The reasoning of the basis for conclusion is that a contingent liability will depress the price of an acquisition and that such liability should consequently be recognised.

This reasoning is fine in theory but acquisition prices are seldom fixed items by items, i.e., by fair valuing the asset and liability elements individually. Rather the price is fixed on the basis of capitalising future cash flows or by earnings multiples. Nonetheless the acquirer and the acquiree may agree to adjust the previously mentioned price formulae on the basis of liabilities identified during the due diligence audit. In doing so the acquirer and the acquiree have come to the conclusion that the entity targeted for acquisition has a present obligation that will result in future cash outflows. If there had not been such an agreement between the acquirer and the acquiree, it would have meant that the fair value of the liability could not have been reliably measured (let us recall that the definition of fair value implies a willing seller and willing buyer). Therefore, at the acquisition date, only provisions can be recognised and contingent liabilities cannot qualify for recognition.

To conclude, we consider that the requirement to recognise contingent liabilities in the fair value of the liabilities acquired is not consistent with the definition of a liability stated in the Framework and that only provisions that meet the IAS 37 definition should be recognised. As regards contingent liabilities of the acquiree, we believe that either the acquisition is a trigger for a contingent liability and then the acquirer should recognise a provision in accordance with IAS 37 or the acquisition is not a trigger and then the acquirer should continue to report an off-balance sheet contingent liability.

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

We agree that assets acquired and liabilities assumed should be measured at fair value at the balance sheet date. However, as mentioned in our answer to question 6 above, we disagree with the recognition of contingent liabilities at the balance sheet date. We also agree that minority interest should be recognised in accordance with the allowed alternative treatment of the current IAS 22, i.e., at the minority's proportion of the fair value of the assets and liabilities.

## Question 8 – Goodwill

We agree that goodwill should be recognised as an asset because it represents a payment made by the acquirer for intangible assets that cannot be recognised because their fair value cannot be measured reliably. Such intangible assets consist e.g. of customer lists, suppliers' network, market share, etc. Arguments could be found either to amortise or not to amortise goodwill.

As goodwill is an asset, it could be argued that it is consumed in the business process and that it is gradually being replaced by internally generated goodwill. In contrast, one could also argue that the intangible assets represented by the goodwill generally have an indefinite life (like land) and that they should stay on the balance sheet at their original fair value inasmuch as they are supported by future cash flows in accordance with the provisions of the Framework.

While we agree with the above second possibility on grounds of convergence with US GAAP, we also consider that the amortisation of goodwill could be maintained if it can be demonstrated that it has a finite life. Thus the treatment of goodwill would be symmetrical to that of intangible assets.

## Question 9 – Excess over the cost of a business combination of the acquirer's interest of in the net fair value of the acquiree's identifiable assets and liabilities (negative goodwill)

We agree that the fair value of the net identifiable assets and liabilities should be reassessed in case of negative goodwill because it might well be possible that a provision is identified or that the assets have been previously overstated. If it is not the case, it generally means that the acquirer has made a bargain purchase ("lucky buy") and, therefore, it is correct to recognise the excess of the fair value over the cost of the acquisition in the income statement. Nevertheless, when the negative goodwill is identified to a contingent liability that is not recognised in the purchase accounting, we consider that negative goodwill should be set-up as a liability and released to income when the contingent liability meets the IAS 37 recognition criteria.

We also have a problem of terminology and we do not understand why the future IFRS should not use the term of "negative goodwill". The so-called "Excess over the cost of a business combination of the acquirer's interest of in the net fair value of the acquiree's identifiable assets and liabilities" is impossible to use in numerical tables (143 letters!) and we do not see any justification for the use of this periphrasis since "negative goodwill" is just the opposite difference of goodwill and it reflects the nature of the difference in a concise and understandable way.

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

We generally agree with the principles set out in question 10 but we recommend that the 12-months deadline could be extended when the determination of the fair value requires the approval of regulatory or taxation authorities and when the obtaining of such approval requires more than 12 months. Nevertheless we note that the 12-months deadline requirement could turn out to be costly for the preparers because, in large acquisitions with the integration of a considerable number of businesses, the auditors might not be in a position of auditing the fair values within their normal year-end mandate and they might require additional fees to certify that the audit of the fair value has been completed within the required deadline.

In all other circumstances the adjustments of goodwill made after 12 months would be treated as the correction of an error as proposed in the ED.

**Other points**

*Materiality*

We recommend that the future exposure draft contains a materiality clause as did IAS 22 and all the standards issued by the previous Board. In the current sensitive, bureaucratic and litigious environment where the auditors want to protect themselves, the absence of such a clause could cause undue cost and effort to the preparers which would have to explain, justify and even disclose elements that that would not affect the judgment of the users.

*Disclosure requirements*

The requirement of paragraph 66 (i) concerning the amount of the acquiree's result included in the acquirer's accounts since the acquisition date is impracticable when the acquiree is merged into the acquirer or into an existing subsidiary of the acquirer after the acquisition.

While paragraph 69 is designed to enable the users to assess the impact of an acquisition on the accounts of the acquirer, such information will very often not be disclosed on grounds of undue cost an effort when the acquiree is merged as explained in the above mentioned paragraph. Therefore we do not see the rationale of a requirement that is not practicable or that could even be misleading because the business strategy has been refocused.

Paragraph 70 requires the same information as that of paragraph 66 for the each business combination occurring after the balance sheet date but before the accounts are authorised for issue. We consider that the requirements of letters (f) to (i) are exaggerated even with the limitation of undue cost and effort since, in many circumstances, the acquirer has not the right to access the financial information of the acquiree due to the requirements of the anti-trust authorities.

We disagree with the requirement of paragraph 72 (a) regarding gains and losses during the period that are related to assets and liabilities acquired. This requirement is not practicable in case of merger as already stated above. In addition we do not see the benefits for the users in distinguishing say the gains and losses that are related to the assets of the acquiree by opposition to the assets of the acquirer.

The future IFRS should also specify that comparative figures are requested only for the disclosures of paragraph 74, i.e., the accumulated impairment losses (letter a), the movement of goodwill (letters b and d), and deferred tax adjustments (letter c). Comparative figures would not make sense for the other disclosure requirements and unnecessarily load the financial statements.

## CONSEQUENTIAL AMENDMENTS TO IAS 36 – IMPAIRMENT OF ASSETS

### Question 1 – Frequency of the impairment tests

We consider that the frequency is adequate especially bearing in mind that the ED allows to use the most recent calculations if the recoverable amount exceeded the carrying amount of goodwill by a substantial margin and if the circumstances have not changed. Nevertheless paragraph 85 says that the goodwill test should be performed more frequently than annually if there are indications that goodwill may be impaired. We recommend that the future modified IAS says that the previously mentioned indication refer to exceptional circumstances such as, e.g., the decision to sell a business.

### Question 2 – Intangible assets with indefinite useful lives

We agree that the recoverable amount of intangible assets with indefinite useful lives be measured in accordance with the requirements of IAS 36 for assets other than goodwill.

### Question 3 – Measuring the value in use

a) We consider that the future IFRS should avoid being prescriptive and that it should allow to prepare the calculations on either a pre- or post tax basis because both methods should produce the same results if correctly applied.

b) We consider that the addition of item (ii) in paragraph 27 (a) requiring "to take into account management past ability to forecast cash flow accurately" is not clear: does it mean that the reliability of management past projections should be assessed before making estimates of future cash flows ? Instead of that unclear requirement, we recommend that the future IFRS emphasizes on the relevance of the projections of future cash flows, which should be based on the most recent forecasts established by management and taking into consideration all the latest events that may have occurred.

   We also find that the guidance of appendix B is very theoretical and we are concerned with the fact that the appendix is an integral part of the standard. We would recommend that this guidance is treated as illustrative only and that it clarifies how the projection of future cash flows and the determination of the discount rate are determined in practice. Nevertheless that guidance should not prevent enterprises that have already systems in place to use them as long as they comply with the requirements of paragraphs 27 to 50 (subject to our above proposal for change).

Finally the time period should not be explicitly limited to five years (paragraph 27(b)) the requirement that the period shall be in line with the useful life of the asset is sufficient.

c) Please refer to (a) and (b) above

**Question 4 – Allocating goodwill to cash generating units**

a) We have some concern about the requirement to allocate goodwill to the lowest level that management monitors it. The lower goodwill is allocated, the less consistent will that allocation be, since it becomes more sensitive to any change in the reporting structure. Moreover, the most useful information is provided to users when aggregating cash generating units with similar characteristics, notwithstanding the fact that they may be monitored independently for internal reporting. However the key factor is the convergence with US GAAP and companies which are listed in the US or have subsidiaries listed in the US should not be prevented to apply the US GAAP methodology, since explaining differences related to impairment testing under two different bases would result in a nightmare.

The Board should also address the issue of matrix organisations and the interrelation of impairment testing with primary and secondary segments. Though companies may be organised on a geographical basis, they may determine a CGU on the basis of the secondary segment when goodwill is related to a product category that is present in several units that are monitored separately in the primary segment. Nevertheless we agree that there should be an upside limit to the determination of cash generating units but such limit should be based on either the primary or the secondary segment.

b) We agree in principle that, when goodwill is allocated to a CGU and when this CGU is sold, goodwill should be included in the gain or loss on disposal. Nevertheless we have concerns about the practicability of this requirement especially when a part of the cash generating unit is divested and goodwill continues to generate future cash flows while inefficient hard assets have been disposed of.

c) Please see under (b) above.

**Question 5 – Determining whether goodwill is impaired**

a ) We agree that the recoverable amount of a cash generating unit (CGU) to which goodwill has been allocated should be determined as the higher of its value in use and of its net selling price. This approach is consistent with that of the current IAS 36 and it has proved to be workable in practice.

b and c) We disagree with the screening mechanism and the two-step approach that is used in the ED, that is first to identify the potentially impaired goodwill of a CGU when the carrying amount of the CGU exceeds its recoverable amount and then to determine the implied value of goodwill on the basis of the difference between the recoverable amount of the CGU and the fair value of the CGU's assets (excluding goodwill), an impairment loss being recognised when the carrying amount of goodwill is higher than its implied value.

In doing so the Board wants to mimic the situation that is occurring at the time of the acquisition but the exercise is very theoretical if not irrelevant especially when the CGU results form the merger of the acquiree with an existing business of the acquirer (or the acquirer itself): goodwill is a residual value at certain point of time and then becomes a very nebulous asset, which results in a mix of acquired and internally generated goodwill. Therefore, we doubt very much that the implied value of goodwill has any informative value since its sole purpose is to determine the impairment loss on goodwill. This exercise has also the perverse effect of recognising an impairment loss because the assets have gained in value. We are also concerned by the fact that the determination of the fair value of the assets of the CGU will be a very lengthy and complicated process since enterprises have neither records nor the use of the fair value of the tangible and intangible assets under the going concern convention. The fair value process may also turn out to be very costly especially if the auditors require outside appraisal values to protect themselves.

Therefore, we propose that the impairment loss should be recognised in accordance with the current requirements of IAS 36. Since goodwill is an asset, we do not see any valid reason why its impairment loss should be measured differently. We appreciate that our proposal is not consistent with US GAAP but we recommend that the Board addresses this issue with the FASB in its long term convergence project.

## Question 6 – Reversal of impairment losses

We do not see any valid reasons why impairment losses of goodwill should not be reversed. Again goodwill is an asset and if the conditions that had prevailed to the impairment of goodwill no longer exist we do not see why the impairment could not be reversed.

## Question 7 – Disclosures

We consider that the purpose of the disclosures is to help the users to understand the assumptions used by the preparers when determining the recoverable amount of goodwill and the impairment losses on it. While we understand the rationale for the disclosures by business segments, we consider that some of them are meaningless when they are aggregated (e.g. discount rates). In this context we agree with the following disclosures of paragraph 134 (the *italics* denote our proposals) :

a) the carrying amount of goodwill: *in total and by segment*
b) the carrying amount of intangibles with infinite useful lives: *in total and by segment*
*c)* the basis on which the recoverable amounts of the cash-generating units have been determined (value in use or net selling price): *general policy of the entity and assumptions for the most significant impairments*

In contrast we disagree with disclosures whose purpose is to enable the users to verify the information disclosed by the preparers. The accounts are audited and the users should rely on the work of the auditors. We also disagree with the disclosures of simulations because, to be useful, the simulations should take into account assumptions determined by the users. If the preparers determine the assumptions they will incur time and effort to prepare calculations and disclosures that probably do not address the requirements of the users. In this context, we disagree with the disclosures of letters (e) and (f) of paragraph 134.

We also do not understand the rationale for the disclosure paragraph 134 letter (d), i.e., "the amount by which the aggregate of the recoverable amounts of the cash-generating units exceeds the aggregate of their carrying amounts". In such a situation the CGUs are not impaired and there are no problems and no disclosure is necessary.

To conclude, we consider that the disclosures of paragraph 134 letters (d) to (f) go far beyond what is necessary for the users to assess the reliability of goodwill in the financial statement and that the Board has failed to demonstrate the usefulness of such disclosures. Consequently we urge the Board to readdress this issue and to establish disclosures that are practicable for the preparers and useful for the users.

## <u>CONSEQUENTIAL AMENDMENTS TO IAS 38 – INTANGIBLE ASSETS</u>

### Question 1 – Identifiably

We consider that the definition goes too far and that it would result in recognising to the balance sheet assets that do not necessarily meet the reliable measurement criterion of the framework. We recommend that the two requirements of paragraph 11 (letters a and b) be made cumulative, i.e. by using the word "and" instead of "or" and that letter (b) be modified as follows (our changes are denoted in *italics*):

"An asset meets the identifiably criterion in the definition of an intangible asset when it:

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

b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations".

As it stands currently, the requirement of paragraph 11 does not address the issue of companies which acquire intangibles that would never be re-sold separately from tangible assets. This is very frequent in the consumer goods business. For example a mineral water brand would never be re-sold without the spring and the bottling plant. Likewise a re-sale of a brand (e.g. chocolate, frozen foods, etc) implies in most cases the re-sale of manufacturing assets. Consequently we do not see the point of entering in all the cost (appraisers) and effort of identifying intangible assets that would never be re-sold separately.

In contrast we acknowledge that, for example in the pharmaceutical business, it is very common to re-sell intangible independently from other tangible assets and in such a case the separate identification of intangible asset makes sense. Nevertheless our proposed modification would allow this.

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

Again we consider that the requirements go to far and we disagree with them. Paragraph 89 of the Framework says that "an asset should be recognised when it is probable that future economic benefits will flow to the enterprise and the asset has a cost that can be measured reliably". Under the requirements of paragraphs 29 and 30 there is a presumption that all intangibles acquired in a business combination meet the probability recognition criterion with the exception of assembled workforce (as per paragraph 31).

The future revised standard would thus result in having certain intangible assets recognised in the balance sheet in a business combinations and not recognised if they are internally generated which is against the reliability qualitative characteristic of the Framework (paragraphs 31 and 32). We also disagree with the statement of paragraph 30 that says that "sufficient information should always exist to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity". In the example of the previous question (mineral water spring) there is no reliable way for measuring the value of the intangible asset separately since it is embedded in goodwill. The entity could of course estimate a theoretical royalty from the trademark and determine the present value of the future cash flows but that value would not reflect market expectation since the trade mark would never be licensed.

In addition we are also concerned about recognising separate intangible assets for In Process Research and Development. We consider it is inconsistent to recognise IPR&D as an intangible asset in a business combination for enterprises that do not capitalise development costs since they fail the capitalisation criteria. The fact that IPR&D has been paid for in a business combination should be reflected in goodwill.

We therefore propose to limit the recognition of intangible assets in a business combination to those that could be re-sold separately.

**Question 3 – Indefinite useful life**

We agree with the removal of the rebuttable presumption since intangible assets such as trade marks may have an indefinite value. Also it would not be correct to test for impairment intangible assets that have a contractual life over 20 years.

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

We agree in principle but we consider that the criterion "renewable without cost" is not appropriate. The relevant criterion should not be the cost of renewal but whether the enterprise has the intent and ability to renew the intangible asset for a further period.

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

We agree.

**Other point**

We disagree with the removal of letter (d) of paragraph 58 (paragraph 54 of the current standard) regarding overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis. We consider that, in case of internally generated intangible assets such overheads should be considered as being directly attributable to the asset, especially when an enterprise utilises its own staff on a software project that is capitalised.