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INTANGIBLE BUSINESS

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International Accounting Standards Board
30 Cannon Street
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4 April 2003

Dear Sir

RESPONSE TO ED 3

I enclose the response from Intangible Business to ED 3. We are a niche valuation and intangible asset advisory company. Our comments address the Exposure Drafts of IAS 36 on Impairment and IAS 38 on Intangible Assets.

One of our service areas is valuation work required in connection with financial reporting and, in particular, purchase price allocations to recognise intangible assets following an acquisition, and impairment reviews. I lead this area for Intangible Business - my background is in the specialist valuation groups of Ernst & Young, Arthur Andersen and Deloitte & Touche. Prior to that I worked at the Accounting Standards Board where I developed the intangible asset and impairment proposals that underlie UK standards FRS 10&11. Intangible Business has further strong credentials in the area of intangible asset valuations and impairment reviews.

This response, therefore, draws on our experience of the practical needs of preparers of accounts and the rigour required by standard setters.

If you have any queries in connection with our response, please contact me on 020 7261 0661 (direct), 07881 511555 (mobile) or email at shan.kennedy@intangiblebusiness.com. We would be very pleased to elaborate on any of the points discussed.

Yours faithfully

Shân Kennedy

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RESPONSE FROM INTANGIBLE BUSINESS LIMITED
to
EXPOSURE DRAFT of IAS 38: INTANGIBLE ASSETS

Question 1: Identifiability

We agree 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. We note that this is consistent with the requirements of SFAS 141.

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

We agree that, with the exception of an assembled workforce, sufficient information can reasonably be expected to exist to measure reliably the fair value of an intangible asset acquired in a business combination.

Question 3: Indefinite useful life

We agree with the proposal to remove the rebuttable presumption that an intangible asset's useful life cannot exceed 20 years, and to require its useful life to be regarded as indefinite when there is no foreseeable limit on the period of time over which the asset is expected to generate net cash inflows for the entity.

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

We agree with the proposals in paragraphs 91 and 92 of the Exposure Draft (ED) regarding the inclusion of a renewal period in the useful life of an intangible asset.

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

We agree with the proposal that an intangible asset with an indefinite useful life should not be amortised.

Comment in respect of paragraph 35 of the ED of IAS 38

In addressing the issue of measuring the fair value of an intangible asset acquired in a business combination, the ED makes comments about measurement methods in paragraph 35. We consider that the guidance provided in paragraph 35 is outdated. We note, in particular, that this guidance originates from that included in FRS 10, which was drafted at a time when intangible asset measurement techniques were less sophisticated and developed than they are now.

The method of valuing intangible assets that is currently considered most rigorous and reliable is 'relief from royalty'. It requires application of:

- customer/stakeholder research;
- market intelligence; and
- financial information

in respect of:

- the intangible asset;
- its position against comparables; and
- its position against other contributors to business value.

The methodology derives a forecast notional royalty income stream (relating directly to the intangible asset) which is discounted to reach net present value.

The relief from royalty method may be supported by other methods such as ‘premium profits’. We consider that reference to the relief from royalty methodology should be made in paragraph 35.

We note that the ED of revised IAS 36 proposes, in paragraph 134(f), that where recoverable amount is determined by reference to net selling price (which we have commented in our response to that ED is likely to be approximated by fair value), the methodology used to determine net selling price shall be disclosed. It would, therefore, be consistent with that paragraph if the methodology used to determine the fair value at which the intangible asset was initially recognised was also disclosed.

RESPONSE FROM INTANGIBLE BUSINESS LIMITED
to
EXPOSURE DRAFT of IAS 36: IMPAIRMENT

Overall comments

In overall terms, we consider that the Board has suggested a comprehensive set of changes and improvements to the impairment review under IAS 36. Specifically:

- we agree with the proposals in respect of frequency of tests;
- we consider that the impairment review process for intangible assets would be easier to apply if intangible assets were reviewed by reference to fair value rather than by reference to recoverable amount;
- a number of different factors should be taken into account in the measurement of value in use but that in practical terms, it is easier to reflect these through the discount rate than through cash flow forecasts;
- the proposals regarding allocation of goodwill to cash-generating units are appropriate;
- the proposals in respect of determining whether goodwill is impaired are appropriate and, in particular, that the screening test makes practical sense;
- that reversals of goodwill impairment should continue to be allowed but under stricter conditions; and
- that the disclosures suggested would represent a strong improvement to the robustness of the impairment review but that these need to be balanced carefully with confidentiality concerns of the preparers of accounts.

We note that the Board does not provide specific guidance or comments in respect of intangible asset valuation methodologies. We note the recent increases in the number of intangible asset valuations that are performed and consequent developments and improvements in methodologies. We consider that the Board should now start to refer in its guidance to preferred methodologies, such as 'relief from royalty'.

Question 1: Frequency of impairment tests

We concur with the proposal that an intangible asset with an indefinite useful life, or that is not yet available for use, should be tested for impairment at the end of each annual reporting period.

We also concur with the proposal that acquired goodwill should be tested:

- before the end of the first reporting period after which it was acquired; and, thereafter
- annually, or more frequently if there is an indication of impairment.

In respect of the first requirement above, we note that it is unlikely that an entity would identify an impairment before the end of the first reporting period in which the goodwill was acquired, as this would be likely to imply that there had been an overpayment for the acquisition from which the goodwill arose. This proposal does, however, focus the attention of acquirers on the consideration paid in acquisitions.

Question 2: Intangible assets with indefinite useful lives

The Exposure Draft (ED) proposes that the recoverable amount of intangible assets with indefinite useful lives should be measured at the higher of value in use and net selling price. We concur with this approach in principle but note that this is inconsistent with SFAS 142 under which intangible assets with indefinite useful lives are reviewed for impairment by reference to their fair value. We note, however, the comment in paragraph C11 of the Basis for Conclusions that, at this stage, the Board was not seeking to reconsider the general approach to impairment testing under IAS 36.

In practice, fair value is likely to approximate to net selling price and we consider that reporting entities will find it easier to determine fair value than to determine recoverable amount in respect of indefinite-lived intangible assets. We note also that a fair value determination will have been performed on acquisition of the intangible asset. An entity would need to determine value in use in connection with the impairment review only where fair value, as adjusted to achieve net selling price, was lower than carrying value and where it was considered that there were reasons why value in use would be higher than fair value – i.e. that the intangible asset had a higher value to the owning entity than it would have in the market generally.

We note that no guidance is provided on appropriate methodologies that could be used to determine fair value/ net selling price of intangible assets although the approach adopted by the entity would be disclosed under the proposals at paragraph 134.

We consider that, overall, the impairment review would be simpler to apply if intangible assets were tested by reference to their fair value.

Question 3: Measuring value in use

(a) Elements to be reflected in future cash flows

- *The ED proposes that both expected future cash flows and expectations about possible variations in the amount or timing of the future cash flows should be taken into account.*
  We concur that, ideally, a net present value calculation should take into account both expected value and possible variations from expected value. In practice, however, we doubt that preparers of accounts would find it feasible on a cost/ benefit basis to prepare both a forecast of expected cash flows (a time-consuming exercise if performed properly) and variations from these cash flows for all cash-generating units (CGUs). We suggest, therefore, that a more practicable alternative would be to consider possible variations from expected value only where it has been difficult to forecast expected value with any certainty – for instance, in the case of entities with only a short past history and/or volatile past results or future expectations.

- *The ED proposes that the time value of money and the price for bearing the uncertainty inherent in the asset should be taken into account.*
  It is standard valuation practice in determining the fair value of an intangible asset to discount the expected cash flows at the risk-adjusted rate of return required by the asset. In determining the value in use of an intangible asset, however, it would be more appropriate to factor uncertainty risk into the cash flow forecasts and to discount at the weighted average cost of capital (WACC) of the CGU.

We consider it important that the Board provides guidance on whether the size of the CGU should be taken into account in determining its WACC. Generally, if the capital asset pricing model (CAPM) is used to determine the cost of equity component of the WACC, an adjustment is made to reflect the size of the unit, in this case the CGU, for which WACC is being computed. This is highly relevant as an entity is likely to have determined the price it is willing to pay to make an acquisition by reference to the entity's WACC rather than the CGU's WACC, i.e. by reference to a larger unit than the CGU. The CGU, being a smaller unit that the entity, may have a premium added in determining its cost of equity to reflect that it was smaller than the entity and hence more risky.

- If the size of the CGU is taken into account, this would provide a more relevant test by reference to the CGU; but
- if the size of the CGU is not taken into account, this would provide a more relevant test by reference to the acquisition undertaken that gave rise to the goodwill.

We would appreciate guidance from the Board in this area. We note that current interpretation of SFAS 142 is that the size of the CGU is taken into account.

- *The ED proposes that other factors, such as illiquidity, should also be taken into account.*
  We note that care should be taken in this respect. As it is a value in use calculation that is proposed rather than a fair value calculation, illiquidity should be taken into account only in so far as it affects the cash flows achievable from the asset under the current owner – it should not be taken into account in terms of the marketability of the asset per se, which would, however, be appropriate in a fair value calculation.

- *The ED asks for comments on whether entities should be permitted to reflect the above elements either in cash flow forecasts or in the discount rate.*
  If a standard CAPM model were used to derive the cost of equity of the asset, both the time value of money and uncertainty relevant to value in use would be reflected in the discount rate. We consider that this is the most practicable approach to determining value in use.

Question 3(b): Assumptions to reflect past actual and management's past ability to forecast

We agree that assumptions should reflect both past actual cash flows and management's ability to forecast cash flows accurately. Good forecasting would be supported by robust information and analysis, such as:

- research on market size, market segmentation and future growth prospects;
- details of anticipated market share;
- strategic sales and marketing plans;
- competitor benchmarking;
- distribution and channels to market; and
- past results.

Question 3(c): Additional guidance in Appendix B

We note that this guidance is the same as that provided in SFAS 142. Overall, we consider that the guidance provides a useful background and reminder to the difference between the traditional and expected value approach to determining the expected present value of the cash flows.

With respect to our comment earlier that we consider the Board should provide guidance as to whether the size of the CGU should be taken into account when determining the discount rate to apply to the cash flows, we note the following. Paragraph B17 notes that the entity's WACC could be used as a starting point in determining the discount rate and paragraph B18 notes that consideration should be given to risks such as country risk, currency risk and price risk. This seems to imply that the size of the CGU should also be taken into account but we consider that this should be clarified by the Board.

We note that paragraph B20 makes reference to the requirement in paragraph 48 of the ED that a pre-tax discount rate be used. We generally oppose the use of a pre-tax discount rate. The CAPM, which is the model used in practice to determine cost of equity, returns a post-tax not a pre-tax cost of equity. Any adjustments to reach a pre-tax cost of equity from the post-tax rate are, at best, approximate. (We note also that SFAS 142 permits the use of a post-tax cost discount rate.) We understand that the rationale behind the use of a pre-tax rate is the difficulty, in certain cases, of determining the tax rate applicable to the CGU concerned. Our practical experience, however, is that in many cases, entities have no difficulty in assessing the tax rate applicable to a particular CGU. We suggest therefore, that a more rigorous and practical approach would be to require that post-tax cash flows and a post-tax discount rate are used except where the entity is unable to determine the rate of tax applicable to the CGU in question.

Question 4: Allocating goodwill to cash-generating units

(a) Should this be at the lowest level at which management monitors the return on the investment in goodwill, provided this is at or below the segment level?

When goodwill arises in respect of a business combination, an amount has been paid over and above the fair values of the assets acquired to reflect economic benefits from assets that are not capable of being individually identified and separately recognised. At the time that the price is decided, management may not have full information regarding the entity it is acquiring and, in particular, is unlikely to be able to identify precisely how it will monitor its investment and return in the combined entity. As a result, determination of the price payable is likely to be made based on multiples of the primary businesses acquired.

After the acquisition, management will obtain further information about the acquired entity and may be in a position to allocate goodwill at a greater level of detail than the primary businesses acquired. Under the proposals in paragraphs 73-77, management would then be required to monitor goodwill at a greater level of detail than was known about at the date of acquisition. We note the provision that goodwill may be allocated at the level of several CGUs combined, where it cannot be allocated on a reasonable and practical basis to individual CGUs. We consider that this provides a reasonable and practicable compromise between monitoring goodwill at the level of the primary businesses identified at the date of acquisition and at the detailed level of individual CGUs.

We agree that it is sensible to provide a cap on the size of a CGU to which goodwill is allocated by reference to a segment as defined under IAS 14.

(b) Disposal of an entity within a CGU

We agree that when an entity disposes of an operation within a CGU, the goodwill associated with that operation should be included in the determination of the profit or loss on disposal.

One method of measuring the amount of such goodwill is on the basis of relative values. However, we consider that it would be more appropriate to allow also for the possibility that some other method might be more appropriate by reference to the nature of the goodwill concerned. To avoid abuse of this provision, the standard could be drafted such that the relative value adjustment is used unless some other method of determining the amount of goodwill involved can be shown to be more appropriate. This could include a corresponding disclosure requirement.

(c) Reorganisations of CGUs

Our view in respect of reorganisations is the same as that set out above in respect of disposals.

Question 5: Determining whether goodwill is impaired

(a) Recoverable amount of a CGU to be the higher of the unit's value in use and net selling price

We agree that this is the appropriate method of determining the recoverable amount of a CGU to which goodwill has been allocated.

(b) Use of a screening mechanism for identifying potential goodwill impairments

We consider that the screening mechanism provides a reasonable approach in practice to identifying whether there may be an impairment in acquired goodwill. There may be occasions when the book carrying values of intangible and tangible assets are lower than their fair values and, in these situations, the screening mechanism could result in an impairment in goodwill not being identified.

In practice, however, we consider that it would be unduly onerous to require companies to identify the fair values of all their tangible and intangible assets in order to identify whether any undervalues of these assets were concealing an overstatement in the carrying value of goodwill.

We do, however, consider that the screening mechanism could be augmented by an "intelligent review" of a CGU to assess whether there is a likelihood that the above situation has occurred. This would include making a judgmental assessment of whether tangible and intangible assets were carried at significantly below their fair values and whether there was any reason, based on the nature of the acquired goodwill, to believe that the goodwill itself was impaired.

(c) Use of "implied" value for goodwill

We agree that for goodwill that has 'failed' the screening test, the appropriate approach is to perform the second step of the impairment review and to use an implied value for goodwill, as defined in paragraph 86 of the ED, in assessing whether impairment has taken place.

We note, however, that if intangible assets were tested for impairment by reference to their fair values, as is the case with US GAAP, rather than by reference to recoverable amount, the second step would be less onerous.

Question 6: Reversals of impairment losses for goodwill

The ED proposes that impairments of goodwill may not be reversed. This is a proposed change to IAS 36 and FRS 11 to bring it into line with SFAS 142.

The explanation for this in the Basis for Conclusions is that the Board was concerned about the potential for recognition of internally generated goodwill, albeit that the Board acknowledges that it is impossible to prevent some cushion arising in the assessment of the carrying value of acquired goodwill from internally generated goodwill.

We consider that there are instances where goodwill is impaired as a result of a specific external event and that there is a subsequent reversal of that event, consistent with the requirements of IAS 36 and FRS 11. An example would be legal action. We agree that it could be difficult to distinguish whether the reversal of the impairment had arisen from the reversal of the external event or from the subsequent development of internally generated goodwill. However, we consider that there would be objective indicators as to what had caused the reversal, for instance, the length of time that had passed and, in the case of quoted entities, sudden changes in share prices. We are, therefore, of the view that reversals should be permitted with the restrictions currently included in IAS 36 being augmented through additional guidance with respect to:

- passage of time (with, for instance, a period of more than one year between the event causing the impairment and the event reversing the impairment resulting in a prohibition of reversal); and
- other external indicators such as share price movements.

Without clear evidence from these further indicators that the original acquired goodwill was back in place, goodwill impairment reversals should not be permitted.

Question 7(a): Disclosure of estimates used to measure recoverable amounts of CGUs containing goodwill or intangible assets with indefinite useful lives

We agree, in principle, that the use of disclosure requirements is an effective method of making impairment reviews robust. We note that paragraph 134 of the ED sets out disclosure requirements that are far more extensive than those previously seen in UK, US or International GAAP.

We consider that the approach to disclosure by segment could, in certain situations, be meaningless in practice. Assumptions might vary significantly from one CGU to another within a segment and aggregating them would involve the aggregation of non-homogenous items. We note, however, that in such situations the proposals of paragraph 137(c) would result in separate disclosures for that CGU.

We agree with the proposals of subparagraphs (a), (b) and (c) of paragraph 134.

In respect of subparagraph (d), we consider that information concerning the extent to which the recoverable amount of an individual CGU exceeds its carrying amount would be useful and relevant. We note, however, that for confidentiality reasons, preparers of accounts are likely to be reluctant to disclose such information. We consider, therefore, that the Board may have reached a practicable compromise by proposing that this information is provided on an aggregate basis for the CGUs in a particular segment. In practice, the extent to which aggregate recoverable amount exceeds aggregate carrying value could be distorted by a large excess in one CGU dwarfing figures in respect of other CGUs within a segment. Nonetheless, we consider that this proposed requirement would provide useful information to users of accounts and that, in particular, year-on-year comparisons of the size of the surplus would be helpful. Where there is a sudden drop from one year to the next, entities may voluntarily wish to provide further background.

<u>Subparagraph (e) – (i)</u>
Where there is more than one CGU within a segment, it is not clear how the proposals would apply. It appears that this information would be requested separately for each key assumption indicating that every key assumption for every CGU within the segment would need to be disclosed. Please could the Board provide guidance in this area.

Typically, a cash flow forecast is dependent on assumptions in the following seven areas:

(i) sales growth
(ii) operating profit margin
(iii) working capital needs
(iv) capital expenditure requirements
(v) taxation
(vi) length of explicit cash flow period
(vii) growth rate in the terminal period

If the requirement to disclose information about assumptions were retained, we consider that the standard should specify which of the above should be disclosed. This would provide greater consistency between reporting entities and avoid confusion in complying with the proposal.

We consider it unlikely that entities would willingly disclose information in respect of points (i)–(iv) above. Point (v) has been specifically excluded from the impairment review, although our comments in respect of taxation are set out in our response to question 3(c) above. Points (vi) and (vii) are addressed in the response to subparagraphs (ii) and (iii) below.

Situations may well arise in which the impairment reviews for individual CGUs are sensitive to any or all of the factors at (i)-(iv) above. Disclosure of information in respect of these factors would enhance the robustness of the impairment review and enable users of accounts to form their own views as to whether entities were being over optimistic in their projections. There is a proposal that the projections be based on past history and take account of past ability to forecast – the need for additional disclosure is really dependent upon the extent to which the Board believes that auditors would be able to control over optimism in forecasting without any additional disclosure.

Overall, whilst we can see the reasoning behind the Board's proposal of these disclosures and agree that they would add robustness to the impairment review, we consider that they are likely to be resisted by preparers of accounts. We note in this respect that, unless US standards were to be altered to include similar disclosures, these proposals could be viewed as being so onerous that they would influence whether a company sought to report under US or International GAAP.

<u>Subparagraph (e) - (ii)</u>
There may be sound reasons why the explicit cash flow period should be longer than five years. This would be the case for businesses with product or economic life cycles of more than five years. We consider that, rather than using the word 'justified' in this paragraph, which sounds pejorative, the word used should be 'appropriate'.

<u>Subparagraph (e) - (iii)</u>
We agree that, in theory, this would be useful information that would assist the robustness of the impairment review. In practice, however, entities might set a range of, say, 0%-5% for their nominal long-term growth rate, which would allow them to make significant variations from year to year without disclosing any change in assumptions. This disclosure would be more meaningful if it required companies to disclose only the top and bottom end of any range used.

<u>Subparagraph (e) – (iv)</u>
This is a detailed disclosure proposal. The disclosure would strengthen the quality of impairment reviews as entities would be required to perform some form of stress testing of results, albeit at a single variable level, and with a cushion from other CGUs within a segment. Performing this check would assist entities with interpreting the results of their impairment reviews and provide management with useful information.

<u>Subparagraph (e) – (v)</u>
This disclosure proposal does not appear to be accompanied by a proposal to disclose the weighted average growth rate described. If the disclosure is to have meaning, we consider that both the weighted average growth rate and the change that would result in the aggregate recoverable amount of the CGUs being equal to the aggregate carrying value should be disclosed. We consider that this would be an extremely valuable disclosure.

Subparagraph (f) – (i)
We consider that net selling price might be used to measure the recoverable amount of CGUs where it was difficult to forecast cash flows accurately. In these cases, we expect that net selling price would be likely to be estimated based on the 'multiples' method of valuation, for instance, a value based on a multiple of historical or forecast EBITDA (earnings before interest, tax, depreciation and amortisation). As with the disclosures proposed in subparagraph (e)–(i) above, there would be difficulties providing these in a meaningful way other than for individual CGUs.

As described earlier (see response to question 2 above), fair value might be used as an approximation to net selling price in application of the impairment review to indefinite-lived intangible assets. In this case, the methodology described would then indicate the way in which the fair values of the intangible assets concerned had been determined – such as relief from royalty method, premium profits method etc. We consider that this would provide useful and relevant information.

Subparagraph (f) – (ii)
Our view on these proposed disclosures is the same as that for the disclosures proposed at subparagraph (e)-(iv) above.

Question 7(b)

We agree that, under the circumstances set out in paragraph 137, it would be appropriate, in order that the disclosures are meaningful, for the disclosures to be made at an individual CGU level. We note, as in earlier comments, however, that this might cause preparers of accounts concern with respect to confidentiality.

Comment in respect of paragraph 37 of the ED of IAS 36

We note that paragraph 37(b) prohibits the inclusion in the cash flow forecasts used to assess recoverable amount of future capital expenditure that will improve or enhance the asset in excess of its standard of performance assessed immediately before the expenditure is made.

We note that this prohibition is consistent with that in SFAS 142. In practice, however, acquirers may purchase a business in the knowledge that through capital spend they can enhance the capacity of the acquired entity. The price paid would reflect the plan to make the capital spend and to reap the benefits of the enhanced capacity. We consider that this prohibition should be relaxed to allow the inclusion of expenditure that any rational purchaser would incur and that would enhance the capacity of the current business but that does not relate to the introduction of a new business.