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Dear Sir David

Exposure Draft ED 3 - Business Combinations

We appreciate the opportunity to respond to the International Accounting Standards Board's exposure draft of its proposed IFRS, ED 3 - *Business Combinations*. This letter represents the views of KPMG International and its member firms.

Summary of main points

Combining phase I and II into one final standard

We note that there are several areas where the IASB proposes guidance in ED 3, but then plans to revisit those areas in its current joint project with the US FASB on the application of the purchase method in phase II. These areas include accounting for "true" mergers and the possible use of fresh start accounting; common control transactions; contingent consideration; contingent liabilities; acquisitions achieved in stages; and minority interests.

Currently, the Board intends to finalise ED 3 in the fourth quarter of 2003, while issuing an exposure draft on phase II in the second quarter of 2003 and a final IFRS on phase II in 2004. However, we believe it is unwise to issue two major standards in less than twelve months addressing many of the same topics, but with different transitional provisions and effective dates.

We believe that issuing guidance based on ED 3 in the areas mentioned above would be premature given plans for further discussion and wider debate in phase II. We are concerned that if the guidance is issued as planned currently, i.e. in a relatively short timeframe but at two different dates, inconsistencies introduced in phase I and amended in phase II will only cause confusion for preparers and users of financial statements and will not contribute to the acceptance of IFRS. We therefore strongly recommend that the Board consider combining the proposals in phase I and II in one final standard to be issued in (early) 2004.

We are aware that this recommendation has an impact on the transitional provisions for first-time adopters with a date of transition in early 2004, but we believe that this can be dealt with by requiring that the final IFRS on Business Combinations be applied retrospectively for business combinations taking place after a specified transition date. We would, however, restrict such retrospective application to first-time adopters only.

Uniting of interests

We support the proposal to eliminate the uniting of interests method as a practical solution. We agree with the Board that true mergers do exist, but, like the Board, acknowledge the difficulty in describing appropriately the very limited circumstances where this is the case. However, as the Board also is considering fresh-start accounting in phase II, we recommend that the elimination of pooling be postpone until the phase II discussions have been completed, so that all changes in guidance in respect of accounting for true mergers are issued at once.

Goodwill

We understand that one of the driving factors behind issuing the proposals in ED 3 in their current form is the Board's desire to converge with other major standard setters, especially with the recent US standards on business combinations and intangible assets. In general, we support the Board's objective of convergence. However, in the case of ED 3, we are not convinced that the proposed new accounting model for goodwill – the impairment-only model – is preferable to the existing model whereby goodwill is amortised systematically over its estimated useful life and impairment tested only if an indication of impairment exists.

Therefore we do not support the proposal in ED 3 to cease amortisation of goodwill and to rely entirely on an annual impairment test. Instead, we believe that the current requirements on the amortisation of goodwill, with impairment testing only where an indication of impairment exists or when the amortisation period exceeds a rebuttable presumption, should be retained. Our main arguments for reaching this conclusion are:

- The move to a non-amortisation model necessitates the introduction of a different, more complicated impairment testing model for goodwill, which has significant practical application issues and is costly to implement and operate;

- We believe that, in many instances, goodwill will have a determinable useful life that is in fact relatively short (e.g., in industries with short life-cycle products or where barriers to entry are low);

- Annual impairment testing would, at best, in effect depreciate short-lived goodwill on valuation basis. However, for many other assets it is considered acceptable to depreciate them on a straight-line basis, as an approximation of the asset's consumption, even if this does not track their decline in value, as depreciation is a cost allocation method, not a valuation method;

- The non-amortisation of goodwill introduces the opportunity for accounting arbitrage for identifiable intangibles with finite useful lives (see further below under *Intangibles*); and

- It introduces inconsistency with the treatment of internally generated goodwill under IAS 38 (see further below under *Inconsistencies*)

The above points are discussed more fully in our answers to Question 8 (Appendix 1) and Question 5 (Appendix 2), but in summary, we do not believe that one model – cost allocation or valuation – is superior to the other, either conceptually or from an information value standpoint. In our experience, the current amortisation model for goodwill under IAS 22, in combination with IAS 36, has largely proven to be operational in practice and, in our view, is striking an appropriate balance between costs for preparers and benefits for users of financial statements. Therefore we believe that the current model should be retained.

Impairment

For similar reasons, we also disagree with the proposed two-step approach to impairment testing for goodwill, which we believe to be unnecessarily complicated. In addition, we have concerns that the proposed approach may give financial statement users a false sense of robustness of the carrying value of goodwill, whereas in practice the level of judgments and assumptions involved in performing the proposed impairment test are considerable and may lead to variances among different entities in similar circumstances, depending on the judgments made. We are also concerned that the reliance on impairment-only may amplify the tendency for recognising infrequent, but large "big bath" impairments, which in our view cannot be mitigated solely by more disclosure requirements.

While we agree that the implied fair value calculation may have some conceptual merit, we do not believe that the benefits of this approach outweigh the cost to implement and operate this model. If goodwill would continue to be amortised, as we prefer, we believe that the current impairment model under IAS 36, with further improvements and additional implementation guidance, should be retained.

We also note that, whereas convergence with US GAAP may have been an important consideration in the IASB's choice for the impairment-only model for goodwill, the definition of cash generating units in IAS 36 generally results in impairment testing under IFRS being performed at a lower level than under the equivalent US standard. The two standards therefore would not produce similar results. In addition, the IASB's proposal – with which we concur – to exclude identifiable intangible assets that were not recognised separately from goodwill at the acquisition date from the implied fair value calculation of goodwill would introduce a further difference between the future IFRS and its US equivalent.

Expected present value in cash flow projections

We find the additional guidance provided with respect to the calculation of value in use (paragraphs 25A and 27 of the amended IAS 36) to be useful and appropriate.

We disagree, however, with the expected cash flow method proposed in Appendix B. We do not believe that discounting the statistical average of the range of expected cash flows at the risk-free rate is correct. The IASB implies that regardless of whether the risk elements are reflected in the cash flows or in the discount rate, the result should be the same as using the expected cash flow method demonstrated in Appendix B. We believe that this is not the case (see our response to Question 3 in Appendix 2 which includes an example to demonstrate the point).

Further, we believe that the use of probabilities of cash flows to capture risk elements makes the calculation of value in use unnecessarily complex and less reliable.

Intangible assets

Indefinite useful life

We have a strong preference to retain the current IAS 38 requirement that all intangible assets be amortised over their useful lives. A rebuttable presumption regarding an intangible asset's useful life (eg, the current 20 years) should be retained, whereby impairment testing is required to be performed annually only if this presumption is rebutted.

Consequently, we do not support the IASB's proposal to introduce indefinite useful lives for certain intangibles.

Recognition criteria

We agree that the identifiablity of an intangible asset should be based on its separability or legal/contractual rights. However, we have some concerns about the practical application of these recognition criteria, notably with respect to the detailed level at which such intangibles will have to be separated (e.g., trade dress, slogans). Our experience indicates that this is particularly difficult where the identifiable intangible assets are not traded in an observable market and generate cash flows only when used with a collection of other assets, both tangible and intangible.

Accounting arbitrage

We also have concerns over the accounting arbitrage opportunities introduced by the proposed model, whereby goodwill and intangible assets with an indefinite useful life are no longer amortised systematically, but only those that are identifiable separately from goodwill. While the intention of ED 3 seems to be to recognise as many intangibles as possible separately from goodwill, the differing amortisation regimes will provide a disincentive for entities to do so, in order to avoid annual amortisation charges.

Negative goodwill

We disagree with the Board's proposal that, after having adjusted any imprecision in the fair value measurement of identifiable assets and liabilities or the purchase consideration, negative goodwill presents an immediate profit. We believe that an exchange between informed and willing parties, other than in a forced or liquidation sale, must by definition be at fair value and that therefore no party can obtain an immediate profit. Even if a bargain purchase apparently occurs, in the shape of a surplus of non-monetary assets, in our view the benefits do not materialise immediately.

Negative goodwill often results from the non-recognition of future losses and expenses that do not meet the recognition criteria at the date of acquisition. Where this is the case, we believe it is appropriate to recognise the negative goodwill as a negative asset to the extent that it relates to such future losses and expenses and to amortise the negative goodwill as those costs are incurred, as currently required by IAS 22. However, unlike the current requirement, we suggest treating any remaining excess as a revaluation reserve, which would be transferred to retained earnings consistent with the treatment of revaluations under IAS 16.

Restructuring provisions

We agree with the Board's proposal 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.

Inconsistencies

We are concerned about the various inconsistencies introduced by ED 3. We urge the Board to reconsider the guidance proposed in the following areas:

Goodwill – as the Board acknowledges in the Basis for Conclusion (BC 107), the requirement not to amortise goodwill results in an inconsistent treatment for entities that grow through acquisitions versus those that have only organic growth. While all costs of internally generated goodwill are expensed, the Board acknowledges that, ordinarily, purchased goodwill is consumed or impaired, but often this is not recognised if the purchased goodwill is replaced, over time, by internally generated goodwill. As a result, entities with purchased goodwill may have an accounting advantage, when compared to other entities with only organic growth.

Intangible assets – more inconsistencies are created by the different recognition criteria for intangible assets, depending on whether those intangibles are acquired or internally generated.

We are particularly concerned with acquired in-process research and development and other intangibles acquired in a business combination, such as customer lists or non-contractual customer relationships, that cannot be capitalised under IAS 38 if internally generated, but must be recognised separately when acquired in a business combination. For in-process research acquired in a business combination there is the additional inconsistency that the initial expenditure will be recognised as an asset, but any subsequent expenditure would continue to be expensed.

In addition, the Board has changed the recognition criteria for intangibles acquired in a business combination in such a way that it no longer is necessary to prove that the benefits derived from the intangible asset are probable. It is assumed that probability is reflected in the fair value measurement and therefore always will be satisfied for intangibles acquired in a business combination. Whilst we reserve our judgment on this issue until a fuller consideration is exposed by the IASB, we do not believe that such a fundamental change, leading to an inconsistency with the Framework, which identifies the probability of future economic benefit as a recognition criterion in paragraph 85, should be introduced through ED 3. Instead, we believe the Board needs to undertake a fuller debate of the role of probability as a recognition or measurement criterion as part a broader discussion (e.g., a future Concepts project).

Contingent liabilities – likewise, we disagree with the proposal to recognise contingent liabilities acquired in a business combination, both at initial recognition and subsequently, at fair value, which results in inconsistencies with IAS 37 and the Framework. The arguments supporting these proposals do not warrant such inconsistencies without a further debate about the broader conceptual issues involved.

Disclosure

We find many of the proposed disclosure requirements in both ED 3 and in the revisions to IAS 36 to be excessive and believe that they fail to meet a cost-benefit test. We anticipate that compliance with these requirements will be extremely onerous and do not believe the Board has demonstrated the need of financial statement users for this disclosure.

As mentioned above, we do not believe that the false sense of robustness of the impairment-only model can be compensated by excessive disclosures.

Phase II issue – minority interest

We note from discussions in phase II of the business combinations project that the Board has concluded that minority interests are treated as part of group equity. Whilst the Board is not inviting specific comments on its phase II decisions at this stage, we would like to share our concerns with the direction of the IASB's discussion on this issue. The Board seems to have reached conclusions with regard to minority interests on what we consider to be a major conceptual issue without inviting any comments so far and we have some concerns that in phase II commentators would be asked to focus on application issues only rather than on the underlying conceptual issues. We previously already expressed our concerns in this regard in our letter to you on 27 November 2003 (copy attached).

We believe that minority interests should not be treated as group equity. Combining the majority and minority shareholder positions in the accounts is not useful for either party. Minority shareholders normally are not interested in accounts that report their interests as minority, and majority shareholders are interested in seeing the minority interests stripped out. We believe that deducting the minority interests in arriving at net assets and net profit best satisfies the needs of the majority shareholder.

We also do not see the justification for grossing up goodwill and minority interest on acquisition. Goodwill is derived as a residual of excess consideration over identifiable net assets acquired and should relate only to the share actually acquired.

Finally, we do not agree that transactions to acquire minority interest or dispose of a portion of existing interest should be treated as transactions in own shares. If a parent acquires 75% of a company, and subsequently another 25%, we believe that the second payment should be treated as a purchase. Similarly, if an entity holds a 100% share and disposes of 25%, we do not believe that accounting for the transaction as an issue of equity instruments reflects the reality.

Our detailed comments on the exposure drafts, including our responses to the questions included in the invitations to comment, are attached as follows:

Appendix 1	Comments on ED 3
Appendix 2	Comments on [draft] IAS 36
Appendix 3	Comments on [draft] IAS 38

Please contact Mark Vaessen at 020 7694 8089 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG

Appendix 1 – Comments on ED 3

Responses to invitation to comment on ED 3

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?

We find the scope exclusions to be appropriate.

Both accounting for transactions under common control and accounting for business combinations resulting in joint ventures are areas where practice issues frequently arise. We agree with the definition of business combinations involving entities under common control and find it helpful in identifying such transactions. However, most practice issues revolve around the accounting for such transactions. We therefore very much welcome the Board's intention to cover the accounting for common control transactions in Phase II and would prefer to see a final standard being issued combining both the definition of and accounting for common control transactions.

We note from discussions in Phase II of the business combinations project that the Board appears to be moving toward a position where minority interests are treated as group equity. This position would have the following implications, which we disagree with:

- On acquisition, goodwill and minority interests would be grossed up.
- The purchase of additional interest in a subsidiary will be treated as a purchase of own equity instruments (i.e. debit to equity).
- The sale of a minority interest would be treated as the issue of own equity instruments (i.e. credit to equity).
- The disposal of the parent's controlling interest will require the minority share to be eliminated as if it were a purchase of own equity.

We believe that minority interests should not be treated as group equity. Combining the majority and minority shareholder positions in the accounts is not useful for either party. Minority shareholders normally are not interested in accounts that report their interests as minority, and majority shareholders are interested in seeing the minority interests stripped out.

We believe that deducting the minority interests in arriving at net assets and net profit best satisfies the needs of the majority shareholders.

We also do not see the justification for grossing up goodwill and minority interest on acquisition. Goodwill is derived as a residual of excess consideration over identifiable net assets acquired and naturally should relate only to the actual share acquired. Furthermore, the grossing up of goodwill would be arbitrary. If a parent company owns 80% of a subsidiary, it will have paid a premium to acquire that 80%, which would be reflected in goodwill. If it had purchased 100%, the goodwill would not necessarily have been larger as the company may not pay any additional premium for control of the minority share.

Finally, we do not agree that transactions to acquire minority interest or dispose of a portion of existing interest should be treated as transactions in own equity. If a parent acquires 75% of a company, and subsequently another 25%, we believe that the second payment should be treated as a purchase. Similarly, if an entity holds a 100% share and disposes of 25%, we do not believe that accounting for the transaction as an issue of equity instruments reflects the reality.

Essentially, minority interests are a presentational device and represent neither a liability nor equity. We believe the current mezzanine presentation is appropriate and understandable to users.

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?

On balance, we support the elimination of uniting of interests accounting as a practical solution, rather than on conceptual grounds. While we believe that a few true mergers do in fact occur, we also acknowledge the difficulty in drawing the boundaries of purchases versus poolings. For this reason, we concur with the practical solution proposed by the Board, which we also understand to be driven to a certain extent by the wish to converge with US GAAP. We would like to note, however, that practice under IAS 22, as complemented by SIC 9, has resulted in very few transactions being accounted for as uniting-of-interests.

It sometimes can be difficult to identify an acquirer, even in cases that are not true mergers, and in such cases, the parties involved will have to structure the business combination in such a way that one of them becomes the acquirer. Depending on which party is chosen to be the acquirer, the amount of identifiable intangible assets and goodwill recognised in the consolidated financial statements of the new group will be different.

We believe that more guidance should be provided on identifying the acquirer in situations where this may be difficult. The Board has included certain indicators in proposed paragraph 20, however, we find the list to be incomplete and suggest the following situations be added:

- The situation described in IAS 22.16(c) where one party's share of the equity in the combined entity depends on how the business that it previously controlled performs subsequent to the business combination. In this case, the party with the contingent interest is presumed to be the acquiree.

- The existence of a premium in the terms of exchange (i.e. the party paying the premium usually is the acquirer).

If the Board proceeds with the proposal to eliminate uniting-of-interests accounting, we suggest that stronger wording be used to ensure that all business combinations are accounted for under the purchase method. The use of the words "nearly all" in paragraph 14 gives the impression that the IASB itself still believes that true mergers do exist. Paragraphs 18, 20, and 21 include such wording as "assumes that", "there are usually indications", and "normally" in providing guidance on identifying an acquirer. Even though paragraph 17 requires that an acquirer be identified for all business combinations within the scope of the proposed IFRS, we are concerned that the wording will be perceived to provide an opportunity for users to apply different accounting to transactions they consider to be true mergers.

We understand that the Board is contemplating fresh-start accounting for true mergers. If guidance from Phase II is issued shortly after Phase I as planned, users could be confused by two changes in accounting to be applied to true mergers within a relatively short period. This supports our view that the IASB should not address accounting for business combinations in two phases, but should instead wait and issue all guidance at once in one standard.

Regardless of whether the uniting-of-interests method is eliminated in respect of mergers, we suggest that the approach be maintained in IFRS. We note that it is necessary for the IFRS to retain the definition of uniting-of-interests method as we believe there are transactions to which it will continue to apply. For example, we believe that this method is required in accounting for business combinations in which a new entity is formed to effect the combination of the new entity and the party identified as the acquirer. This is further explained in our response to Question 4 below. We also anticipate that the uniting-of-interests method may be required for certain common control transactions once they are addressed in Phase II of the business combinations project.

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 paragraph 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?

While we agree that a business combination should be accounted for based on the substance of the transaction, we have some concern over the IASB's articulation of how a reverse acquisition should be identified. Our concern relates to the loss of the shareholders' perspective that is used in IAS 22.13, SIC 9.4 and SIC 9.8. Although IAS 22.13 relates to the case in which there is no acquirer, SIC 9 clarifies that the shareholder perspective should be applied to all acquisitions. The concept is that an acquirer is identified when one of the shareholder groups obtains control over the combined entity. Ultimately, in the accounting entries, one of the entities has to take the role of the acquirer but this flows from the identification at the shareholder level. The proposition in ED 3 is that one of the entities is the acquirer itself, rather than inheriting this status from its pre-combination shareholders. We recommend that the Board include the shareholders' perspective in the discussion of determining the acquirer in a business combination.

In addition, while we find the proposed additional guidance in Appendix B to be useful, we suggest a clarification in respect of the reporting of consolidated equity. We understand that the first part of paragraph B7(c) requires the value of total reported equity to be presented as if the legal subsidiary were the issuer. However, the Board's intention in respect of the second sentence, where the entity is required to reflect the legal parent's equity structure, is unclear. In the illustrative example, this is demonstrated as simply disclosure of the number of issued equity instruments of the legal parent, while the value reflects that of the legal subsidiary. While this example appears to satisfy the wording of the guidance in paragraph B7, we believe that the presentation should be different. The issued equity value should reflect that of the legal parent and the difference between that value and the value of the total equity of the legal subsidiary should be recorded as a separate reserve. Regardless of whether the Board agrees with this presentation, more clarity is required in this paragraph.

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 proposal to identify one of the combining entities that existed before the combination as the acquirer as this treatment will reflect the substance of the transaction regardless of its legal form. We believe, however, that the Board should include in the IFRS guidance as to how the acquirer is brought into the new entity.

For instance, suppose Company A obtains control of Company B but the new group structure is such that both A and B are held by a new company, NewCo. The accounting in NewCo should reflect the same result as if A had become the parent of B. However, A still needs to be brought into NewCo's consolidated accounts before B can be brought in using the purchase method. We suggest that the combination between NewCo and A be dealt with by uniting-of-interests accounting, and for that purpose the uniting-of-interests method should be retained in the IFRS.

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. We find the proposed guidance in respect of the recognition of restructuring provisions in a business combination to be appropriate and consistent with IAS 37.

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 strongly disagree. The proposed accounting treatment would create unjustifiable inconsistencies with both the *Framework* and with IAS 37, as well as significant practical application issues. While we understand that not recognising a contingent liability may in certain circumstances result in negative goodwill, we see the inconsistency between the recognition of acquired and non-acquired contingent liabilities to be an even greater concern. We note that the Board states its intention to revisit the role of probability in the *Framework* and we suggest that recognition of contingent liabilities in a business combination be deferred to this wider discussion. At present, we do not see the merit of incorporating recognition criteria in this proposed IFRS that represents a departure from both the *Framework* and IAS 37.

We also disagree with the proposal to continue to re-measure at fair value contingent liabilities recognised as a result of a business combination. If the Board decides to move forward as proposed in respect of contingent liabilities, we recommend that the original value be retained until such time as the liability qualifies for recognition under IAS 37, or until the provision is no longer needed and released. The reason that a contingent liability would be recorded at fair value originally is because this would represent its cost. Furthermore, if the contingency reaches the liability recognition criteria under IAS 37, it should be treated in accordance with IAS 37. The measurement of a provision under IAS 37 may incorporate entity-specific assumptions and accordingly, the provision may not necessarily be recorded at fair value as observable in the market.

We also note that further inconsistency would be introduced if contingent liabilities are addressed in Phase I and contingent assets are left for Phase II. This inconsistency supports our argument that the Board should complete Phase II of the business combinations project in advance of finalising the IFRS so that all guidance can be issued at once.

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?

We agree with the proposal to require minority interest in the acquired net assets to be recorded at fair value. We note that the question of *measurement* of minority interest is independent of the question of the *nature* of minority interest which we have addressed in the cover letter and in our response to Question 1 in this Appendix.

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 that goodwill acquired in a business combination should be recognised as an asset. However, we do not support the Board's proposal that goodwill not be amortised, but instead tested annually for impairment.

While there may be cases where goodwill may have an indefinite life, we believe that in many other instances, goodwill will have a determinable useful life that is in fact relatively short. This is the case, for example, in industries where products have a relatively short life-cycle or where the barriers to entry are low. Failure to amortise goodwill in these situations would create an inconsistency between the accounting in a company that acquires goodwill and in one that generates it internally. The company acquiring goodwill would have no charge to the income statement and the company generating internal goodwill would.

We also are concerned that the difference in accounting treatment of goodwill versus other intangibles will lead to accounting arbitrage. Companies will be motivated to record intangibles separately only to the extent that they would prefer to amortise them rather than leave them in goodwill to be impairment tested only.

The non-amortisation approach also will lead to larger charges to the income statement in years where impairment is detected. In reality, however, it is likely that the goodwill did not decline in value in that single year. Annual impairment testing would, at best, in effect depreciate short-life goodwill on a valuation basis. In respect of many other assets it is considered acceptable to depreciate them over a straight-line basis, even if this does not track their decline in value, as depreciation is a cost allocation method, not a valuation method. We believe that, in general, an amortisation model is simpler, no more arbitrary and results in no less a fair presentation than a non-amortisation model.

In summary, we do not believe that one model (cost-allocation or valuation) is superior to the other, either conceptually or from an information value standpoint. Also taking into account the practical implications and costs involved for companies if they were required to move to an impairment-only model, we recommend that the IASB retain the current amortisation model for goodwill. We suggest that the 20 year rebuttable presumption also be retained. Although any maximum amortisation period is arbitrary, we believe it is necessary to require adequate justification for useful lives that are estimated to be unusually long. In retaining this amortisation model, we also suggest that the requirements for impairment testing not be changed. As long as goodwill is being amortised systematically over a period that does not exceed a rebuttable presumption, we believe that impairment testing should only be necessary if there is an indicator. Our comments on impairment testing are discussed further in Appendix 2.

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 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 do not agree with the proposed treatment.

We believe that purchase accounting is a cost allocation process and thus no more than the cost of the acquisition should be allocated to the acquired net assets. We do not believe that negative goodwill represents instant profit. We believe that an exchange between informed and willing parties must be, by definition, at fair value. Even if the case of a bargain purchase exists, the benefits are not realised immediately.

Negative goodwill results from the non-recognition of future losses and expenses that do not meet the recognition criteria at the date of acquisition.

Based on these arguments, we recommend the following treatment for negative goodwill:

- The identification and measurement of the acquiree's identifiable assets and liabilities, and the measurement of the cost of the acquisition, should be reassessed;

- any excess of fair values over the purchase consideration should be recorded in the balance sheet as a negative asset to the extent that it relates to identifiable and measurable future losses, and credited to income as the future losses to which it relates are incurred; and

- any remaining excess should be treated as a revaluation reserve, and transferred to retained earnings consistent with the treatment of revaluations under IAS 16.

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?

We agree with the 12-month limitation for adjustments to the initial accounting for a business combination. We also agree that any adjustments beyond the 12-month period following the acquisition should be recognised only to correct an error.

Consistent with current guidance under IAS 22, we understand paragraph 64 to apply at any time after the acquisition date, and therefore see it as an exception to the 12-month limit on the adjustment period. We agree with this exception, however, we suggest that the Board explicitly state that there is no limit to the adjustment period in respect of deferred taxes. We understand the rationale for having the exception is to avoid accounting arbitrage. Since recognition of deferred tax assets is somewhat judgemental, there may be a tendency to postpone recognition until after the hindsight period, so that a credit to income (rather than to goodwill) can be recorded. We recommend that the Board include this rationale in the Basis for Conclusions of the final IFRS.

Other comments

Cost of a business combination

Paragraph 24

This paragraph states that in a single transaction, the date of exchange coincides with the date of acquisition. This is consistent with the guidance in IAS 22.20, however the Board has excluded from ED 3 the guidance in respect of situations where the business combination may be subject to conditions that are not yet satisfied on the date of exchange. We recommend that this guidance from IAS 22.20 be repeated in the final IFRS.

Paragraph 26

While we agree that a thin market can result in a price that is unreliable, we believe it is important that the terminology and hierarchy of fair value methods is made as consistent as possible with the guidance in [revised] IAS 39. That guidance incorporates a fair value hierarchy based on:

1. published price quotations in an active market, with additional guidance on what is considered to constitute an active market;
2. recent arms-length market transactions; and
3. valuation techniques, with additional guidance on what valuation techniques are appropriate, the inputs to be used to such models and guidance on when a range of estimates can be considered to provide a reliable measure.

We believe the second and third sentences in paragraph 26 should be deleted and replaced by a reference to paragraphs 98 to 101 in [revised] IAS 39.

The second half of paragraph 26 provides further guidance specific to a business combination, which we agree is useful. However, we believe that guidance should apply only in situations where valuation techniques are required, that is where there is no active market or recent arms-length transaction evidencing fair value.

Similarly, the penultimate sentence states that 'in any event' all aspects of the combination shall be considered. It is unclear whether it is intended that other factors in the combination may override the presumption that the published price at the date of exchange is the best evidence of fair value. For example, might it be appropriate to apply a 'premium for control' to the published price? As we noted in our response the proposed amendments to IAS 39, we believe that it may be appropriate to apply a control premium. However, if the IASB proceeds with the IAS 39 proposals in this respect, we recommend that ED 3 include consistent guidance (i.e. that a control premium should not be applied and that other factors should be taken into account only when there is no active market or recent arms-length transaction evidencing fair value).

Paragraph 28

This paragraph discusses certain costs that are directly attributable to the business combination and thus included in the cost, and others that are considered indirect and expensed as incurred. The IASB has given a number of useful examples in this paragraph, however, there is one area where we believe more guidance would be beneficial. We suggest that the IASB provide guidance in the final IFRS on how to treat payments (including share-based payments) made to management of the acquiring entity as a bonus for the acquisition being completed. We believe that such costs should be treated as indirect costs and expensed as incurred.

Contingent consideration

Paragraph 31

ED 3 introduces a difference in the probability threshold for recognition of two contingencies. Contingent liabilities acquired are to be recorded at fair value whereas contingent consideration is subject to a probability test. In circumstances where additional consideration is contingent on the outcome of a contingent liability, the proposed requirements could lead to a mismatch that would be inappropriate. We suggest that accounting for contingent consideration be revisited under the IASB's broader debate on probability of benefits.

Paragraph 33

Proposed paragraph 33 requires that the initial accounting for a business combination be adjusted for contingent consideration when it becomes probable that the consideration will be paid and the amount can be measured reliably. The IASB, however, does not provide guidance as to how the additional consideration should be measured. If the additional consideration is payable in shares, should they be valued at acquisition date or at the date of the adjustment? If the consideration is payable in cash, should it be discounted to the acquisition date? If the acquisition date value is to be used, the question arises as to whether the IASB then would require a "catch-up" adjustment for any impairment on the change in goodwill. We believe that contingent consideration payable in shares should be valued at the acquisition date and that cash payments should be discounted to the acquisition date. This is the measurement date for the net assets acquired and as such it makes most sense to also value any contingent consideration at this date. In any event, we would welcome greater clarity in this area.

Allocating the cost of a business combination

Paragraph 36

Paragraph 36 sets out the criteria for the separate recognition of identifiable assets, liabilities, and contingent liabilities. As currently drafted, financial assets and liabilities, as defined in IAS 39, may not meet the criteria. We suggest that paragraph 36 be amended to include financial assets and liabilities qualifying for recognition under IAS 39.

Paragraphs 36 and 43

ED 3 does not include the requirement of probable future economic benefits flowing to the acquirer in respect of intangible assets. In the Basis for Conclusions, paragraph BC74, the Board explains that the effect of probability is included in the fair value measurement. We do not believe that the probability included in the valuation reflects the probability requirement of the *Framework*. For example, an asset that has an extremely low probability of causing future economic benefits to flow to the enterprise normally would not be recognised under IFRS. However, even if the fair value takes the low probability into account, some value would be recorded for the asset. We do not agree with this inconsistency and we suggest that the requirement for probable (i.e. at least more likely than not) future benefits as a recognition criterion be brought back in to this IFRS in respect of intangibles acquired in a business combination.

Furthermore, the absence of a probability requirement in recognising intangibles also leads to the recognition of in-process research and development (IPR&D). Paragraph BC79 in the Basis for Conclusions acknowledges that although similar research projects would not qualify for capitalisation under IAS 38, they will be recognised if acquired in a business combination. This inconsistency would be avoided if the current probability test inherent in IAS 22 was maintained in the proposed IFRS.

We understand that the probability concept in the *Framework* will be reviewed as part of a future Concepts project and we believe that the IASB should defer eliminating probability of future benefits from the recognition criteria for intangibles until the concept has been subject to broader debate.

We also note the current guidance under IAS 22 and IAS 38 that prohibits valuing an intangible for which there is no active market at an amount that creates or increases negative goodwill has been omitted from ED 3. We disagree with the proposal to remove this prohibition.

Disclosure

We believe that certain of the proposed disclosure requirements are excessive and do not meet the cost-benefit test. Specifically, we believe the following proposed disclosures to be unnecessary.

Paragraphs 65 and 76

Paragraph 65 is a guidance paragraph and sets out the objective of the disclosures. Paragraph 76 then requires anything to be disclosed that helps achieve the objectives. While we find the objectives to be appropriate, we do not support this approach as we anticipate that it will lead to endless second-guessing in hindsight where good faith efforts to comply have been made. We also note that any disclosures not specifically mandated but required for a true and fair view are required under IAS 1.91(c).

Paragraph 65 also requires that the disclosures be made for business combinations effected in the post-balance sheet period. This requirement is covered by IAS 10 and does not need to be repeated here.

Paragraph 66(f)

We consider the requirement to disclose the amounts recognised for each class of assets, liabilities and contingent liabilities, and their carrying amounts directly before the acquisition to be excessive. We find it hard to see how this information would add value to the financial statements and we believe that it could be difficult and very costly to obtain in circumstances where the acquiree did not comply with IFRS before the business combination. We recommend that this requirement be deleted.

Paragraph 66(i)

This paragraph requires the disclosure of the amount of the acquiree's profit or loss since the acquisition date included in the acquirer's profit or loss for the period. We doubt whether this requirement is practicable as the acquiree's profit or loss may no longer be available when its operations have been integrated with those of the acquirer.

Paragraph 69

We disagree with the requirement to disclose pro forma information about what the results would have been had the acquisitions been made at the start of the period. The disclosures required by this paragraph do not reflect the reality and they appear to question the concept of the purchase method of accounting for business combinations.

Paragraphs 69 and 70

We believe that the IFRS should include a requirement to disclose not only that the undue cost and effort exemption is used, but also the reasons why. Adding this requirement will deter unreasonable use of the exemption, and will make the IFRS consistent with the proposed standard on first-time application of IFRS.

Paragraph 73

We note that this paragraph is inconsistent with the proposed improvements to IAS 16 and IAS 38 as it does not require disclosure of comparative information.

Transitional provisions and effective date

Paragraph 78

We believe the transactions excluded from the proposed IFRS in this paragraph should form part of the scope exclusions. We also note that in the Basis for Conclusions, the Board comments that these transactions will continue to be accounted for under IAS 22 until they are addressed as part of Phase II. We understand, however, that IAS 22 will be withdrawn when ED 3 is finalised and accordingly, we believe this comment should be deleted from the Basis for Conclusions.

Paragraph 84

The proposed IFRS encourages early application in this paragraph. We do not understand how an entity could adopt the standard earlier than the date on which it is released. Does this paragraph mean that the IASB encourages retrospective application? We believe that clarification is required in this regard.

First time adoption considerations

We are aware that our recommendation to combine Phases I and II of the business combinations project would delay the publication of a final IFRS. The effect of a delay until 2004 is likely to be that the publication of the standard falls after the date of transition of First-Time Adopters in the European Union. For example, the IFRS may be issued in June 2004 and a Spanish entity with a December year-end would have a date of transition of 1 January 2004. If the transition requirements in ED 3 are retained in the final standard, we think that this would require the Spanish entity to account for business combinations after the date of transition but before the publication of the IFRS in accordance with IAS 22.

Business combinations in 2004 would, in any event, have been accounted for initially by the first-time adopter under previous GAAP, and, under ED 1 as drafted, they would need to be restated. Accordingly we suggest that where ED 3 is issued as a final standard between the date of transition and the reporting date in a first-time adoption, it should be applied retrospectively to business combinations after the date of transition. This is in line with the requirement to apply retrospectively other new standards in force at the reporting date. We think that this requirement is no more onerous than applying other standards, e.g. IAS 32, fully retrospectively. We would not suggest that the IASB changes the transition requirements for existing users of IFRS, i.e. prospective as proposed.

Appendix B

Allocating the cost of a business combination

We understand that the IASB is addressing issues related to the measurement of the net assets acquired in Phase II of the business combinations project. This further supports our recommendation to combine the two phases as we believe that all issues related to the allocation of the cost of a business combination should be addressed at once.

Paragraph B15

The guidance given in the paragraphs under B15 in respect of determining fair values to be used in the initial accounting for a business combination is not entirely consistent with related IFRSs. We suggest that this paragraph be re-written to provide guidance by reference to other relevant standards wherever possible. For instance, we suggest amending paragraphs (a), (b), (c) and parts of (j) to include references to IAS 39.

Paragraphs B15(e) and (f)

Paragraph B15(f) provides guidance in respect of determining fair values for plant and equipment of a specialised nature. We suggest that this guidance be extended to buildings of a specialised nature in paragraph (e).

Paragraph B15(k)

This paragraph provides guidance on determining the fair value of an onerous contract. The guidance seems to be inconsistent with IAS 37.69, which requires valuation at the minimum net cash flow required to be released from the contract. Proposed paragraph B15(k) ignores the potential case where it would be less costly to cancel the contract than to complete it, and it seems to imply that gross cash flows should be used. We believe that the valuation under ED 3 and IAS 37 should be consistent, and therefore we recommend amending this proposed paragraph.

Drafting Comments

Paragraph 4

We suggest the Board consider presenting this paragraph using a list of bullet points instead of the proposed format. A list format would be easier for readers to follow and understand.

Paragraphs 5 and 6

These paragraphs both use the word "may". Does the Board intend to imply that there are other structures of business combinations or that a business combination is either as described in paragraph 5 or as described in paragraph 6? We suggest that the Board clarify its intention here.

Paragraph 15

This paragraph states that no additional assets or liabilities of the acquirer should be recognised as a result of a business combination. IAS 12.67, however, provides for the recognition of a deferred tax asset of the acquirer by adjusting goodwill or negative goodwill if realisation becomes probable as a result of the combination. We suggest that paragraph 15 of the ED be amended to include a reference to this exception.

Paragraph 26

While we are happy with either "more clearly evident" or "more readily determinable" as used in ED 2 *Share-based payment*, we recommend that consistent terminology be used.

Paragraph 34

The IASB provides guidance on how to treat certain subsequent payments made to the seller in a business combination. We suggest the IASB add clarity by including the following at the end of the paragraph: "i.e. added to (deducted from) the interest of the related financial liability."

Paragraph 43

This paragraph discusses the recognition of the acquiree's identifiable intangible assets. We suggest that the IASB explicitly state that any existing goodwill of the acquiree is not an identifiable intangible asset and should not be recognised by the acquirer.

Paragraph 45

The IASB proposes in this paragraph that the acquiree's contingent liabilities be recognised by the acquirer in a business combination. If the Board retains its proposed accounting for acquired contingent liabilities, we suggest that a statement be added to the IFRS to specify that this does not apply to an acquirer's contingent liability that results from the combination.

Paragraph 58

This paragraph is difficult to digest on the first read. Parts (a) and (b) appear to relate to the first part of this paragraph, when in fact, they relate to the final part, appearing after these subparagraphs. We suggest that this section be re-ordered to be more easily understood.

Appendix 2 – Comments on [revised] IAS 36

Responses to invitation to comment

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 do not agree with the proposal to prohibit amortisation of goodwill. Please see our comments on ED 3 *Business Combinations* in Appendix 1. We also suggest that the requirements under the current IAS 36 be retained and that impairment testing be required only when there is an indicator or when the amortisation period exceeds the rebuttable presumption. Since the amortisation method is not a valuation approach, impairment testing would not be relied on solely to detect deterioration of goodwill and as such, would not be necessary unless there is an indicator or the useful life exceeds a certain threshold.

We continue to support the current approach whereby annual impairment testing applies for any goodwill or other intangible assets with useful lives exceeding a certain threshold. The threshold (e.g. useful lives exceeding 20 years) chosen will of course be arbitrary, but we believe that it is necessary to require assessment of these assets that will remain on the balance sheet for an extended period of time. Under the proposed changes to IAS 36, this also would discourage establishing a useful life as long but definite rather than indefinite to avoid impairment testing.

In addition, we request that [revised] IAS 36 be amended so that annual impairment testing required for intangibles does not necessarily need to be performed at year-end. As proposed, paragraph 8A would require that impairment testing for indefinite life intangible assets be done at year-end. We find this inappropriate as it represents an inconsistency between impairment testing for goodwill and for intangible assets.

We also suggest that the IASB include a requirement that if an impairment test is not done at the balance sheet date, the entity must consider any events occurring subsequent to the test that would significantly change the result of the test. This could be done by introducing guidance similar to IAS 19.57 in respect of actuarial valuations that are not performed at the balance sheet date.

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 do not agree with the proposal to ascribe indefinite useful lives to certain intangible assets. We believe definite useful lives should be established for all intangibles and we support a rebuttable presumption (e.g. 20 years), as included in the current IAS 38. We also believe that the current requirements in respect of annual impairment testing for intangibles with useful lives in excess of a rebuttable period should be retained and that the current guidance for measuring the recoverable amount of assets other than goodwill and recording related impairment losses should be maintained.

Question 3 – Measuring the 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?

In respect of parts (a) and (b) of this question, we find the additional guidance provided in proposed paragraphs 25A and 27 to be useful and appropriate. We also agree that an entity should be permitted to reflect the elements listed in paragraph 25A either as adjustments to future cash flows or as adjustments to the discount rate.

We disagree, however, with the expected cash flow method proposed in paragraph 26A and Appendix B. This proposal in effect requires that regardless of whether the risk elements are reflected in the cash flows or in the discount rate, the result should be the same as using the expected cash flow method demonstrated in Appendix B. We disagree. The outcome of the proposal will be to discount risky cash flows at a risk-free rate, which is a flawed approach. For example, two sets of cash flows may have the same overall average outcome, yet the first set may be widely distributed and the second set narrowly clustered around the average. The first set should be considered riskier because of the wider variability in possible outcome, and so the two averages should not be discounted at the same rate, let alone the risk-free rate.

Furthermore, if the cash flows are "normally" distributed (i.e. in a normal bell curve), the statistical average is the same as the most-likely outcome; we presume that the IASB would argue that the most likely outcome should not be discounted using a risk-free rate. We also find that the use of probabilities of cash flows to capture risk elements makes the value in use calculation unnecessarily complex and less reliable.

Accordingly, the expected value method should not be adopted. Instead, we believe that companies should continue to have the choice of making the risk adjustments either to the cash flows or to the discount rate.

Further, we regret that the IASB has not taken this opportunity to improve the guidance in respect of calculations of value in use. Specifically, we strongly encourage the IASB to provide additional guidance and/or illustrative examples in the following areas:

- Determining the discount rate:

  Many of the issues encountered in practice surround the determination of the appropriate discount rate, specifically in identifying a pre-tax rate as required by IAS 36. The current guidance suggests that the Capital Asset Pricing Model (CAPM) be used as a starting point, but that it should be independent of the entity's capital structure and that it should be pre-tax. However, the Weighted Average Cost of Capital (WACC) is related directly to an entity's capital structure and it is post-tax. It would be useful if the IASB could reconcile these positions by adding in the explanation that the cost of capital under CAPM is independent of capital structure before the effects of tax. We also believe that there are instances where the WACC is not appropriate (e.g. in a distressed company). We suggest that the IASB acknowledge this by stating the CAPM may be used as a starting point unless there are indications that it will not produce the appropriate discount rate.

  In addition, the Basis for Conclusions in existing IAS 36 leads entities to determine the pre-tax rate by starting with a post-tax rate and cash flows and performing iterations, which is correct but onerous. We understand that the IASB plans to address the use of a pre-tax versus a post-tax rate and to provide more guidance on discount rates in another project but we would like to stress the need for urgent attention to this area.

- Capital expenditure and restructuring costs:

  Difficulty also is encountered when impairment testing is done shortly after an acquisition where the transaction included considerations in respect of synergy, capital expenditure, restructuring or other items that may be disallowed in the impairment test. Testing in this case could lead to an impairment charge immediately after an acquisition. We find this to be inappropriate and believe that changes are required in this regard.

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 that 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-C-20 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?*

As discussed further in our response to Question 5, we believe that the impairment testing requirements under the current IAS 36 should be retained. If the Board follows this recommendation, we agree that goodwill should be allocated to cash-generating units (CGUs) in order for impairment testing to be performed at a level consistent with management monitoring of return on investment.

We note that the guidance in respect of CGU identification earlier in the standard (e.g. in paragraph 59) does not refer to management monitoring of return on investment. We suggest that this reference be brought forward in the standard as guidance for identifying CGUs as well as in allocating goodwill.

While we understand that it is the Board's intention to clarify what is meant by "reasonable and consistent basis" in paragraph 73 and to ensure that goodwill is allocated at an appropriately low level, we do not believe that this objective has been achieved. We are concerned that the added clarification in paragraph 74 actually will result in goodwill not being allocated to CGUs at the lowest possible level. As the guidance clearly states the segment level as the upper limit for allocation and given the excessive disclosure requirements and onerous nature of the two-step approach, we believe that, as currently drafted, revised IAS 36 would encourage entities to make every effort not to allocate goodwill below the segment level. If our recommendation to retain the existing IAS 36 testing is accepted, we suggest that paragraphs 73 and 74 be redrafted explicitly to require allocation at the lowest CGU level possible in testing goodwill.

On the other hand, if the IASB proceeds with the proposed two-step impairment approach for goodwill, we strongly recommend that goodwill not be allocated to the CGU level. We suggest that the allocation be made at a level similar to the reporting unit level used in testing for impairment under US GAAP, which is segment level or one level below. Our experience in applying the US GAAP standards is that the valuations required in the testing can be quite complex and onerous. We do not see a reason for adding further complexity and burden to the IAS valuations by requiring that the testing be done at the CGU level. If the objective of convergence is a driver behind the introduction of the two-step test, then it is logical that the allocation level also be consistent with US GAAP.

In respect of part (b) of this question, we agree with the proposal to allocate the appropriate portion of goodwill in determining the gain or loss on the disposal of an operation. The allocation based on relative values is a reasonable approach unless there is another allocation method that is apparent and more meaningful to a particular entity. For instance, the substance or contractual arrangements underlying the original transaction may indicate a different allocation. We suggest that the IASB include such a provision in the standard so that an entity may use a different approach if there is in fact a more meaningful split. In addition we suggest that the reference to "relative values" be changed to "relative recoverable amounts" to add clarity.

Consistently with the case of a disposal, we find that the allocation of goodwill on the basis of relative values is reasonable in the case of a reorganisation in which the composition of the CGUs is altered. We also believe that a provision should be added in respect of cases where a more relevant allocation is apparent.

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 the net selling price (see proposed paragraphs 5 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 methods 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 that the recoverable amount of a CGU to which goodwill has been allocated should be the higher of the value in use and the net selling price.

We do not agree with the proposed use of the current IAS impairment test as no more than a screening mechanism. The use of a two-step testing approach seems unnecessarily complicated, especially given the number of estimates involved (e.g. forecasts, discount rates). While we understand the arguments set out in the Basis for Conclusions, we do not agree that the incremental benefit of the second step (i.e. the implied value of goodwill calculation) outweighs the cost. We anticipate that the requirement for an entity to estimate fair values of all assets at each annual testing date is a significant undertaking and not to be underestimated.

We also note that, whereas convergence with US GAAP may have been an important consideration in the IASB's choice for the impairment-only model for goodwill, the proposed approach would still result in differences with the US equivalent standard. As mentioned in our response to Question 4, the definition of CGUs in IAS 36 generally results in impairment testing under IFRS being performed at a lower level than under US GAAP. The two standards would therefore not produce similar results. In addition, the IASB's proposal – with which we concur - to exclude identifiable intangible assets that were not recognised separately from goodwill at the acquisition date from the implied fair value calculation of goodwill would introduce a further difference between the future IFRS and its US equivalent.

If the Board decides to move forward with the proposal to adopt the impairment-only model for goodwill, despite our reservations as noted, we recommend complete convergence with US GAAP. We presume that the main motivation for moving to a valuation model would be convergence, and as such, we believe that the IASB should eliminate the differences in impairment testing as well. This would mean proceeding with the two-step approach but changing the allocation of goodwill to testing units to a higher level.

Question 6 – Reversals of impairment losses for goodwill

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

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

If the IASB moves forward with the proposals not to amortise goodwill but to test it annually for impairment, then we agree that an entity should not be permitted to reverse an impairment loss recorded in respect of goodwill. We believe that allowing such a reversal would be inconsistent with the prohibition on recording internally generated goodwill under IAS 38.

However, if the IASB decides to reconsider the proposed approach and continue to require goodwill to be amortised, we disagree. In this case, the carrying amount of goodwill would continue to represent goodwill acquired in a business combination and a reversal of an impairment loss as allowed under the current IAS 36 subject to limits for amortisation that would have been recorded, would be appropriate.

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

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

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

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

We believe that the proposed disclosure requirements are excessive. We do not believe that the false sense of robustness of the impairment-only model can be compensated for by excessive disclosures. While we understand the argument that such disclosures are designed to ensure that the impairment testing is done correctly, we argue that the cost involved in meeting some of the requirements (e.g. 134(e)(iv) or 134(f)(ii)) far outweighs the benefit.

We do agree that some of the proposed disclosure information may be useful to financial statement users, however, we find that it would be more appropriate for it to appear in a Management Discussion and Analysis document.

We expect the application of these proposals to be a significant undertaking for companies and we anticipate that many will find the requirements impracticable. The cost and effort that will be involved in meeting these requirements for all goodwill balances will be extremely onerous, especially for large multinational groups.

In particular, we find that the following requirements fail a cost-benefit assessment:

- In the instance where an entity has a substantial margin in its impairment tests, disclosures set out in paragraphs 134 and 137 should not be required.

- Paragraph 134(d) proposes to require information to make readers aware of how close the entity is to recording an impairment loss. We believe that this information has limited utility as the reader would be left to make judgements about what should be considered “close” and what should not.

Other comments

Summary of approach

We suggest that the IASB include a summary of the approach as to timing and levels of testing taken in the proposed IAS 36. A summary similar to that proposed in the [draft] revised IAS 21.15-17 would be helpful in presenting the overall approach up front.

Paragraph 4

We believe that the proposed changes to this paragraph have a significant impact for finance lease receivables. Proposed paragraph 4 scopes out financial instruments that are within the scope of IAS 39. As finance lease receivables are scoped out of IAS 39, this implies that they would be subject to impairment testing under IAS 36. As there currently is no guidance on finance lease receivables, we would welcome proposals on accounting for impairment of these assets. However, as stated in our comment letter in response to the proposed amendments to IAS 39, we believe the impairment principles in IAS 39 would be more appropriate to apply to these receivables than those in IAS 36.

Paragraphs 20A

We do not believe that the relaxation of the testing requirements is articulated appropriately in paragraph 20A. The objective should be an assessment of the current recoverable amount, simplified by using old data. The current wording seems to suggest using the old recoverable amount itself. The IASB should clarify the wording in this paragraph or provide additional guidance.

Paragraph 73

This paragraph requires that goodwill be allocated to CGUs for impairment testing. It is not clear, however, whether the allocation can be changed after the initial acquisition. The proposed paragraph refers to allocation "from" the acquisition date. We find this wording to be ambiguous and request that the IASB clarify its intention in this respect.

Paragraphs 86 and 87

Paragraph 86(b) requires any intangible assets that were not recognised separately at acquisition, but subsequently meet the recognition criteria, to be excluded from the calculation of implied fair value of goodwill. The proposals, however, do not include guidance on how to treat any subsequent expenditures on such intangibles that are included in the balance sheet at the date of the impairment test. We presume that the guidance in paragraph 86(b) relates to the unrecognised value of the intangible asset, as discussed in paragraph C33 of the Basis for Conclusions. We would welcome further clarification on this issue in the form of implementation guidance or an illustrative example.

In addition, we suggest that the IASB demonstrate the implied value calculation in the following scenarios:

- where an intangible that existed but was not recognised separately on acquisition satisfies the recognition criteria at the testing date;
- where an intangible that did not exist on acquisition has been recognised at the testing date; and

- where an intangible has not been recognised because it was internally generated, but would be recognised if acquired in a business combination.

Paragraph 93

We find it onerous to require an entity to perform an impairment test in respect of goodwill acquired in a business combination before the end of the first reporting period following acquisition. For example, if a business combination is effected in November, we do not believe that the entity should have to perform the goodwill impairment test one month later if it has a December year-end. Instead we recommend that the IASB amend the proposal to require testing within 12 months of the acquisition.

In addition, we do not agree with the IASB's proposal to require the goodwill impairment test to be performed on the same date every year. For instance, in the example presented above, if the IASB proceeds with the proposal, the entity would have no choice but to perform the test in December of every year. We believe that if an entity is required to perform the first test before the end of their reporting period, they should be permitted to choose a different month in which to evaluate goodwill in subsequent years.

Paragraph 139

This paragraph encourages early application of the revised standard. Since the revised standard is to be effective for goodwill and intangibles acquired in a business combination from the date it is released, we are unclear as to what is meant by early application in this case. We have provided a similar comment in respect of the proposed early application of ED 3 and of revised IAS 38.

Appendix A

We believe that more illustrative guidance would be welcome and suggest that the IASB add some examples to demonstrate the allocation of goodwill and the calculation of implied value with adjustments for unrecognised assets. These are both areas where the new guidance could be misinterpreted or misunderstood and illustrating the application certainly would prove to be helpful.

Appendix B

The example provided in paragraph B8 demonstrates the use of probabilities using the same cash flow amount with varying interest rates and timing. We suggest that the Board clarify that the change in discount rates relates to the timing of payments.

Drafting comments

Paragraph 6(c)

This paragraph specifies that impairment reversal requirements apply equally to all assets and CGUs. We suggest that the IASB explicitly state that this paragraph does not apply to impairment losses recognised in respect of goodwill.

Paragraph 83

We do not believe that the requirement that goodwill be tested by reference to all of the CGUs (i.e. the top-down test) is explicit enough. While this requirement is implied in reading paragraph 85, we suggest that the guidance would be clearer if it was set out in paragraph 83.

Appendix B

Paragraph B12

We believe that this paragraph should actually form part of the standard itself as it provides a principle as opposed to detailed implementation guidance or illustration.

Appendix 3 – Comments on [revised] IAS 38

Responses to invitation to comment

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 find the separability and contractual/other legal rights criteria appropriate, however we believe that the interaction between these criteria, as set out in paragraph 11, and the control criterion discussed in paragraphs 12 to 15 needs further clarification. Under current IAS 22 and IAS 38, intangible assets are not recognised if they are not controlled by the entity acquiring them. For instance, a customer list normally would not meet the current recognition criteria as it cannot be controlled. This notion seems to be retained in the new paragraph 15. However, the illustrative guidance indicates that items such as customer lists and non-contractual customer relationships can be capitalised if they meet the criteria in paragraph 11, that is, based on these items being separable.

We believe that the recognition criteria need to be consistent for intangibles acquired in a business combination and those acquired separately, and therefore, we recommend that the control requirement should be emphasised in the final standard.

In addition, we are concerned about the potential for intangible assets to be separated excessively to the point where the recognition loses its meaning and utility. For example, we believe that an intangible item such as a brand should be recorded as such and not separated into individually identifiable components.

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 have some doubts about the IASB's presumption that fair values of all intangible assets can be measured reliably. There are certainly intangible items that may carry an intellectual property right but for which a fair value is not reliably determinable. For example, a slogan is likely to be protected by a legal right but a fair value would be difficult, if not impossible, to determine.

In addition, we have experienced some difficulty in practice in determining the fair value of intangibles that do not have an observable market. In certain cases, when an intangible asset is not traded in an observable market, its fair value is estimated based on cash flows and difficulties in determining fair values on this basis arise notably for intangibles that only generate cash flows when used with a collection of other assets, both tangible and intangible.

Difficulty also has been experienced in identifying and measuring the value of customer relationship assets. There are significant differences in professional opinion amongst valuation specialists regarding the factors that should be considered in determining such values. These issues affect both the recording of intangibles acquired in a business combination and subsequent impairment testing under [revised] IAS 36. In certain cases, it would seem appropriate to recognise intangibles based on whether they can be sold individually or with a group of similar intangibles. However, we would not want to rely solely on separability as the identification criterion as there are certain intangibles that are not separable that we believe should be recognised. Therefore, we recommend that the IASB establish criteria for recognition and measurement that strikes a balance. At one end of the scale the inalienable asset (e.g. a broadcast license) should be recognised, but at the other end, there should be no recognition of legal rights that are merely a means of protecting a larger asset.

We also note that proposed paragraph 30 states that "sufficient information should always exist to measure reliably the fair value…" The use of the word "should" leads us to question the Board's proposal in a case where such information is not available. According to the proposals for revisions to IAS 38, we presume that if the intangible asset cannot be reliably measured, it should not be recognised separately from goodwill. However, ED 3 proposes dropping the reliable measurement criterion assuming that if an intangible is identifiable, it can be measured reliably.

Paragraph 32 discusses the recognition of intangible assets separately from goodwill in a business combination, including specific mention of in-process research and development. We have concerns about the inconsistency introduced by this paragraph. Even if the probability recognition criterion is assumed to be met, the capitalisation of research acquired in a business combination is in direct conflict with the requirements for internally generated research. We do not support such inconsistency with the Framework and with the requirements for internally generated research. In the Basis for Conclusions, paragraph B13, the Board notes that it will consider the role of probability in the Framework more generally as part of a later Concepts project and that it also may revisit IAS 38 at a later stage to determine whether it should make the recognition criteria for internally developed research consistent with acquired in-process research.

We respectfully disagree with this approach. We strongly prefer the Board not to move ahead with introducing significant inconsistencies before these issues are addressed more broadly within the context of the future Concepts and Intangible Assets projects.

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 not 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 disagree with the proposal to remove the rebuttable presumption from IAS 38. Our recommendation in respect of goodwill, as set out in Appendix 1, is to retain the current amortisation model and a rebuttable presumption (e.g. 20 years). Similarly, we believe that a definite useful life should be established for all intangible assets and that a rebuttable presumption be retained.

However, if the non-amortisation model is adopted for goodwill, we suggest that some intangibles also may be identified as having indefinite useful lives. In this case, we suggest that the IASB include a requirement that useful lives over a certain threshold be subject to the same impairment testing as those with indefinite useful lives. This recommendation is consistent with our response to Question 1 in Appendix 2, which addresses the frequency of impairment tests under revised IAS 36.

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 than can be renewed? If not, under what circumstances should the useful life include renewal period(s)?

We agree.

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?

In our response to Question 3 above, we have noted that we believe a useful life should be established for all intangible assets and that they should be amortised over this period.

However, if the Board proceeds with its proposal to not amortise goodwill, we believe that certain intangible assets also could be identified as having indefinite useful lives. In these cases, we would agree that such intangible assets should not be amortised but instead tested for impairment.

Other Comments

Paragraph 58(d)

Paragraph 58 gives examples of costs that are directly attributed to internally generated intangibles and therefore should be included in the cost of the asset. Part (d) of this paragraph requires the allocation of applicable overheads to be included in the cost of internally generated intangible assets. It is not clear why the IASB proposes to delete this part of the paragraph. We believe that an allocation of overhead can be attributable directly to the generation of an intangible and therefore should be included in the cost of the asset.

Paragraph 93

The IASB clarifies in this paragraph that amortisation of an intangible asset with a definite useful life is to begin once the asset is available for use. We suggest that additional guidance be provided on determining the point at which an asset is considered "available for use". For instance, if development of an asset is complete, but consumption is delayed for a period, when should amortisation commence? We believe that if the asset is of the nature that its useful life does not begin to deplete until it is in use, then amortisation should not commence until that point. Any decline in value occurring in the meantime would be detected through impairment testing. We ask that the IASB provide guidance on implementing this requirement to clarify its intention in such situations.

Paragraph 127

This paragraph encourages early application of the revised standard. Since the revised standard is to be effective for intangible assets acquired in a business combination from the date it is released, we are unclear as to what is meant by early application in this case. We have provided a similar comment in respect of early application of ED 3 and revised IAS 36.

Drafting comments

Paragraph 7

We suggest that the reference to share-based payment be deleted from the definition of "cost" in this paragraph and added to proposed paragraph 26.

Paragraph 22 and 29

We believe it would be more appropriate for the probability discussions in paragraphs 22 and 29 to appear in the Basis for Conclusions.

Paragraph 31

We find that this paragraph presents an argument to support the IASB's view on workforces. Therefore, it would be more appropriate for it to appear in the Basis for Conclusions.