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Sir David Tweedie
Chairman International Accounting
Standards Board

LONDON

Comments on "ED3 - Business Combinations" and on "Proposed Amendments to IAS 36 Impairement of Assets and IAS 38 Intangible Assets"

Dear Sir,

ABI welcomes the opportunity to comment on "ED 3 – Business Combinations" and on "Proposed Amendments to IAS 36 Impairment of Assets and IAS 38 Intangible Assets".

Our comments take as point of departure those of EFRAG in its draft comments published on its website (www.efrag.org), which we attach for your reference. In particular, ABI agrees with the EFRAG comments in the part of the document on the *main comments on ED 3*. In any case, we should like to underscore some problems with *Exposure Draft 3 Business Combinations* of special importance for the Italian banking system.

In the attached document:

- we offer some comments, following the points touched on by EFRAG in its own paper;
- we supplement EFRAG's answers to the questions on ED3;
- we answer the questions relating to ED on IAS 36.

Yours sincerely,

Giuseppe Zadra
(General Manager)

LG/
Progetto IAS/Position Paper/Commenti ABI su ED3

ABI's comments on ED3

Abolition of Pooling Accounting

We agree that the *Pooling of Interest Method* should not be applied to the transactions included in the Exposure Draft.
However, we believe that the abolished rules for pooling accounting can be used to govern combinations of entities under common control, and that therefore the rules now being abolished should be recouped in Phase II of the project.
We agree with EFRAG on the use of fresh start accounting in all transactions where it is hard to identify the acquiring and the entity acquired.
We should further like to note that in some special contexts (as is the case of the Italian banking system) this accounting method could apply to a large number of transactions. We accordingly consider that the problems of how to apply fresh start accounting and of the situations in which it could be applied should be considered by the IASB in Phase I of the business combination project.

Goodwill accounting

In our view, the identification and "selection" of the Cash Generating Unit ("CGU") is the crucial moment in goodwill accounting; specifically, it is decisive to application of the impairment test.
We feel that the definition of CGU given in ED 3 could lead to making the impairment test at too detailed a level. Accordingly, we think that the rules for allocation of goodwill need to be modified to increase the size of the CGUs, for two reasons:
- convergence of IAS with US GAAP: in the US GAAP the reporting units seem to be much broader than the CGUs as defined under IASB;
- excessive complexity, especially for the banking industry, for which CGUs could coincide with thousands of branches and operational units.

Furthermore, given the specificities of the sector, a guide to goodwill accounting and allocation especially for banks would be desirable.

Standards for asset and liability accounting and accounting for negative Goodwill

We agree with EFRAG's comments on the following two matters:
- it is inconsistent to enter liabilities in accounting of business combinations when they cannot be entered according to other IAS;
- it is illogical to enter immediate proceeds when the interest in the net fair value of identifiable assets and liabilities exceeds the purchase cost (negative goodwill).

In business combinations, these two aspects are bound up with one another, in that there is a need to account for additional liabilities (ordinarily not entered) when the interest in the net fair value of the identifiable assets and liabilities exceeds the purchase cost. We therefore believe that the accounting of business combinations must use methods of entry that are not inconsistent with the rules laid down in the other accounting standards. In this particular case, we consider it more appropriate to enter a "negative goodwill" rather than "immediate proceeds" or a liability normally not enterable.

Impairment Test

In principle EFRAG's comments are right: acquired goodwill should be distinct from the acquirer's pre-existing goodwill and from the internally generated goodwill after the transaction.

From a practical point of view, we think that any solution adopted must stress simplicity and certainty in application. In particular, let us observe that in banking it will be quite problematic, in practice, to make the distinction between goodwill "acquired" and that "internally generated".

Disclosures

We agree with EFRAG that "the amount of disclosures required by the proposal [is] excessive".
In our opinion, the excessive burden of the disclosures is strictly bound up with the procedures for allocating goodwill, discussed above. The approach via CGUs, in our view, is different, over-detailed, compared with the "reporting unit" approach used by the US GAAP. The CGU approach could mean excessive segmentation of the process of calculating goodwill and allocating fair value, and therefore make the disclosures too costly.

Criteria for Recognising Intangible Assets Acquired in a Business Combination

In principle we agree with EFRAG: "assets and liabilities, which do not qualify for recognition under other standards, would be recognised as components of goodwill".
However, we consider that some specifically banking assets, such as "core deposits", owing to their great importance in bank acquisitions, should be covered by a special set of rules or else treated separately as examples in the guidelines given in the appendix to ED3.

Other problems not dealt with in the EFRAG letter

The concepts and terminology of the ED in any event raise problems of comparability with US GAAP

Apart from the difference (at least conceptual) between CGU and report unit, there is the problem of gauging the practical importance of terminological differences, in some cases conceptual differences (to cite another example, the reference to the notion of "recoverable amount") before we can conclude that effectively the new provision of ED 3 fully reflect the impairment test system (on two levels) and the stringent logic set forth in FAS 142. In this regard, we advocate the closest practicable alignment with the GAAP to eliminate problems of application.

Determining the "cost" of the "business combination"

This notion is found in para. 23 of ED 3. Although at first reading it may seem intuitively clear, in application to banking it will raise no few problems. We therefore suggest supplementing the illustrative guidelines in the appendix.

Determining the date of acquisition

Defining the reference date as the date on which the purchaser effectively obtains control of the entity acquired seems to be a simple concept, but it nevertheless has to be applied to progressive events (extraordinary corporate events). And conceptually, it is not identical to the date on which the transaction is completed.
Here again, we think a special clarification is in order, which could be provided as part of the illustrative examples in the appendix. Like those we call for above, this clarification would serve the further purpose of better aligning ED3 with existing international standards and practices concerning business combinations (in particular the US GAAP)

EXPOSURE DRAFT 3

BUSINESS COMBINATIONS - QUESTIONS

We agree with the answers and comments of EFRAG's draft response. Below, therefore, we discuss only those of EFRAG's answers for which we feel additional comments are needed.

<u>Question 1 – Scope</u>

The Exposure Draft proposes:

(a) to exclude from the scope of the IFRS business combinations in which separate entities or operations of entities are brought together to form a joint venture, and business combinations involving entities under common control (see proposed paragraphs 2 and 3 and paragraphs BC9-BC11 of the Basis for Conclusions).
Are these scope exclusions appropriate? If not, why not?

(b) to include in the IFRS a definition of business combinations involving entities under common control, and additional guidance on identifying such transactions (see proposed paragraphs 9-12 and Appendix A, and paragraphs BC12-BC15 of the Basis for Conclusions).
Are the definition and additional guidance helpful in identifying transactions within the scope exclusion? If not, what additional guidance would you suggest, and why?

Answer

We agree with the Board's proposal. However, in our view "business combinations involving entities under common control" should be addressed in this IFRS, without waiting until phase II of the project.

<u>Question 2 – Method of accounting for business combinations</u>

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?

Answer

We agree with the IASB proposal and believe that purchase accounting is the appropriate method for business combinations that are real acquisitions.

We further fell that even in phase I it must be decided, when the assets of the entity acquired kept in a separate company after a purchase business combination, whether or not the new accounting base under the purchase method must be reflected in the balance sheet of the subsidiary, or whether push-down accounting should be applied.

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

The Exposure Draft proposes that an acquirer should recognise separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably (see proposed paragraphs 36 and 45 and paragraphs BC80-BC85 of the Basis for Conclusions).
Is this appropriate? If not, why not?

Answer

We do not believe it is appropriate to recognise contingent liabilities in an acquisition if it is not possible to recognise them under the current requirements.
We consider it better to enter these liabilities as negative goodwill especially if the interest in net assets (not counting these liabilities) is greater than the purchase cost.

<u>Question 8 – Goodwill</u>

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?

Answer

We agree that goodwill acquired in a business combination is an asset. The main problem is measuring and allocating it.

We believe that this process must be conducted at a higher level than that of the Cash Generating Unit. Accordingly, we consider that the goodwill allocation process must be revised, with a view among other things to greater convergence with the US GAAP, where this allocation is performed at the level of the reporting unit.

Proposed Amendments to IAS 36

IMPAIRMENT OF ASSETS

Question 1 – Frequency of impairment tests

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

Answer

a) We agree on the frequency of impairment test proposed by the IASB.
b) We share the same concern expressed by EFRAG and OIC about the different timing of the impairment test for goodwill and intangible assets with indefinite life. Nevertheless, we believe it could be an acceptable compromise allowing testing goodwill for impairment at a date other than the balance sheet date for the first time it is tested (within the end of the year in which the acquisition has occurred), provided that as of the second year it has been recognized in the financial statements, it is then consistently tested at the balance sheet date.
c) The requirement of testing for impairment *indefinite intangible assets* *whenever there is an indication, other than annually*, is reported just in the appendix (par.C7). Paragraph 8 and 8A, indeed, refer, respectively, to "*Balance sheet date*" and "*the end of each annual reporting period*". Differently, the requirement of testing for impairment *goodwill* *whenever there is an indication, other than annually*, is included in the text of the standard (par. 85). Why? As Appendix C is not an integral part of the standard, does this have any particular implication, especially in the perspective of E.U. endorsement ?

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?

Answer

Yes we agree as the indefinite life does not make different *the way* an intangible contributes to the Entity cash flows. Therefore, the length of the useful life cannot be a discriminating issue for the way intangible assets are measured. We do not agree with EFRAG to the extent that intangible with indefinite life should be treated as goodwill. Goodwill indeed is the remainder of the excess cost, once it has been spread over the identifiable assets and, therefore, when compared with other intangible assets it lacks the feature of identifiability.

<u>Question 3 – Measuring value in use</u>

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?*

Answer

Yes we agree on (a).

In respect of (b), we think it should be clarified how to take account of management's past ability and who is to take account of it. Especially:

(a) Are the accountants asked to modify the management's best estimates arguing about the level of accuracy the management's forecast have proven to have in the past? If so, is this reasonably expectable?

(b) Does it have to be taken into account in a different way, and if so how, an inability resulted in over-valuation as well as an inability resulted in undervaluation of the cash flows? Is this anyhow linked with the use of budgets?

<u>Question 4 – Allocating goodwill to cash-generating units</u>

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?*

Answer

Yes we agree with the IASB proposals (a), (b) and (c). However, as to (b) we suggest the Board might find appropriate considering the opportunity to add, in the Appendix A, a more detailed example to clarify the calculation of relative values and the consequent determination of the goodwill to be associated with the operation disposed.

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?

Answer

We agree on the proposal just as long as it is intended to be a temporary solution to be discussed again along with a more broadly definition of the objective of accounting measurement (par. C 17).

Inasmuch the IAS 38 prohibits explicit recognition of any *internally generated goodwill* whereas the proposed system results in an backdoor capitalization *of internally generated goodwill* (C64) , it creates a strong discrimination between entities who have gone through a combination and entities who have *not* gone through a combination, and, within the same entity, between CGUs to which goodwill has been allocated and CGUs to which goodwill has *not* been allocated. It also seems to may end in a less favorable treatment for smaller and younger entities whose internally generates goodwill is often limited. An example may help. Given two banks, both with a market value of about 5 times the book value. Book Value of the first is 10 times book value of the second. The first, indeed, runs about 100 branches while the second just run 10 branches. Both banks buy 50 branches from a third bank, who is selling out the all of its 100 branches. Both banks pay a price of 50 million euros and recognize goodwill for 45 millions as carrying value of a branch is generally trivial. As they start managing and monitoring the acquired branches along with the preexisting ones, both banks allocate goodwill to a unique CGU made out of the old and the new branches. After one year, both banks realize that the acquisition was not a bargain and the value of the acquired branches is indeed about 50% of the price paid. Even if the substance of what has happened to both banks is the same, it is highly likely that the impairment loss the larger bank will recognise, if any, is going to be much smaller than the one the other banks is recognising. The former, indeed, had a preexisting internally generated goodwill of about 10 times larger than the latter.

Question 6 – Reversals of impairment losses for goodwill

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

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

Answer

We agree with the concern expressed by some Board members and reported in par. C64 about a possible inconsistency with the way goodwill is tested for impairment.
Again we believe this issue need to be addressed again along with a more broadly definition of the objective of accounting measurement (par. C17).

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?

Answer

We agree on the concern the EFRAG expressed about the excess of information required.
Particularly, we underline as for when the entity itself is a CGU requirement par 134(d) requires disclosure of the recoverable amount of the whole entity to be made at any year. This again invites to offer a broader solution to the objective of Accounting Measurement.

April XX, 2003

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

DRAFT COMMENT LETTER FOR
COMMENTS BY NO LATER THAN MARCH 7, 2003

Dear David,

Re: ED 3 Business Combinations,
Proposed Amendments to IAS 36 *Impairment of Assets*, and IAS 38 *Intangible Assets*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft 3 *Business Combinations* and *Proposed Amendments to IAS 36 Impairment of Assets and IAS 38 Intangible Assets.* This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

Generally we support the proposal to eliminate the use of pooling of interests accounting. However, whilst we accept that in most instances an acquirer can readily be identified, we are concerned that in a number of borderline cases it is difficult to decide which entity is the acquirer and which the acquired – hence, very different consolidated balance sheets result from such a narrow decision. We believe therefore that fresh start accounting may be appropriate in such cases but note that IASB intends to consider this only in phase II of the Business Combinations project. We have therefore to reserve judgement on that aspect.

In principle we agree with impairment testing of goodwill and intangibles on a regular basis because, in theory at least, it better reflects loss in value than a somewhat arbitrary amortisation process. However, we have serious concerns about the reliability and complexity of the proposed impairment test. Where future cash flows are reasonably predictable the impairment test may be relied upon to produce useful information to investors or other users of financial statements. That may be the case, for example, in the utilities industry. In developing and more volatile industries (such as "high tech" and telecoms industries), on the other hand, future cash flows are less predictable. Moreover the complexity of the impairment test and the allocation of goodwill to a number of cash generating units may suggest a spurious degree of accuracy. In such cases we suggest that IASB should further consider the possible use of amortisation as an alternative accounting treatment.
We recognise that a number of assumptions and allocations have to be made in applying the impairment test to individual cash generating units and that it is important for users of financial statements to understand the effects of those factors. Nevertheless, we regard the extent of disclosures as being excessive to the point of drowning the important information in a sea of detail.

We therefore urge IASB to simplify the impairment test itself and to reconsider the need for all items of disclosures.

We expand on these points and provide other general comments in Appendix 1 to this letter. Appendices 2, 3 and 4 set out our answers to the questions raised in the draft standard and the proposed amendments to IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*.

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Johan van Helleman
EFRAG, Chairman

Summary of EFRAG's *main* comments on ED 3 *Business Combinations*, Proposed Amendments to IAS 36 *Impairment of Assets*, and IAS 38 *Intangible Assets*:

Abolition of Pooling Accounting

We support the Board's proposals to eliminate use of the pooling of interest method. Too often in the past business combinations that were in reality the acquisition of one entity by another have been portrayed as mergers in order to avoid goodwill amortisation costs and the restatement of assets and liabilities at fair values. We agree that in most business combinations there is a dominant party that can be recognised as being the real acquirer. Clearly it is inappropriate to use anything but purchase accounting in such cases.
Nevertheless, we are concerned that in a number of borderline cases it is much more difficult to identify who is the acquirer and who the acquired. Depending on which way the decision goes there can be very different balance sheets because the assets and liabilities of only one of the combining entities are adjusted to fair value. In our view there is a strong case for using "fresh start" accounting in such situations because the balance sheets of both entities are then adjusted to reflect fair values. Fresh start accounting will, we understand, be considered by the Board in phase II of the Business Combinations project and we therefore intend to comment further on this issue at that time.
However, our initial thoughts are that if fresh start accounting is to be used as an alternative to purchase accounting, the Board will need to put forward suitable, non-arbitrary and unambiguous criteria for its use.

Accounting for Goodwill

We have considered the two alternative accounting treatments of testing goodwill for impairment and amortisation over its useful life. Overall, the impairment only approach facilitates assessment of the remaining goodwill's fair value on an annual basis and results in the recognition of a write-down only if the fair value of acquired goodwill is impaired, whereas the periodic amortisation of goodwill results in an amortisation charge even if there is no loss in the value of the acquired business.

We do, however, have concerns about the complexity and the reliability of the impairment testing requirements. The concern about complexity relates to the need to allocate goodwill to a number of cash-generating units (in a major acquisition) and then to determine the present value of future cash flows to establish the value in use. Different discount rates may have to be used for the various cash-generating units (CGUs) and estimated in accordance with some complex requirements as set out in Appendix B of ED 3. Whilst there is some convergence with US requirements in the impairment test the US requirements are applied at a higher level and to that extent are less complex.
The reliability of estimates of future cash flows can vary greatly depending on a number of factors such as maturity of the industry (a developing industry will have less easily determinable future cash flows than a mature industry) and economic prospects (interest rates being volatile or projections of future revenues being reduced in a period of economic downturn, for example).

Normally EFRAG does not support the introduction of options in International Financial Reporting Standards, but in view of the complexity of the impairment test and the lack of reliable numbers in certain cases we urge IASB to consider permitting the alternative approach of amortisation (see also our response to Question 8 of ED 3).

Recognition Criteria for Assets and Liabilities

In certain cases the Exposure Draft ignores the recognition criteria of assets and liabilities laid out by the Framework and existing standards (e.g. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). As a result, certain assets and contingent liabilities would be recognised only because of the business combination.
We do not agree with this approach and suggest applying the recognition criteria of other standards and the framework, consistently in a business combination. It would seem inconsistent to include contingent liabilities acquired in a business combination at fair value but not contingent assets. Furthermore it appears wrong to account for acquired contingent liabilities on the balance sheet but not other contingent liabilities, although we support the view that contingent assets and liabilities are part of the factors which determine the price of the acquisition.
We also regard it as inconsistent to recognise certain intangibles (e.g. in-process research and development) in business combinations when they may not be recognised otherwise. After the business combination the acquired intangibles will be shown in the consolidated financial statements in a line item that may give the impression it shows all in-process research and development whereas it shows only that acquired in the business combination. Care will be needed to avoid such misunderstandings.

Accounting for "negative goodwill"

If the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities exceeds the cost of the acquisition, it is proposed that the excess has to be recognised immediately in profit or loss after reassessing the identification and measurement of the net assets acquired and the measurement of the cost of the combinations.
Negative goodwill can arise in various ways: for example, bargain purchases, forced sale by the vendor, expectation of future losses or expenses. We find it illogical to recognise an immediate gain in all such cases and believe it more appropriate to adopt a parallel treatment to the accounting for positive goodwill. A gain would thus not be recognised until the future expenses or losses are incurred.

Impairment Test

The impairment test as proposed does not distinguish between acquired goodwill and pre-existing goodwill of the acquirer nor between acquired goodwill and goodwill internally generated after the transaction. This results in "cushions", so avoiding recognition of real impairment losses in certain situations when the impairment test is performed. We believe that this undermines the reliability of the information obtained.
The Board claims that there seems to be no alternative design for the impairment test to avoid this. This may be true of the replacement of acquired goodwill by the self-generated goodwill of the acquired business but we believe a stronger effort should be made to eliminate the cushion provided by the pre-acquisition, self-generated goodwill of the acquirer. The current UK accounting standard FRS 11 *Impairment of Fixed Assets and Goodwill* attempts to make such a distinction.

Disclosures

We consider the amount of disclosures required by the proposal to be excessive. We, therefore, urge IASB to consider reductions in the level of detail. For example, we believe if a segment includes different cash-generating units, where for some cash-generating units the recoverable amount is net selling price and for others it is value in use, the information required by paragraph 134 (e) and (f) may be of little benefit to the reader.

Criteria for Recognising Intangible Assets Acquired in a Business Combination

The Exposure Draft proposes that the probability recognition criterion is always satisfied for separately acquired intangible assets (paragraph 22) and for intangible assets acquired in a business combination (paragraph 29). In addition it proposes 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.
We disagree with the Board's proposal because we believe that the general principle that an asset is recognised only (i) when future economic benefits will probably flow to the entity and (ii) the cost or value can be measured reliably should be consistently applied in all situations, including business combinations. The current proposal results in an inconsistent treatment of internally generated and externally acquired intangible assets, because the probability criterion for recognition of an asset as defined in the Framework is now presumed to be satisfied in the case of a business combination or individual acquisition. We are aware that the proposal reflects long-standing US practice whose object was to recognise as far as possible any assets and liabilities existing at the date of the combination that, even though contingent, had entered into the assessment of the price. That approach was understandable when goodwill was regarded as a single unidentifiable residual. The current proposals, however, which allocate goodwill to cash generating units and track the continuing value of each, offer the possibility of a new approach. Contingent assets and liabilities, which do not qualify for recognition under other standards, would be recognised as components of goodwill and separately assessed for impairment. That recognises them for what they are - rights or obligations whose outcome is too uncertain for them to be recognised individually as assets or liabilities but forming part of the premium paid for acquisition of the business. There would be no possibility of misleading users by including in post acquisition balance sheets items that would not appear there if they had arisen in the normal course the company's business.

EXPOSURE DRAFT 3
BUSINESS COMBINATIONS

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?

Draft Response

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

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

QUESTION 2 – METHOD OF ACCOUNTING FOR BUSINESS COMBINATIONS

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

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

Draft Response

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

Question 3 – Reverse acquisitions

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

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

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

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

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

Draft Response

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

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

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

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

Is this appropriate? If not, why not?

Draft Response

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

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?

Draft Response

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

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?

Draft Response

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

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

We do think it illogical to recognise contingent liabilities in an acquisition, if it is not possible to recognise them under the current requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* The nature of a contingent liability does not change as a result of an acquisition and we believe the IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* criteria should still be applied. Although the purchase price of the acquired entity may include an allowance for contingent liabilities (and for contingent assets), we are not convinced that their fair values can be measured reliably.

Many contingent liabilities arise from legal claims (for example for tobacco or fast food industries) and can result in very large figures according to Appendix B15 (l), which requires the amount of the contingent liability to "reflect all expectations about possible cash flows and not the single most likely or the expected maximum or minimum cash flow". The resulting number does not reflect the potential future cash outflow because it is based on an average expectation covering a wide spectrum of possible outcomes. It is very difficult in reality, sometimes impossible, to quantify the possible outcome of contingent matters such as legal proceedings.

Once contingent liabilities are recognised separately, the acquirer must measure them at their fair values with changes in fair value recognised in profit or loss (paragraph 46). Such contingent liabilities are explicitly excluded from the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* We disagree with the proposal, because it results in inconsistent treatment between contingent liabilities acquired in a business combination and other contingent liabilities of the same or a different entity.

In addition, we understand from BC74 that the Board agreed that the role of probability in the Framework should be considered more generally as part of a later Concepts project. While we welcome this initiative, we believe that meanwhile the recognition criteria for assets and liabilities should not be altered in the case of a business combination.

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?

Draft Response

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

Question 8 – Goodwill

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

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

Draft Response

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

We considered the two alternative methods of accounting for goodwill after initial recognition i.e. testing for impairment and amortisation over the useful life.
The first method has as significant advantages that in cases of indefinite useful life of goodwill with no indication of diminution in value of the acquired entity, no amortisation or impairment has to be recognised so that no charge to income has to be made. In addition, this method has been adopted in the U.S.A. and inclusion in IFRS will therefore bring about worldwide convergence.
On the other hand the impairment test as proposed has conceptual and practical weaknesses, for example:

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

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

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

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

Question 9 – Excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities

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

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

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

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

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

Draft Response

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

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?

Draft Response

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

Other comments

1. Disclosure requirements of paragraphs 73 to 76

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

<u>PROPOSED AMENDMENTS TO IAS 36</u>
<u>IMPAIRMENT OF ASSETS</u>

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?

<u>Draft Response</u>

We do not agree with the Board's proposal that:

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

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

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?

<u>Draft Response</u>

Yes, we agree. Although avoidance of arbitrage would suggest that the treatment of intangibles with indefinite useful lives acquired in a business combination should be the same as goodwill, we accept that all intangibles should continue to be reviewed for impairment under IAS 36 *Impairment of Assets* until such time as the standard is reviewed in its entirety.

<u>Question 3 – Measuring value in use</u>

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

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

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

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

Draft Response

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

QUESTION 4 – ALLOCATING GOODWILL TO CASH-GENERATING UNITS

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

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

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

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

Draft Response

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

<u>Question 5 – Determining whether goodwill is impaired</u>

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?

<u>Draft Response</u>

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

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

to be made. However, we do believe that the Board could do more to identify and eliminate from the calculation the pre-existing goodwill of the acquirer.

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

Question 6 – Reversals of impairment losses for goodwill

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

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

Draft Response

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

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

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

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

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

Draft Response

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

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

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

PROPOSED AMENDMENTS TO IAS 38
INTANGIBLE ASSETS

Question 1 – Identifiability

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

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

Draft Response

WE AGREE THAT THE SEPARABILITY AND CONTRACTUAL OR OTHER LEGAL RIGHTS CRITERIA ARE APPROPRIATE FOR DETERMINING WHETHER AN ASSET MEETS THE IDENTIFIABILITY CRITERION IN THE DEFINITION OF AN INTANGIBLE ASSET AS PRESCRIBED IN PARAGRAPH 11.

QUESTION 2 – CRITERIA FOR RECOGNISING INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION SEPARATELY FROM GOODWILL

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

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

Draft Response

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

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

QUESTION 3 – INDEFINITE USEFUL LIFE

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

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

Draft Response

We support the useful life requirements in paragraphs 85 – 90. The existing 20 year useful life presumption is arbitrary and often unrealistic. Although we agree that an indefinite life is usually dependent on future maintenance expenditure, it

is difficult to determine how much is required to maintain the asset at its present level of performance (see paragraph 88). This approach therefore introduces another arbitrary element.

<u>Question 4 – Useful life of intangible asset arising from contractual or other legal rights</u>

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)?

<u>Draft Response</u>

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

<u>Question 5 – Non-amortisation of intangible assets with indefinite useful lives</u>

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?

<u>Draft Response</u>

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

Other comments

1. Directly attributable expenditures

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

END