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EFRAG

European Financial Reporting Advisory Group

April 04, 2003

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

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.

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 an alternative accounting method – for example "fresh start" accounting - may be more appropriate in such cases but note that IASB intends to consider this only in the late part of phase II of the Business Combinations project. We stress the need to further establish a method as soon as possible and we have therefore to reserve judgement on that aspect.

We recognise the advantage of impairment testing of goodwill and intangibles with indefinite useful life on a regular basis that, in theory at least, better reflects loss in value than a somewhat arbitrary amortisation process. However, we have serious concerns about the intermingling of internally generated goodwill (before and after the acquisition) as well as 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 telecom industries), on the other hand, future cash flows are less predictable. 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, yet the logic of such allocations is not followed through, inasmuch as internally generated goodwill of the acquirer existing at the point of acquisition is not distinguished from purchased goodwill allocated to the same cash generating unit. The result is a cushion that would shield many large acquirers from ever having to recognise a goodwill impairment.

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 related 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.

Since the application of none of the two methods on a stand alone basis is a totally satisfying solution for the accounting of acquired goodwill, we believe that a distinction between goodwill with definite economic life (where the application of amortisation is required) and goodwill with indefinite economic life (where the application of the impairment-only approach is required) is a conceptually sound and practical approach which reduces complexity in many cases without impairing the quality of information compared to the proposed impairment-only approach.

Although 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, we regard the extent of required disclosures as being excessive to the point of drowning the important information in a sea of detail.

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 the use of the pooling of interests 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. Our initial thoughts are that if "fresh start" accounting is to be used instead of purchase accounting in such cases, the Board will need to put forward suitable, non-arbitrary criteria for its use. "Fresh start" accounting will, as we understand, be considered by the Board in the latter part of phase II of the Business Combinations project and we therefore intend to comment further on this issue at that time, although we would prefer to have this method proposed as soon as possible.

We strongly believe that the Board should revisit the timing of the project and the issuance of the standard to ensure that decisions made in an early phase should not be revised in a later phase of the same project, thereby changing a standard, which is already established in the interim.

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 goodwill is impaired, whereas the periodic amortisation of goodwill (in combination with impairment testing as currently required by IAS 22 *Business Combinations*) results in an amortisation charge even if there is no loss in the value of the acquired business.

We do not believe that introducing an option for entities to choose one or the other method would improve financial reporting, because it would impair the comparability of financial statements. However, the impairment-only method denies the fact that in many cases the useful life of goodwill can be estimated. In such cases amortisation of goodwill over its useful life is a well established accounting principle, currently mandated in IAS 22 *Business Combinations*. We see no conceptual or practical reasons to change this. Only in those instances where management can demonstrate that goodwill has an indefinite life do we see merits in applying the impairment-only approach. We urge the Board to reconsider the accounting for goodwill, thereby adopting the same approach as for intangibles in making a distinction between definite and indefinite useful life.

<u>Recognition Criteria for Assets and Liabilities</u>

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. In addition, it would seem inconsistent to include contingent liabilities acquired in a business combination but not contingent assets. Furthermore, it appears wrong to account for acquired contingent liabilities on the balance sheet but not for other contingent liabilities. 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. Such inconsistencies should be avoided.

<u>Accounting for “negative goodwill”</u>

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 combination.

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 is more appropriate to adopt a parallel treatment to the accounting for positive goodwill. A gain would thus be recognised in the period the future expenses or losses are incurred.

<u>Impairment Test</u>

The proposed impairment test does not distinguish between acquired goodwill and pre-existing goodwill of the acquirer nor between acquired goodwill and goodwill internally generated after the combination. This results in “cushions”, so avoiding recognition of real impairment losses of goodwill 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 for the replacement of acquired goodwill by 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.

We urge the Board to delete the second step of the impairment test (paragraph 86). We believe that the second step, which measures the amount of goodwill impairment by comparing its carrying amount with its implied value, is costly and does not usually improve the quality of the information.

In our view it suffices to allocate the identified impairment firstly to goodwill and then to intangible assets with indefinite useful life that are part of the cash-generating unit and any remainder to other assets on a pro-rata basis.

Disclosures

We consider the amount of disclosures required by the proposal to be excessive. We therefore urge the Board to consider reductions in the level of detail. For example, we believe that if a segment includes different cash-generating units, of which for some cash-generating units the recoverable amount is determined by the net selling price while for others the recoverable amount is determined by its value in use, the information required by paragraph 134 (d), (e) (ii), (iv), (v) and (f) (ii) may be of little benefit to users and too burdensome for preparers.

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 U.S. 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.
However, we believe that contingent assets and liabilities, which do not qualify for recognition under other standards, should be recognised as components of goodwill. 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. Thus, 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 of 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?

Response

(a) We agree with the scope exclusions of phase I of the Business Combinations project, but believe that phase II should deal with these issues.

However, as phase I and II are closely related we have severe concerns about the possibility of splitting the development of standards in such a way that proposals of an earlier phase are revised in a later phase within a very short period of time. This would be detrimental to a good grasp and understanding of the eventually proposed accounting for the whole area of business combinations. Furthermore, it would lead to unfortunate short-term changes in financial reporting with the risk of discrediting IFRSs. We therefore ask the Board to reconsider the process and timing of the development of this standard and to combine the different exposure draft phases into one comprehensive standard.

(b) We regard the definition of business combinations involving entities under common control and the additional guidance on identifying such transactions as helpful.

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?

Response

We agree with the abolition of the pooling of interests method. We also agree that purchase accounting is the appropriate method to account for business combinations that are genuine acquisitions. In our view it will be possible to identify an acquirer in most business combinations.
However, there are genuine mergers of equals where it is impossible to identify an acquirer. As the proposal of the Board allows no alternative method for such situations, an acquirer has to be adjudged. We believe this is an unfortunate approach with no conceptual justification. Therefore, an appropriate method should be developed as soon as possible. For the interim period we accept that the purchase method should be applied even to such mergers.

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?

Response

(a) We agree with the proposed description of the circumstances in which a business combination should be accounted for as a reverse acquisition.
However, we believe that the application of the control concept might lead to different interpretations and might therefore result in different determinations of the acquiring entity in situations of reverse acquisitions. (See our Other comment 1 (b) on the definition of control.)

(b) We regard the proposed additional guidance together with the illustrative examples as appropriate.

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

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?

<u>Response</u>

We agree with the proposal that in a business combination where a new entity is formed to issue equity instruments an acquirer has to be identified based on the evidence available.

However, this identification of an acquirer is not self-evident when no clear indications of control exist. Therefore, we ask the Board to clarify the criteria that should be applied in identifying the acquirer by way of an illustrative example.

<u>Question 5 – Provisions for terminating or reducing the activities of the acquiree</u>

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?

<u>Response</u>

We agree with the Board's 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. We strongly believe that general recognition criteria defined by the Framework should be applied consistently, in business combinations as well as in other situations.

<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?

<u>Response</u>

No, we do not believe that the proposal is appropriate. We believe that contingent liabilities should be recognised 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

We think it is inconsistent to recognise contingent liabilities in an acquisition, if it is not possible to recognise them under the current requirements for recognition of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* The nature and probability of a contingent liability do not change as a result of an acquisition and we believe the Framework and 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), they are not obligations or assets of the acquiree and 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 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. Furthermore, it would result in an asymmetrical treatment of contingent liabilities and contingent assets at least until a later phase of the project is implemented.

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. However, 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?

Response

We agree with the Board's proposal requiring any minority interest in the acquiree to be stated at the minority's proportion of the net fair values of those items.

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?

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 disagree that goodwill should always be accounted for at (non-amortised) cost less any accumulated impairment losses.

The impairment only approach has the advantage that in cases of indefinite useful life with no indication of diminution in value of the acquired entity, no charge to income has to be made. However, the impairment test as proposed has conceptual and practical weaknesses, for example:

- in applying the impairment test acquired goodwill and pre-existing internally generated goodwill will be intermingled;
- the projection of future cash flows is difficult, especially in developing and volatile industries;
- annual impairment testing is an onerous and very judgemental process, raising difficulties for many companies.

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.

We have considered proposing to introduce an option for companies to choose one or the other method, but have in the end not accepted this approach, because it might have an adverse effect on the comparability of financial statements.

Instead, we prefer to retain the amortisation approach with regular impairment testing (as currently required in IAS 22 and IAS 36) in those cases where goodwill has a definite useful economic life. We believe that management has to determine the useful life of goodwill. The reason is that we believe that in many instances acquired goodwill is consumed over time.
We acknowledge that the determination whether goodwill has a definite useful economic life is accompanied by the arbitrary element of determining its length, but we believe that this does not provide sufficient reason to ignore that core goodwill may diminish in value over its useful life and in such cases amortisation results in information that is a more faithful representation than impairment testing. The determination of the useful life of goodwill should be mainly based on the useful life of the acquired business as a whole. Factors like the nature of the business, the workforce, customer relationships or life-cycle of the acquiree's products to which goodwill is attached should be considered when determining the life of goodwill. In cases where these factors lead to the conclusion that the economic life of the business is definite (e.g. where the business is carried primarily by one product, whose life-cycle is assumed to end in no more than 10 years after the acquisition), the acquired goodwill should be amortised over the expected life.
In those cases where management can not determine the useful life of goodwill, which is then supposed to be indefinite, an impairment-only approach should be applied. In such cases impairment testing better reflects the economic reality, because no amortisation or impairment has to be recognised if there is no indication of diminution in value of the acquired goodwill.

Our proposed alternative approach has the additional conceptual advantage of symmetrical treatment of acquired goodwill and other intangible assets.

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?

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" (the excess) does not meet the definition of a liability, we believe that its treatment should be symmetrical to the treatment of positive goodwill. The difference between the purchase price and the fair value of acquired assets and liabilities can either be a premium or discount, reflecting expectations of future gains or future losses. We disagree with the Basis for Conclusions BC112 that potential future losses, which had a depressing effect on the purchase price, have a similar effect on the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities. Both, positive and negative goodwill reflect residuals. Accordingly, negative goodwill should be recognised as income to the extent that it does relate to future losses and expenses over the period expected to be necessary to restore profitability of the acquired entity. Therefore, we prefer to retain the present requirements for negative goodwill (IAS 22 *Business Combinations* paragraphs 59 to 63).

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?

Response

We believe that adjustments to estimates of the total cost of the combination should normally be made within 12 months of the acquisition date and accept the transitional exceptions carried forward from IAS 22 as an interim measure.
However, we ask the Board for further clarification in which period potential adjustments or corrections have to be included. The following example illustrates the lack of clarity in ED 3:
An entity makes an acquisition in November 2006 and its balance sheet date is December 31. Should the adjustment of the initial accounting, which is finalised in November 2007, be included in the financial statements of the year 2006 or 2007? And how should the adjustment be recognised in the case that the acquiring entity reports on a quarterly basis?
We ask the Board to include an illustrative example in order to address these questions.

Other comments

1. Changes to the definition of control

(a) We believe that the proposed revision of 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. These changes of definition are beyond the scope of ED 3 *Business Combinations* and their reasons should be better indicated as such in the Basis for Conclusions (BC9 to 15).

(b) With reference to Question 3 – Reverse Acquisitions, our understanding is that the same control concept should be applied (paragraphs 17 to 21) as in IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* (paragraph 6). However, the interpretation of paragraphs 17 to 21 could result in different parties being adjudged to be the acquirer. According to ED 3 (paragraph 21), IASB's intention is that "all pertinent facts and circumstances shall be considered to determine which of the combining entities 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". Others could understand that even though 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 combined group even if not exercised. It is difficult in particular to see how the rights of the majority group of shareholders can be ignored in a situation that requires us to look through the normal parent-subsidiary relationship; the shareholders can always dismiss the management; if they do not do so, it must be assumed that they willingly accepted the management even if it came predominantly from the smaller company.
Dependent on the interpretation of the control concept in situations of reverse acquisitions a different acquirer can be determined. Therefore, we ask the Board to clarify the use of the control concept.

2. 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.

3. Information about the outcome of the field visits

In general we welcome the field visits as additional information before issuing a new standard particularly in areas where new accounting principles are implemented.
We therefore ask the Board to make a general summary of the information gathered at its field visits available to the public, at least in areas where the gathered information made the Board change the draft standard.

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?

Response

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.
However, we believe that if an impairment has occurred, the value of the impairment to be recognised could vary between the date the impairment test is carried out and the balance sheet date. It is therefore necessary for an entity to review and update the underlying data of the impairment test at balance sheet date and take these into account.

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?

Response

Yes, we agree. Although one could argue that the similar character of intangibles with an indefinite useful life acquired in a business combinations and goodwill would suggest having the same treatment, we believe that goodwill – although recognised as an asset – is not an identifiable asset but a residual. Therefore, the impairment test for goodwill is different and intangibles should continue to be reviewed for impairment under IAS 36 *Impairment of Assets*. The potential room for arbitrage is almost eliminated by our proposal (i) to delete the second step of the impairment test of goodwill and (ii) to allocate the amount of impairment firstly to goodwill, secondly to intangible assets with indefinite useful life and the remainder to all other assets on a pro-rata basis (see our answer to question 5).

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?

Response

(a) We agree that the elements listed in paragraph 25A should be reflected in an asset's value in use.

(b) While we agree that management's track record in forecasting is relevant, we do not think an accounting standard can be framed in the terms suggested. A more effective approach might be to require assumptions and projections to reflect management's best estimates rather than any targets that may form the basis for internal budgets and plans.

(c) We agree that the additional guidance in Appendix B is appropriate.

<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?

<u>Response</u>

(a) We agree with the Board's proposal. 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.

(b) We agree with the relative fair value approach in the case of the disposal of an operation within a cash-generating unit, but we believe that the wording of paragraph 81 (b) should be adjusted to "…on the basis of the relative values or such other basis, that can be demonstrated to be more reliable, of the operation disposed…".

(c) We agree with the relative fair value approach in the case of reorganisations of the reporting structure.

<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>Response</u>

We do not believe that this is an appropriate method for measuring impairment losses for goodwill.

We believe – as argued in our answer to Question 8 of ED 3 - that the impairment test as currently proposed is conceptually imperfect, because pre-existing internally generated goodwill of the acquirer and goodwill internally generated after the acquisition are not separated from the measurement of acquired goodwill at a later stage. Therefore 'cushions' of internally generated goodwill will avoid the recognition of impairment losses in certain cases. 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.

To increase the robustness and reliability of measurement and decrease the complexity of the impairment test we recommend the following amendments:

(i) We propose to delete the second step of the impairment test (paragraph 86). This would mean that the impairment of a cash-generating unit would be identified by comparing the carrying amount of the unit, to which goodwill is allocated, with its recoverable amount (paragraph 85). We believe that the second step of the test, which is proposed to measure the amount of goodwill impairment by comparing its carrying amount with its implied value, is costly and does not usually improve the resulting information.
The identified impairment should be allocated firstly to goodwill and then to intangible assets with indefinite useful life. Any remainder of the impairment should then be allocated to other assets on a pro-rata basis.

(ii) Although 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, 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 do not agree that reorganisation and restructuring create problems solely for the measurement and allocation of this particular part of the goodwill (Basis for Conclusion C38 ED IAS 36). We agree with the dissenting view of the two Board members voting against the proposal, who argue that when the impairment test is feasible and appropriate, it should be applied in a "rigorous manner, eliminating pre-existing internally generated goodwill" (AV11).

<u>Question 6 – Reversals of impairment losses for goodwill</u>

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?

<u>Response</u>

Yes, we agree that reversal of goodwill impairment should not be treated as any other reversal of impairment. Taking into account the likelihood that originally acquired goodwill is mixed up with newly internally generated goodwill after the date of acquisition, it is difficult to distinguish any reversal of previously impaired from internally generated goodwill. Therefore, this strict principle prevents additional recognition of internally generated goodwill.

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

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?

Response

(a) No, we believe that disclosed information should provide users of financial statements with an understanding of the risk exposure of the entity rather than provide all data necessary to perform a re-calculation. Therefore, we believe the list of required items given in paragraph 134 should be reduced; the following paragraphs in particular should be deleted:

- 134 (d)
- 134 (e) (ii), (iv), (v)
- 134 (f) (ii)

The information required by these paragraphs seems to be excessive with no relevance for understanding the financial statements.

(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 (d), (e) and (f) which would then have to be applied on a cash-generating unit basis.

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?

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.

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 clear 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. We suggest that IASB address these issues in a separate "Concepts" project.

The "Examples of intangible assets satisfying the criteria for recognition separately from goodwill" (in the Illustrative Examples) now refer to identifiability, suggesting that this is the only criterion for recognition. In order not to convey a wrong message the other recognition criteria i.e. control, probability of future revenue streams and reliability of measurement should be mentioned as well.

<u>Question 3 – Indefinite useful life</u>

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?

<u>Response</u>

We support the useful life requirements in paragraphs 85 – 90 and the removal of the existing useful life presumption as it is an arbitrary and often unrealistic rule.

<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)?

Response

We support the useful life requirements in paragraphs 91 and 92.

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?

Response

We support the proposal not to amortise an intangible asset with an indefinite life according to paragraphs 103 and 104.

Other comment

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 at least in the case of continuous research and development activity (e.g. in the car manufacturing design unit). In such cases the analogy should be with IAS 2 *Inventories,* which seems to us to be the more appropriate comparison.