CL 61

IASB PROPOSALS ON BUSINESS COMBINATIONS, IMPAIRMENT AND INTANGIBLE ASSETS

Note – these responses are confidential and should not be put on public record

The International Accounting Standards Board (IASB) has invited comments on any aspect of the exposure draft of its proposed IFRS Business Combinations, proposed amendments to IAS 36 Impairment of Assets, and proposed amendments to IAS 38 Intangible Assets. There were also specific questions asked, which are included and discussed below. Note that all comments must be submitted by 4 April 2003.

IFRS 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?

a) We are of the opinion that the scope exclusions are appropriate on the basis that the substance of joint ventures and business combinations involving entities under common control are far removed from the substance of an acquisition of an entity from a third party. It would be inappropriate to force joint venture partners to identify a controlling party if the decision would be arbitrary. Furthermore, it would be unreasonable to fair value the balance sheet in the event of a group reorganisation.

We are also of the opinion that the scope exclusions should be expanded to include 'mergers of equals' as described in the answer to question 2.

b) We are of the opinion that the definition and additional guidance provided on business combinations involving entities under common control are both helpful and appropriate.

Question 2 – Method of accounting for business combinations

The Exposure Draft proposes to eliminate the use of the pooling of interests method and require all business combinations within its scope to be accounted for by applying the purchase method (see proposed paragraphs 13-15 and paragraphs BC18-BC35 of the Basis for Conclusions). Is this appropriate? If not, why not? If you believe the pooling of interests method should be applied to a particular class of transactions, what criteria should be used to distinguish those transactions from other business combinations, and why?

We do not believe that the elimination of the pooling of interests method is appropriate. It is unreasonable to arbitrarily determine an acquirer in the event of a 'merger of equals'. The relevance of financial statements would be impaired by the fact that of two equivalent businesses, one is recorded at fair value and the other remains at historical cost, and the decision of which company's balance sheet is fair valued is arbitrary. This is exacerbated by the fact that companies would be given the opportunity to select the most advantageous company to identify as the acquirer, a judgmental decision that could be argued either way.

We are of the opinion that a user of financial statements would find it more helpful to have a set of financial statements that have been prepared on a consistent basis rather than half at fair value and half at historical value. On this basis, it would be reasonable to allow the pooling of interest method for mergers of equals.

The criteria to be used to distinguish these transactions should be consistent with the criteria for identifying the acquirer when using the purchase method. This is appropriate because it ensures that there is consistency within the accounting framework. IFRS X, paragraphs 19-20 provides criteria for control, which could be used in determining a 'merger of equals'.

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?

a) We agree with the description of circumstances in which a business combination should be accounted for as reverse acquisitions.

b) We are of the opinion that the additional guidance is useful and sufficient.

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?

We agree with the approach suggested on the basis that forming a new entity to issue equity instruments to effect a business combination is strictly a legal structuring of a transaction. The substance of the transaction is no different than an acquisition without such a structure. Therefore, to account for such a transaction based on the legal structure would impair the comparability and reliability of the financial statements.

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

Under IAS 22, an acquirer must recognise as part of allocating the cost of a business combination a provision for terminating or reducing the activities of the acquiree (a 'restructuring provision') that was not a liability of the acquiree at the acquisition date, provided the acquirer has satisfied specified criteria. The Exposure Draft proposes that an acquirer should recognise a restructuring provision as part of allocating the cost of a business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see proposed paragraph 40 and paragraphs BC55-BC66 of the Basis for Conclusions). Is this appropriate? If not, what criteria should an acquirer be required to satisfy to recognise a restructuring provision that was not a liability of the acquiree as part of allocating the cost of a combination, and why?

We agree with disallowing allocations of the cost of a business combination to provisions for terminating or reducing activities of the acquiree that were not a liability at the date of acquisition.

Question 6 – Contingent liabilities

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

We agree that contingent liabilities at the acquisition date should be recognised separately, provided the fair values can be measure reliably, as part of allocating the cost of a business combination, but only if it is probable that the contingent liability will occur. Otherwise, there would be a disconnect between what is required at acquisition and what is required in the normal course of business by IAS 37 and the Framework.

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 recognized as part of allocating the cost to be measured initially by the acquirer at their fair values at the acquisition date. Therefore, any minority interest in the acquiree will be stated at the minority's proportion of the net fair values of those items. This proposal is consistent with the allowed alternative treatment in IAS 22 (see proposed paragraphs 35 and 39 and paragraphs BC88-BC95 of the Basis for Conclusions). Is this appropriate? If not, how should the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of a business combination be measured when there is a minority interest in the acquiree, and why?

We agree with requiring the 'allowed alternative treatment' approach initially defined in IAS 22. This is important in promoting comparability and reliability, and it also better reflects the premise of control over the net assets of the acquired entity.

Question 8 - Goodwill

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

We agree with the recognition of goodwill as an asset and we also agree that after initial recognition that goodwill should be recorded at cost less any accumulated impairment losses. We agree that goodwill does meet the definition of an asset and therefore should be recorded as such.

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?

We disagree with the approach suggested. This is because the most accurate determination of fair value in an acquisition is the purchase price of that acquisition. Therefore, it is most reasonable to assume that the fair value of net identifiable assets has been overstated (as is eluded to in step (a) of the exposure draft approach). Therefore, the non-monetary assets should be reduced proportionately, after all appropriate liabilities and contingent liabilities have been recognized.

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 recognized within twelve months of the acquisition date (see proposed paragraphs 60 and 61 and paragraphs BC123-BC126 of the Basis for Conclusions). Is twelve months from the acquisition date sufficient time for completing the accounting for a business combination? If not, what period would be sufficient, and why?

(b) with some exceptions carried forward as an interim measure from IAS 22, adjustments to the initial accounting for a business combination after that accounting is complete should be recognised only to correct an error (see proposed paragraphs 62 and 63 and paragraphs BC127-BC132 of the Basis for Conclusions). Is this appropriate? If not, under what other circumstances should the initial accounting be amended after it is complete, and why?

We agree with the timeframe for recognising adjustments to provisional values. We also agree with the treatment of adjustments to the initial accounting for a business combination.

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?

We are of the opinion that the frequency of impairment testing is appropriate.

Question 2 – Intangible assets with indefinite useful lives

The Exposure Draft proposes that the recoverable amount of an intangible asset with an indefinite useful life should be measured, and impairment losses (and reversals of impairment losses) for such assets accounted for, in accordance with the requirements in IAS 36 for assets other than goodwill (see paragraphs C10-C11 of the Basis for Conclusions). Is this appropriate? If not, how should the recoverable amount be measured, and impairment losses (and reversals of impairment losses) be accounted for?

We agree with the methods proposed for measuring the recoverable amount and impairment losses of intangible assets with an indefinite useful life.

Question 3 – Measuring value in use

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

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

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

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

a) We agree with the elements listed in proposed paragraph 25A. We also agree with the option of reflecting those elements either as adjustments to the future cash flows or adjustments to the discount rate as both methods should provide the same answer and depending on the circumstances one method may be less costly to use than the other.

b) Assumptions on which cash flow projections are based invariably take into account both past actual cash flows and management's past ability to forecast cash flows accurately. Furthermore, cash flow projections have to stand up to the test of both internal standards and the standards of the external auditors. As such, it is unnecessary to make specific reference to past actual cash flows and management's past ability to forecast in the text of the accounting standard.

c) The additional guidance in proposed Appendix B is appropriate.

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?

a) Testing goodwill 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, is appropriate.

b) Goodwill associated with an operation that is disposed of should be included in the carrying value of the operation disposed of when determining the gain or loss on disposal. This goodwill should be allocated on the relative values of the operations disposed of. The term relative values should be further defined as being based on the recoverable amounts of the each the operations included in the cash-generating unit.

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, it would be appropriate for the goodwill to be reallocated. Basing the reallocation using the relative fair value approach is reasonable and necessary to be internally consistent with this standard.

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?

a) It is appropriate to measure the recoverable amount of a cash-generating unit as the higher of the unit's value in use and net selling price.

b) The use of a screening mechanism for identifying potential goodwill impairments is appropriate.

c) If an entity is performing the impairment test, the amount of the impairment loss for that goodwill is appropriately measured as the excess of the goodwill's carrying amount over its implied value.

Question 6 – Reversals of impairment losses for goodwill

The Exposure Draft proposes that reversals of impairment losses recognized for goodwill should be prohibited (see proposed paragraph 123 and paragraphs C62-C65 of the Basis for Conclusions). Is this appropriate? If not, what are the circumstances in which reversals of impairment losses for goodwill should be recognised?

We disagree with the prohibition of the reversal of impairment losses in all circumstances. We are of the opinion that the allowance for reversing impairment losses included in IAS 36, which is restricted to exceptional circumstances, is more appropriate. The value of the goodwill may be exactly as it was prior to the goodwill impairment if it has been caused by a specific external event of an exceptional nature that has reversed (ie. Government regulation). Therefore, it is unreasonable to value the goodwill at an arbitrarily low value when the effects of that event have been reversed.

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?

a) We strongly oppose the disclosure requirements proposed by the exposure draft paragraph 134, most notably c, d, e, and f. Disclosure of the items suggested in these sections would provide highly sensitive budget/forecast assumptions to competitors / suppliers / customers. It is inappropriate to require a company to disclose confidential commercial details.

b) This question becomes irrelevant based on the response to question (a).

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?

We agree with the separability and contractual/other legal rights criterion for determining whether an asset meets the identifiability criterion in the definition of an intangible asset.

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

This Exposure Draft proposes clarifying that for an intangible asset acquired in a business combination, the probability recognition criterion will always be satisfied and, with the exception of an assembled workforce, sufficient information should always exist to measure its fair value reliably (see proposed paragraphs 29-32 and paragraphs B11-B15 of the Basis for Conclusions). Therefore, as proposed in ED 3, an Exposure Draft of a proposed International Financial Reporting Standard *Business Combinations*, an acquirer should recognise, at the acquisition date and separately from goodwill, all of the acquiree's intangible assets, excluding an assembled workforce, that meet the definition of an intangible asset (see proposed paragraphs 36, 43 and 44 of ED 3). Do you agree that, with the exception of an assembled workforce, sufficient information can reasonably be expected to exist to measure reliably the fair value of an intangible asset acquired in a business combination? If not, why not? The Board would appreciate respondents outlining the specific circumstances in which the fair value of an intangible asset acquired in a business combination could not be measured reliably.

We agree with the premise that sufficient information can reasonably be expected to exist to measure reliably the fair value of an intangible asset acquired in a business combination, but if no such evidence is available, would expect to include the intangible asset acquired within goodwill.

Question 3 – Indefinite useful life

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

We agree with the treatment suggested for the useful life of intangible assets on the basis that limiting the useful life to twenty years is arbitrary.

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

The Exposure Draft proposes that if an intangible asset arises from contractual or other legal rights that are conveyed for a limited term that can be renewed, the useful life shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost (see proposed paragraphs 91 and 92 and paragraphs B33-B35 of the Basis for Conclusions). Is this an appropriate basis for determining the useful life of an intangible asset arising from contractual or other legal rights that are conveyed for a limited term that can be renewed? If not, under what circumstances should the useful life include the renewal period(s)?

We agree with the opinion that the useful life should include the renewal period only when there is evidence to support renewal by the entity without significant cost. However, we believe that the term significant cost should be further defined to be equal to or in less than the open market cost of renewing the initial contract or legal rights.

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

The Exposure Draft proposes that an intangible asset with an indefinite useful life should not be amortised (see proposed paragraphs 103 and 104 and paragraphs B36-B38 of the Basis for Conclusions). Is this appropriate? If not, how should such assets be accounted for after their initial recognition?

We agree with the non-amortisation of intangible assets with an indefinite useful life.