Comments to *ED 3*
Business Combinations

CL 47

Question 1 – Scope

The Exposure Draft proposes:

(a) to exclude from the scope of the IFRS business combinations in which separate entities or operations of entities are brought together to form a joint venture, and business combinations involving entities under common control (see proposed paragraphs 2 and 3 and paragraphs BC9-BC11 of the Basis for Conclusions).

Are these scope exclusions appropriate? If not, why not?

(b) to include in the IFRS a definition of business combinations involving entities under common control, and additional guidance on identifying such transactions (see proposed paragraphs 9-12 and Appendix A, and paragraphs BC12-BC15 of the Basis for Conclusions).

Are the definition and additional guidance helpful in identifying transactions within the scope exclusion? If not, what additional guidance would you suggest, and why?

Response

We agree with the above proposals.

Question 2 – Method of accounting for business combinations

The Exposure Draft proposes to eliminate the use of the pooling of interests method and require all business combinations within its scope to be accounted for by applying the purchase method (see proposed paragraphs 13-15 and paragraphs BC18-BC35 of the Basis for Conclusions).

Is this appropriate? If not, why not? If you believe the pooling of interests method should be applied to a particular class of transactions, what criteria should be used to distinguish those transactions from other business combinations, and why?

Response

For practical purposes we agree with the proposal. We believe that the purchase method is the appropriate method in accounting for business combinations which are 'real' acquisitions.

But should a 'true' merger actually occur in practice, applying the purchase method of accounting would clearly result in the wrong accounting treatment. However, we believe that this issue will be reconsidered as part of *Phase 2* of the Business Combinations project.

In addition, we would like to make the point for consideration in *Phase 2* of the Business Combinations project that group restructurings (e.g. transfer of net assets from one entity to another, with the former's subsequent liquidation) should not result in any requirement to restate assets and liabilities to fair value, as in substance nothing has changed from a Group point of view.

Question 3 – Reverse acquisitions

Under IAS 22 Business Combinations, a business combination is accounted for as a reverse acquisition when an entity (the legal parent) obtains ownership of the equity of another entity (the legal subsidiary) but, as part of the exchange transaction, issues enough voting equity as consideration for control of the combined entity to pass to the owners of the legal subsidiary. In such circumstances, the legal subsidiary is deemed to be the acquirer. The Exposure Draft:

(a) proposes to modify the circumstances in which a business combination could be regarded as a reverse acquisition by clarifying that for all business combinations effected through an exchange of equity interests, the acquirer is the combining entity that has the power to govern the financial and operating policies of the

other entity (or entities) so as to obtain benefits from its (or their) activities. As a result, a reverse acquisition occurs when the legal subsidiary has the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities (see proposed paragraph 21 and paragraphs BC37-BC41 of the Basis for Conclusions).

Is this an appropriate description of the circumstances in which a business combination should be accounted for as a reverse acquisition? If not, under what circumstances, if any, should a business combination be accounted for as a reverse acquisition?

(b) proposes additional guidance on the accounting for reverse acquisitions (see proposed paragraphs B1-B14 of Appendix B).

Is this additional guidance appropriate? If not, why not? Should any additional guidance be included? If so, what specific guidance should be added?

Response

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

(b) The proposed additional guidance together with the illustrative examples is appropriate, but it would be helpful if the IFRS made it clear that the comparative figures presented should be those of the legal subsidiary and not those of the legal parent.

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?

Response

We agree with the proposal, as the substance and not the legal form of the transaction should be considered in determining whether or not it is a business combination.

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?

Response

We fully understand the Board's desire to prevent the abuse of restructuring provisions in accounting for acquisitions but fear that the approach proposed would lead to the omission of useful, relevant information and potentially to misleading financial reporting. The proposals seek to determine values for what has been acquired. However, in doing so, they ignore what is often a very important part of the ***cost*** of making the acquisition which the acquirer has decided to incur in order to bring the investment to working condition for its intended use.

Terminating or reducing the activities of the acquiree results directly from the business combination itself and represents the effect of providing for the synergies as planned by management. To exclude these costs from the total cost of the acquisition leads to inadequate measurements:

- the costs of restructuring would be shown as part of the operating performance of the combined entity which they are not; and
- goodwill would be understated. In some cases, goodwill could even be made negative. In this case, income would be reported while the restructuring expense would be deferred until the restructuring costs became a liability in accordance with IAS 37.

In our view, this would lead to distortions of both the income statement and the balance sheet.

And finally, the proposals would ignore the expected (highly probable) outflows decided by management for restructuring but would reflect what are by definition improbable outflows by requiring inclusion of contingent liabilities.

We therefore **rather propose** that a **restructuring provision be allowed** to be created **as at the date of acquisition** - based on the event i.e. the acquisition - which then would be adjusted during the initial 12 month allocation period, with corresponding adjustments being made to goodwill.

In order to avoid any abuse, we recommend that the Board set up **strict criteria** against which the restructuring plan should be assessed, in order to make sure that the plan actually results from the combination of the two entities. Similarly, the conditions set out in the present IAS 22, paragraph 31 could be adapted and modified - in order to prevent further abuse: this might encompass, for instance, a limitation of restructuring provisions to costs which are expected to be incurred within 12 months from the date of acquisition.

With the accompanying explanatory disclosures, this approach would provide users with important information which would be more useful than that proposed in the draft where relevance suffers considerably to the advantage of excessive abuse prevention constraints.

Finally, it is also worth noting that making excessive restructuring provisions would in any case not necessarily be the optimal solution for an entity as the resulting higher goodwill would then be subject to annual impairment testing - and at the other extreme the understatement of goodwill as a result of not recognizing these provisions contrary to our recommendation would further inflate any goodwill "cushion" created from internally generated goodwill.

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?

Response

No, we do not believe that the proposal is appropriate. We believe that contingent liabilities should be recognised separately only if they satisfy the requirements of IAS 37. Our main concerns with the proposal are:

- non-compliance with the requirements of IAS 37;
- unreliable measurement; and
- potential recognition of a contingent liability with a low probability of it actually becoming a liability.

We think it inappropriate to recognise contingent liabilities in an acquisition if it is not possible to recognise them under the current requirements of IAS 37. The nature of a contingent liability does not change as a result of an acquisition, and we believe the IAS 37 criteria should still be applied. Although the purchase price of the acquired entity may include **an allowance** for contingent liabilities (and for that matter contingent assets as well), we are not convinced that their fair values can always be measured reliably. Certainly, if the proposals are accepted, somewhat clearer guidance on the meaning of "reliable measurement" must be given (ED 3.36(d)).

Many contingent liabilities arise from legal claims (e.g., tobacco, pharmaceuticals) and can result in very large figures according to Appendix B15 (l), which requires the amount of the contingent liability to "reflect all expectations about possible cash flows and **not the single** most likely or the expected maximum or minimum cash flow". The resulting number does not reflect the potential future cash outflow because it is based on an average expectation covering a wide spectrum of possible outcomes. It is very difficult in reality, sometimes impossible, to quantify the possible outcome of contingent matters such as legal proceedings.

Once contingent liabilities are recognised separately at the date of acquisition, the acquirer must measure them at their fair values with changes in fair value recognised in profit or loss (paragraph 46). Such contingent liabilities are explicitly excluded from the scope of IAS 37. We disagree with the proposal, because it results in inconsistent treatment between contingent liabilities acquired in a business combination and other contingent liabilities of the same or a different entity.

One possibility however might be to include contingent liabilities as part of the acquisition cost if they meet the IAS 37 criteria during the initial allocation period (i.e. within 12 months from the date of acquisition).

In addition, the Board has agreed that the role of probability in the *Framework* should be considered more generally as part of a later Concepts project. While we welcome this initiative, we believe that meanwhile the recognition criteria for assets and liabilities should not be altered in the case of a business combination. Any paradigm shift of the probability criterion from recognition to measurement should not be prejudged: it has still not been subject to a proper due process.

Question 7 – Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

IAS 22 includes a benchmark and an allowed alternative treatment for the initial measurement of the identifiable net assets acquired in a business combination, and therefore for the initial measurement of any minority interests. The Exposure Draft proposes requiring the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost to be measured initially by the acquirer at their fair values at the acquisition date. Therefore, any minority interest in the acquiree will be stated at the minority's proportion of the net fair values of those items. This proposal is consistent with the allowed alternative treatment in IAS 22 (see proposed paragraphs 35 and 39 and paragraphs BC88-BC95 of the Basis for Conclusions).

Is this appropriate? If not, how should the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of a business combination be measured when there is a minority interest in the acquiree, and why?

Response

We agree that the minority's interest in the acquiree's identifiable assets, liabilities and contingent liabilities should be stated at their fair values at the acquisition date. (For our comments on recognizing contingent liabilities as at the date of acquisition, please refer to question 6 above).

Question 8 – Goodwill

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

Do you agree that goodwill acquired in a business combination should be recognised as an asset? If not, how should it be accounted for initially, and why? Should goodwill be accounted for after initial recognition at cost less any accumulated impairment losses? If not, how should it be accounted for after initial recognition, and why?

Response

We agree that goodwill acquired in a business combination should be recognised as an asset.

However, we disagree with the proposed annual impairment test for goodwill and would rather **prefer the retention of the amortization method** allowed currently under IAS 22 for the following pertinent reasons:

- the complicated second tier approach is conceptually flawed as an entity will be unable to separate the internally generated goodwill from the implied value of goodwill subsequent to acquisition. This fact is further exacerbated when an entity acquires an operation and immediately integrates it into its existing operations. In such a case, any pre-existing internally generated goodwill will act as a further buffer thus making the second tier test ineffective in establishing whether or not the carrying amount of goodwill has actually been impaired;
- to require an entity to fair value all the identifiable assets, liabilities and contingent liabilities as if it acquired them in a business combination on the date of the impairment test would be a costly exercise (external appraiser needed - audit issue?). Again, we find this test very theoretical and strongly believe that the cost of doing so would far outweigh any potential benefit which could to be received by the entity concerned;
- the introduction of an impairment test will result in substantially increased volatility of the income statement - this especially being the case when the economy is in a downward trend;

- while amortization is to some extent arbitrary, so is the complex alternative that is being proposed; and
- the introduction of the second tier test would further complicate the present one tier impairment test approach and will lead to the financial statements not meeting the very first qualitative characteristic - that being one of understandability.

And finally, as a residual value goodwill is conceptually a difficult, amorphous and nebulous item which we believe has a **limited useful life**. It is difficult to see the benefit of moving away from IAS 22 to impairment testing of an asset which, in any event, becomes increasingly meaningless as we move forward from the acquisition date.

Based on the above arguments, we strongly believe that for both **practical and conceptual reasons** the **amortization of goodwill should continue** into the new Standard.

We do however acknowledge that US GAAP may not re-align itself with IFRS and the adoption of an impairment-only approach would have the advantage of removing what is very often the quantitatively largest divergence between IFRS and US GAAP. Therefore, should the Board insist on following its proposed non-amortization approach for goodwill, it is essential that the potentially complex and costly impairment process envisaged be **simplified** in a few key aspects, as described in our comments on the proposed revisions to IAS 36 (Question 5). A reasonable balance with what is practicable, as mentioned in BC 107, and avoidance of undue cost and effort would otherwise not be achieved.

In the event, however, that the two tier impairment test is **not simplified**, we **strongly believe** that consideration should also be given in **retaining the amortization method as an allowed alternative**. This would certainly be appropriate for entities operating in circumstances where convergence and level playing field issues are **less critical**.

Question 9 – Excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities

In some business combinations, the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of the combination exceeds that cost. The Exposure Draft proposes that when such an excess exists, the acquirer should:

(a) reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and

(b) recognise immediately in profit or loss any excess remaining after that reassessment.

(See proposed paragraphs 55 and 56 and paragraphs BC109-BC120 of the Basis for Conclusions.)

Is this treatment appropriate? If not, how should any such excess be accounted for, and why?

Response

We believe that **one exception** should be made to the principle of recording negative goodwill immediately as income, namely where it is identified as reflecting the estimated value of contingent liabilities not reflected in the provisional purchase accounting (see our response to question 6). This should then be released to income during the 12 month initial allocation period as the contingent liabilities meet the IAS 37 criteria for recognition. Any balance remaining at the end of the period should then be credited to income.

Question 10 – Completing the initial accounting for a business combination and subsequent adjustments to that accounting

The Exposure Draft proposes that:

(a) if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer should account for the combination using those provisional values. Any adjustment to those values as a result of completing the initial accounting is to be recognised within twelve months of the acquisition date (see proposed paragraphs 60 and 61 and paragraphs BC123-BC126 of the Basis for Conclusions).

Is twelve months from the acquisition date sufficient time for completing the accounting for a business combination? If not, what period would be sufficient, and why?

(b) with some exceptions carried forward as an interim measure from IAS 22, adjustments to the initial accounting for a business combination after that accounting is complete should be recognised only to correct an error (see proposed paragraphs 62 and 63 and paragraphs BC127-BC132 of the Basis for Conclusions).

Is this appropriate? If not, under what other circumstances should the initial accounting be amended after it is complete, and why?

Response

Adjustments to estimates of the total cost of a business combination can for all practical purposes be normally made within 12 months of the acquisition date. However, in some circumstances (e.g. fair values impacted by regulatory and fiscal requirements which can sometimes take more than 12 months to resolve) extra time is highly desirable in arriving at correct values and we would therefore suggest that some possibility should also exist to take such items into account, albeit on a very restrictive basis, if resolved by the end of next full accounting period.

Thereafter, adjustments should only be made to correct an error (as proposed).

Other comments

Disclosure requirements

Paragraphs 65 to 76 of ED 3 require certain disclosures for past business combinations and business combinations effected during the reporting period or after the balance sheet date but before the issue date of the financial statements.

Although paragraphs 65, 71 and 73 are not explicit as to whether comparative figures are required or not, we believe that paragraph 65 (covering current and future business combinations but *before* the financial statements are authorized for issue) as well as paragraph 71 (asking for cumulative information) do not require comparative figures for the information requested. However, paragraph 73 (changes in the carrying amount of goodwill) and the following paragraphs are not clear in that respect. The Board should clarify whether paragraphs 73 to 76 require comparative information or not.

Also, paragraphs 69(a) and (b) requires a full "pro-forma" reflecting the impact of all acquisitions as if they had been effected from the beginning of the accounting period. This seems a rather excessive requirement, necessitating the restatement of the relevant pre-acquisition period for the effects of the business combination(s).

Paragraph 70 (covering future business combinations but *before* the financial statements are authorized for issue) seems unrealistic in requiring disclosure of all the information in paragraph 66, especially when companies are trying to produce their accounts in a shorter time frame. Items (f) - (i) of paragraph 66 should be re-considered from the practicability perspective, including circumstances where acquirer and acquiree have different accounting year-ends.

Lastly, the requirement in paragraph 67 for disclosure in aggregate should differentiate between reasonably aggregable information and other items such as names and descriptions of combining entities, acquisition dates, details of operations disposed of, percentages of voting shares acquires where aggregation would make no sense.

Comments to Proposed Amendments to *IAS 36*
<u>Impairment of Assets</u>

Question 1 – Frequency of impairment tests

Are the proposals relating to the frequency of impairment testing intangible assets with indefinite useful lives and acquired goodwill appropriate (see proposed paragraphs 8 and 8A and paragraphs C6, C7 and C41 of the Basis for Conclusions)? If not, how often should such assets be tested for impairment, and why?

Response

We do not agree with the proposal that:

(a) indefinite useful life intangibles shall be tested for impairment annually at the *end* of each annual reporting period and whenever there is an indication of possible impairment; and
(b) acquired goodwill shall be tested for impairment annually at *any time* during an annual reporting period, provided the test is performed at the same time every year and whenever there is an indication of possible impairment.

We believe that carrying out annual impairment tests at different dates for indefinite useful life intangibles (at the *end* of each annual reporting period) and for acquired goodwill (at *any time* during an annual reporting period) is impractical. Testing other intangible assets for impairment is conceptually related to testing goodwill for impairment. Therefore, all annual impairment tests should be performed at the same date at any time during an annual reporting period provided the test is performed at the same time every year.

Question 2 – Intangible assets with indefinite useful lives

*The Exposure Draft proposes that the **recoverable amount** of an intangible asset with an indefinite useful life should be measured, and impairment losses (and **reversals** of impairment losses) for such assets accounted for, in accordance with the requirements in IAS 36 for assets other than goodwill (see paragraphs C10-C11 of the Basis for Conclusions).*

*Is this appropriate? If not, **how should the recoverable amount be measured**, and impairment losses (and **reversals** of impairment losses) be accounted for?*

Response

We generally support the Board's proposal, since there is no conceptual reason to make a distinction between intangible assets with indefinite useful life – like trademarks – and acquired goodwill. However, for the same reason, we disagree with the different treatment of intangible assets with indefinite useful lives and goodwill in respect of **reversals of impairment losses** (see question 6). As already mentioned in our previous comment letters, there seems to be a lack of any clear criteria in the *Framework* or elsewhere for determining the appropriateness of impairment reversals, which appears arbitrary in the various standards.

Question 3 – Measuring value in use

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

(a) should an asset's value in use reflect the elements listed in proposed paragraph 25A? If not, which elements should be excluded or should any additional elements be included? Also, should an entity be permitted to reflect those elements either as adjustments to the future cash flows or adjustments to the

discount rate (see proposed paragraph 26A and paragraphs C66 and C67 of the Basis for Conclusions)? If not, which approach should be required?

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

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

Response

(a) Paragraph 25A seems appropriate, as does the choice permitted on whether to reflect in the cash flows or in the discount rate. However, we would request the Board to consider permitting companies to perform calculations on either a pre- or a post-tax basis. For practical purposes the latter often fits in much better with the internal data available and with standard evaluation procedures, e.g. for capital allocation purposes, and if correctly applied will produce the same results

(b) It is unclear how to take past actual cash flows and **management's past ability** (or inability) to forecast cash flows accurately into account, as described in (b) above. This is a very theoretical requirement, and the Board would have to **clarify how it would be done in practice**. Further, more **specific guidance** on determining the appropriate discount rate (e.g. WACC? borrowing rate? or risk-free rate adjusted for asset-specific risks?) would be helpful with additional clarification in *Appendix B*: the IASB should not assume that all preparers have a detailed knowledge of Corporate Finance, so clear guidance is necessary to ensure consistent application of the standard.

Considering management's past ability to forecast cash flows accurately in determining what assumptions should be retained as a basis for cash flow projections seems at first sight appealing. However it is not, in our view, appropriate or consistent with ED3's requirements (e.g. 3.36(d)). A main feature of impairment testing is to base cash flow projections on most recent forecasts established by management, and these will reflect latest knowledge.

Moreover, management may in the past have gone through periods when comparisons of forecast and actual figures show no specific pattern. Generally, there are sound reasons to justify any major discrepancy between actual and forecast performance (for example, September 11). The question that remains is: when should such a justification be retained as being sound, and when should it be rejected and latest forecasts be adjusted?

(c) Please refer to paragraph (b) above.

Question 4 – Allocating goodwill to cash-generating units

The Exposure Draft proposes that for the purpose of impairment testing, acquired goodwill should be allocated to one or more cash-generating units.

(a) Should the allocation of goodwill to one or more cash-generating units result in the goodwill being tested for impairment at a level that is consistent with the lowest level at which management monitors the return on the investment in that goodwill, provided such monitoring is conducted at or below the segment level based on an entity's primary reporting format (see proposed paragraphs 73-77 and paragraphs C18-C20 of the Basis for Conclusions)? If not, at what level should the goodwill be tested for impairment, and why?

(b) If an entity disposes of an operation within a cash-generating unit to which goodwill has been allocated, should the goodwill associated with that operation be included in the carrying amount of the operation

when determining the gain or loss on disposal (see proposed paragraph 81 and paragraphs C21-C23 of the Basis for Conclusions)? If not, why not? If so, should the amount of the goodwill be measured on the basis of the relative values of the operation disposed of and the portion of the unit retained or on some other basis?

(c) If an entity reorganises its reporting structure in a manner that changes the composition of one or more cash-generating units to which goodwill has been allocated, should the goodwill be reallocated to the units affected using a relative value approach (see proposed paragraph 82 and paragraphs C24 and C25 of the Basis for Conclusions)? If not, what approach should be used?

Response

(a) We agree with the proposal because the 'level' of impairment testing should be looked at "through the eyes of management" i.e. at the lowest level at which management monitors the return on its invested capital including the goodwill.

(b) We agree with the proposal in principle but suggest that an exception be permitted where goodwill in a CGU can clearly and unambiguously be identified with a retained part of a CGU.

(c) Please refer to (b) above.

<u>Question 5 – Determining whether goodwill is impaired</u>

The Exposure Draft proposes:

(a) that the recoverable amount of a cash-generating unit to which goodwill has been allocated should be measured as the higher of the unit's value in use and net selling price (see proposed paragraphs 5 (definition of recoverable amount) and 85 and paragraph C17 of the Basis for Conclusions).
Is this appropriate? If not, how should the recoverable amount of the unit be measured?

*(b) the use of a **screening mechanism** for identifying potential goodwill impairments, whereby **goodwill** allocated to a cash-generating unit would be identified as **potentially impaired only when the carrying amount of the unit exceeds its recoverable amount** (see proposed paragraph 85 and paragraphs C42-C51 of the Basis for Conclusions).*
Is this an appropriate method for identifying potential goodwill impairments? If not, what other method should be used?

*(c) that if an entity identifies goodwill allocated to a cash-generating unit as **potentially impaired**, the amount of any impairment loss for that goodwill should be measured as the **excess of the goodwill's carrying amount over its implied value** measured in accordance with proposed paragraph 86 (see proposed paragraphs 85 and 86 and paragraphs C28-C40 of the Basis for Conclusions).*

Is this an appropriate method for measuring impairment losses for goodwill? If not, what method should be used, and why?

Response

(a) We agree with the proposal.

(b) On balance, yes, although the remarks set out below leave significant doubts about whether the regular internal and external costs are really justifiable.

(c) As indicated in our comments on ED 3 (question 8) we believe that for the impairment-only approach to be acceptable, the impairment testing method **must be made less costly and complex**. We appreciate that the Board's proposed screening method and the use of the most recent detailed calculations made in a preceding year of the recoverable amount of a cash generating unit (CGU) (ED 36.20A/96) in many situations go some way to doing this, but this is **not far enough**, especially with regard to **step 2**.

The Board must realise that making quasi-acquisition valuations can be a very expensive exercise. Especially where regulators, auditors and others push for certainty in valuation, often to protect themselves, there will often be pressure to obtain external appraisals (i.e. real cash out of the door). The situation might easily occur where an entity getting into financial difficulties has to incur heavy costs for external valuations - and thus further worsen its financial situation - as a consequence of shortfalls arising in several CGUs at the same time (e.g. in an economic downturn). Would it be in the shareholders' best interests to know what the implied value of the goodwill is **or** would it rather be in their best interests to find a less costly way of getting a meaningful financial picture of the business? Even when done internally, the testing would involve substantial costs for the entity involved.

The value of "implied goodwill" is a piece of information which itself has absolutely no "value in use" whatsoever other than to perform the impairment test as proposed. As already mentioned in our comment letter ED 3 (question 8), goodwill is a residual value at one point in time which thereafter becomes increasingly amorphous, nebulous and meaningless as time progresses.

The fusion of acquired and internally generated goodwill, especially where the acquired business has been fully integrated, would make the figure even more meaningless as well as conceptually inappropriate. While it would be theoretically possible to attempt some splitting of the two elements, it would be completely academic. **The Board should rather concentrate on ensuring that the overall recoverable amount of the CGU exceeds its carrying amount and *abstain* from pointless searches for a "correct" value for goodwill.**

Consequently, **we propose** that the **impairment-only test be simplified** and therefore made less costly as follows:

Compare the recoverable amount of the CGU with its carrying amount and record any shortfall as an impairment loss directly against goodwill, **without moving to the allocation process of step 2**. (This is basically the current IAS approach but with the further strengthening of procedures through annual testing, in compensation for the non-amortisation of goodwill).

As already mentioned in our response to ED 3 (question 8), should the impairment-only approach not be simplified as suggested above, we strongly suggest that consideration should also be given to retaining the amortization method as an allowed alternative.

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

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

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

Response

As already mentioned in question 2 above, we believe that reversals of impairment losses for goodwill should not be prohibited by the new Standard.

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

*The Exposure Draft proposes requiring a variety of information to be disclosed for **each segment**, based on an entity's **primary** reporting format, that **includes** within its carrying amount **goodwill or intangible assets***

with indefinite useful lives *(see proposed paragraph 134 and paragraphs C69-C82 of the Basis for Conclusions).*

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

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

Response

(a) No, we are **strongly opposed** to the disclosure of such detailed information given in paragraph 134 and therefore propose that it be **reduced** for the following reasons:

- the information is excessive and we very much doubt whether users of financial statements are in a position to understand let alone use the disclosed information;
- much of the information is extremely sensitive from both a competitive and legal (litigation) viewpoint;
- the level of detail is almost that required to audit the impairment testing;
- it is not the role of a company to make forecasts of future values; this is the role of the financial analysts and other users of financial statements and the ED seems to be confusing the two; and finally
- we also have doubts on the auditibility of the proposed disclosures and on the preparer's ability to produce them on a timely basis.

(b) We agree with the principle as proposed in paragraph 137 but only with respect to items (a), (b) and (c) in paragraph 134. On items (d) - (f), see above.

Comments to Proposed Amendments to *IAS 38*
<u>*Intangible Assets*</u>

<u>Question 1 – Identifiability</u>

*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** [and therefore capable of being <u>sold</u> either individually or together with the related asset] **<u>or</u>** arises from **contractual** or other legal rights (see proposed paragraphs 10 and 11 and paragraphs B6-B10 of the Basis for Conclusions).*

Are the separability and contractual/other legal rights criteria appropriate for determining whether an asset meets the identifiability criterion in the definition of an intangible asset? If not, what criteria are appropriate, and why?

Response

We agree that these criteria are appropriate.

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

*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 [**<u>including</u> IPR&D**], excluding an assembled workforce, that **meet the definition of an intangible asset** (see proposed paragraphs 36, 43 and 44 of ED 3. ED38.7: "An intangible asset is an <u>identifiable</u> non-monetary asset without physical substance").*

Do you agree that, with the exception of an assembled workforce, sufficient information can reasonably be expected to exist to measure reliably the fair value of an intangible asset acquired in a business combination? If not, why not? The Board would appreciate respondents outlining the specific circumstances in which the fair value of an intangible asset acquired in a business combination could not be measured reliably.

Response

We disagree with the Board's proposed change with regard to the **probability recognition criterion**. Paragraph 89 of the *Framework* requires an asset to meet the criteria of the probability test in order to be recognised. The *general principle* that an asset is recognised when (a) future economic benefits will probably flow to the entity and (b) the cost or value can be measured reliably, should be **consistently applied** in all situations *including* business combinations. The **current proposal results in an inconsistent treatment of *internally generated* and *externally acquired* intangible assets**, because the probability criterion *for recognition* of an asset as defined in the *Framework* is now ***presumed to be fulfilled*** in the case of a business combination **or** separate acquisition. We regard the Board's proposal as a **major change** which should not be introduced in the context of the newly proposed consequential amendments to IAS 38 but instead be considered more generally as part of a **separate Concepts project**. (Please refer also to our response to ED 3 question 6 on contingent liabilities which also disagrees with the premature and inconsistent change in the treatment of the probability recognition criterion).

We further believe that the proposed amendments are **not clear enough** in respect of how to account for **in-process research** and development projects (ED 3 paragraph 36(c)). The *Basis for Conclusions* of ED 3 clarifies in BC67 that any item must first meet the definition of an intangible asset (i.e. be identifiable) in order to be recognised on the balance sheet separately from goodwill. We disagree that an *acquired* in-process research and development project meets the criterion of “control over a resource” and we fail to see why such *acquired* in-process research and development would qualify as an asset while *internally generated* in-process research (and development) would not. The present situation within IFRS and also between IFRS and US GAAP is quite incoherent. Under US GAAP, all research and development (R&D) - whether acquired separately or in a business combination or internally generated - is expensed. After ED 3/IAS 38 *revised* companies would capitalize R&D acquired separately or in a business combination, while often expensing internally generated R&D as frequently it does not meet the IAS 38 strict recognition criteria. Both standard setters clearly need to think about a more coherent approach to R&D overall. Until that is done we believe that no move should be made in the direction of reflecting probability as a measurement rather than a recognition criterion (ED 38.22: "The effect of probability is reflected in the cost of the asset."). Based on experience we would strongly recommend a very cautious approach to any capitalization. In any case, any approach should be adopted by both the IASB and the FASB simultaneously.

We therefore ask the Board to investigate these issues in a **separate Concepts project** and to defer any change in the recognition criteria for intangible assets until this project is completed through a proper due process.

Question 3 – Indefinite useful life

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

Is this appropriate? If not, under what circumstances, if any, should an intangible asset be regarded as having an indefinite useful life?

Response

We support the useful life requirements in paragraphs 85–90. The existing 20-year useful life presumption is arbitrary and often unrealistic. Although we agree that an indefinite life is usually dependent on future *maintenance* expenditure, in practice it will be very difficult to determine how much is required to maintain that asset at its present level of performance (38.88: "A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure *in excess* of that required to maintain the asset at that standard of performance."). This approach therefore introduces yet another arbitrary element.

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

The Exposure Draft proposes that if an intangible asset arises from contractual or other legal rights that are conveyed for a limited term that can be renewed, the useful life shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost (see proposed paragraphs 91 and 92 and paragraphs B33-B35 of the Basis for Conclusions).

Is this an appropriate basis for determining the useful life of an intangible asset arising from contractual or other legal rights that are conveyed for a limited term that can be renewed? If not, under what circumstances should the useful life include the renewal period(s)?

Response

We support the useful life requirements in paragraphs 91 and 92 but with the addition of **management's intent and ability** *to renew*, which we believe to be the more important criteria.

<u>Question 5 – Non-amortisation of intangible assets with indefinite useful lives</u>

The Exposure Draft proposes that an intangible asset with an indefinite useful life should not be amortised (see proposed paragraphs 103 and 104 and paragraphs B36-B38 of the Basis for Conclusions).

Is this appropriate? If not, how should such assets be accounted for after their initial recognition?

Response

We support the proposal not to amortise an intangible asset with an indefinite useful life according to paragraphs 103 and 104 in general, subject of course to a **satisfactory impairment testing process** (see our response to IAS 36 question 5).