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IASB – ED3 – BUSINESS COMBINATIONS

AMENDMENTS TO IAS 36 and IAS 38

CBI RESPONSE **April 2003**

INTRODUCTION AND SUMMARY OF CBI POSITION

1. We welcome the opportunity to respond to the Board's consultation.

2. Our views on the principal issues are as follows:

   - **Pooling of interests** - We do not accept that the pooling of interests method should be prohibited for all transactions.

   - **Contingent liabilities** - We support the general approach to fair valuing acquired assets and liabilities, but we are concerned at the inconsistent treatment of acquired contingent liabilities compared with other contingent liabilities under IAS 37.

   - **Identified intangibles** – Though the usefulness of financial statements would be enhanced by a greater analysis of intangible assets, we have concerns regarding the detailed proposals.

   - **Goodwill** - We consider that the option to amortise goodwill should be maintained.

   - **Impairment testing** - We do not support a two-step approach to impairment testing of goodwill.

   - **Disclosure** – The proposed disclosure requirements are excessive.

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RESPONSES TO IASB QUESTIONS

Q. 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?

We agree with the scope exclusions. However, we have significant concerns over the proposed accounting treatments of transactions involving changes in minority interest in Phase II of the project. We believe that the Board should not proceed to an IFRS based on Phase I before it has published its proposals under Phase II and sought comment on the overall package.

The amendment to the joint venture definition in IAS 28 and IAS 31 goes too far. The unanimous consent on all financial and operating decisions should not be necessary – only unanimous consent on strategic decisions.

Q. 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 ?

Our members can cite a number of examples of true mergers in the UK, where there has been both broad equality in both the valuations of the entities and in the ongoing management of the merged entity. Therefore acquisition accounting will be applied where no acquirer exists, which will lead to other issues. We consider that the elimination of the pooling of interests' method on the pragmatic grounds that it might be abused would be regrettable. Greater efforts should be made to define more strictly the criteria to be applied, with emphasis on the ongoing management and on prohibiting creative structures designed to achieve merger accounting.

Q. 3. <u>Reverse acquisitions</u>

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?

Yes, we agree with the description of circumstances in which reverse acquisition treatment is appropriate.
The additional guidance is appropriate.

Q. 4. <u>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 ?

We agree with the proposals in the context of an acquisition.

As indicated in the answer to Question 3 above, we consider that there are cases where pooling of interests accounting is appropriate and the new IFRS should provide for such situations.

Q. 5. <u>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?

We disagree with this proposal, which again appears to be driven by a desire to avoid abuse rather than to identify which are the correct principles to apply. We would prefer to retain the approach set out in IAS 22.

Q. 6. <u>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?

We agree that contingent liabilities need to be carefully considered in allocating the cost of a business combination. There are a number of issues. Paragraph BC84 states that contingent liabilities identified in a business combination and measured at fair value will continue to be measured at fair value thereafter. Other contingent liabilities will, under IAS 37, be subject to the probable existence criterion. This will be very confusing. The Board should make the review of IAS 37 a priority.

The use in Appendix B15 (l) of 'amounts that a third party would charge to assume these contingent liabilities' would result in misleading results. What is relevant is the best estimate (if reasonably possible to obtain) of the likely outflow to the company which can be very different to what might be necessary to pay a third party to assume the contingent liability (which is not always easy to achieve). As an entity will normally have the choice of between the two, accounts should reflect the option which a rational decision maker would take.

The purpose of the amounts recognised in the accounts must be to reflect liabilities at amounts which are (a) relevant to how the business operates and (b) relevant to users in reaching decisions on the business. This is not what comes out of ED 3.

Q. 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?

We agree that minority interests should be measured initially by the acquirer at fair value. However, the establishment of the fair values is subject to the response to Q.6 above.

Q. 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 that acquired goodwill should be recognised as an asset. We would also agree that where the useful life is indefinite or very long term, then impairment testing with no amortisation is a reasonable approach.

However, it must also be recognised that there are conceptual and practical problems with impairment testing , notably the mingling of internally generated goodwill and the costly and subjective nature of some impairment testing. Therefore use of systematic amortisation, with impairment testing when triggered, is a simple and transparent method to reflect the fact that in many cases purchased goodwill diminishes over time.

Consequently we do not believe that either impairment testing or amortisation is appropriate in all circumstances and strongly believe that the option currently allowed in IAS 22 should be retained.

Q. 9. <u>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</u>

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 agree that the proposed accounting treatment is appropriate and that where negative goodwill results it does generally represent a gain. We believe that the immediate recognition of this gain would be a simple and consistent treatment.

Q. 10. <u>Completing the initial accounting for a business combination and subsequent adjustments to that accounting</u>

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?

We agree with the proposals for a 12 month hindsight period.
We also agree that only adjustments to correct errors should subsequently be allowed.

OTHER POINTS

Deferred tax

Paragraph 64 requires that an element of goodwill be expensed when the income tax carry – forwards not recognised as deferred tax assets at acquisition are subsequently realised. The application of strict matching is inconsistent with both the twelve month fixing of the opening balance sheet and the general approach to impairment of goodwill, which avoids a right down where the current implied value of goodwill is no lower than carrying value.

Disclosures

The proposed level of disclosure is excessive.

Paragraph 69 (b), in requiring a full proforma reflecting the impact of all acquisitions, seems an excessive requirement requiring the restatement of the relevant pre acquisition period for the effects of the business combination(s).

Paragraph 70 also seems unrealistic in requiring all the information in paragraph 66, especially when companies are trying to produce their accounts in a shorter time frame. There is the let out of "undue cost and effort". However, it would be better to have disclosure requirements which most companies are likely to be able to comply with.

We are also concerned about the additional disclosures proposed for interim reports by the proposed amendments to IAS 34. We strongly oppose the proposal that companies provide the information required by Paragraphs 65 – 72 in interim statements.

IAS 36 QUESTIONS

Q. 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?

Generally we agree that annual testing is appropriate for material intangible assets.

The requirements in respect of the time the impairment tests are allowed be carried out – i.e. if other than at the balance sheet date - should be consistent for all intangibles, both goodwill and other intangibles. The standard should also permit individually immaterial intangible amounts to be assessed at longer intervals than annually unless there is evidence of impairment.

Q. 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 that this proposal is appropriate.

Q. 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?

We agree with the guidance in the ED. The choice of discount rate or adjustment to cash flow is appropriate. The auditors will take account of the factors set out in (b) concerning cash flows in assessing management's projections, but the forecast will be the best estimate of the directors. The guidance in Appendix B appears appropriate.

Q. 4. <u>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?

We consider the proposed allocation methods to be appropriate.

Q. 5. <u>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?

We agree with the method of measuring the recoverable amount.

We do not support the adoption of a two-step impairment test for goodwill. The screening test is consistent with IAS 36 and ensures that no cash-generating unit (including goodwill) is carried at more that its recoverable amount. No additional test is necessary. Where the recoverable amount is lower than the aggregate carrying value, it would be appropriate to assume that any impairment relates to goodwill. The second test, the calculation of implied value of goodwill, is inconsistent with the principle of IAS 36 that assets are written down to recoverable amount. A one-step test would be both less costly and simpler.

The proposals draw on US GAAP, but result in an unsatisfactory hybrid between fair values and value-in-use. In the case of US GAAP, other assets will have been individually tested for impairment prior to testing goodwill. In the US, the equivalent step 1 is based on the fair value of a business unit. It checks whether step 2 needs to be undertaken but does not quantify the impairment write-down. The IASB proposed step 1 is a full calculation of the value-in-use and it quantifies the total impairment based on value-in-use, making the step 2 process unnecessary.

Q. 6. <u>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?

We agree with the proposal.

Q. 7. <u>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?

The level of disclosure appears to us to be excessive. In particular, we consider that the disclosures required by paragraph 134(d), (e) and (f) and paragraph 137 would potentially disclose commercially sensitive information with no corresponding need from the user.

IAS 38 QUESTIONS

Q. 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 that the criteria are appropriate.

Q. 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 are not convinced that sufficient information should be assumed to exist to measure the fair value of intangible assets in a business acquisition. We accept that the identification of the principle material intangibles acquired in a business combination may help users to understand the economics of the transaction. It may also facilitate the estimated useful life of each identified intangible asset. However, we are concerned that the application of the principle to all intangibles may be very difficult, as well as giving rise to costs and other issues that far outweigh any benefits to users.

We would suggest the inclusion of a materiality threshold below which intangibles would be subsumed into goodwill. This could be, for example, where classes of intangible assets collectively amount to less than 5% or 10% of the total acquisition cost.

In order to value an intangible asset, it is necessary to identify the cash flows associated with that asset. Whilst some assets are readily identifiable, e.g. trademarks, patents and proprietary technology, others may derive value from the same income stream. This is particularly true in the area of customer-related intangibles. The customer only generates one income stream, yet this may need to be recognised for valuation purposes under different intangible assets. Analysing one income stream into different assets will be very subjective and result in unreliable numbers. We believe that this means that the requirements must be framed flexibly to take account of such issues.

Q. 3. <u>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?

Please see our comments in response to Question 8 of ED 3.

Q. 4. <u>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)?

We consider that the proposed basis is appropriate.

Q. 5. <u>Non-amortisation of intangible assets with indefinite useful lives</u>

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

We support the proposal.