CL 89

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Dear Sirs

ED 3 "Business combinations"

We support the IASB in its aim of producing a set of technically sound standards and are pleased to attach our responses to the exposure draft on business combinations, together with the consequential amendments to IAS 36 and IAS 38.

Whilst we support many of the features in the proposed IFRS, for example non-amortisation of goodwill and the banning of pooling-of-interests accounting for combinations, we do so only on the grounds of pragmatism to achieve convergence with the US. Conceptually, we believe that these proposals are flawed.

There are certain areas of the proposed guidance with which we do not agree, particularly the approach to accounting for negative goodwill and recognising contingent liabilities and in-process research and development.

In addition, we would recommend that the Board completes its work on Phase II of business combinations to enable one, integrated IFRS to be issued.

These responses represent the views of AstraZeneca PLC. Should you have any queries or wish to discuss these responses further, please do not hesitate to contact Bill Hicks (+44 1625 517294) or Andy Chard (+44 1625 517279).

Yours faithfully

Bill Hicks
Chief Statutory Accountant

Question 1 – Scope

The Exposure Draft proposes:

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

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

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

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

(a) We agree with the proposal to exclude the formation of joint ventures and business combinations involving entities under common control.

(b) We believe the definition and guidance are helpful. However, we believe that the proposed alterations to the definition of joint control are too simplistic and should be refined to recognise that unanimous consent of joint venture partners is not necessary for non-strategic decisions.

Question 2 – Method of accounting for business combinations

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

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

We do not support, in theory, the proposal to eliminate the pooling of interests method. There are a number of examples of genuine mergers in the UK in particular and we believe the application of the criteria for mergers in the UK FRS 6 “Acquisitions and mergers” results in the most meaningful business combination accounting for shareholders. However, we do appreciate that the proposals have the benefit of achieving convergence with US GAAP although, with the proposed business combination “grandfathering” provisions in ED1, the elimination of the need for companies to prepare reconciliations with US GAAP will take some time. Accordingly, on pragmatic grounds, we support the proposal.

We note that some wording in the proposed IFRS uses such phrases and words as “nearly”, “normally” and “there are usually indications” which may be seen as diluting the requirement to account for all business combinations under this IFRS using purchase accounting.

With this in mind, we would like the IASB in Phase II of the business combination project to consider fresh start accounting as a possible alternative to the purchase method.

Question 3 – Reverse acquisitions

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

(a) proposes to modify the circumstances in which a business combination could be regarded as a reverse acquisition by clarifying that for all business combinations effected through an exchange of equity interests, the acquirer is the combining entity that has the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. As a result, a reverse acquisition occurs when the legal subsidiary has the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities (see proposed paragraph 21 and paragraphs BC37-BC41 of the Basis for Conclusions).

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

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

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

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

(b) We believe the additional guidance and illustrative examples are helpful. However, we believe that the example should be clarified such that the value of the issued share capital is that of the legal parent, with the difference between the nominal value of these shares and the deemed value of shares that would have been issued by the legal subsidiary credited to a separate reserve. We would like the final standard to make it clear that comparative figures should be those of the legal subsidiary, rather than the legal parent.

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

The Exposure Draft proposes that when a new entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination should be adjudged the acquirer on the evidence available (see proposed paragraph 22 and paragraphs BC42-BC46 of the Basis for Conclusions).

Is this appropriate? If not, why not?

We believe this general principle is appropriate. However, guidance as to how to account for the combination of the new entity and the acquirer entity should be given.

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

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

Is this appropriate? If not, what criteria should an acquirer be required to satisfy to recognise a restructuring provision that was not a liability of the acquiree as part of allocating the cost of a combination, and why?

We agree with the proposal which is consistent with IAS 37 "Provisions, Contingent Liabilities and Contingent Assets".

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 do not agree with the proposal, both for intial recognition and subsequent remeasurement. In particular, the recognition and subsequent remeasurement of the contingent liability would not be in accordance with the guidance in IAS 37 "Provisions, Contingent Liabilities and Contingent Assets" (and this seems inconsistent with the reasoning given by the Board for the proposal set out in question 5). Although we accept that, in certain cases, the purchase price of an entity will reflect an allowance or the value of contingent liabilities, the proposed guidance would seem unworkable, inconsistent and open to abuse.

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 believe the proposal is appropriate, that is the minority share should be based on the fair value of the identified assets and liabilities acquired. However, further to our response to question 7 above, we do not believe it is appropriate to value contingent liabilities and, as a consequence, there should be no minority share.

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 should be recognised as an asset.

In theory, we do not agree with the proposal that goodwill should not be amortised but accounted for any accumulated impairment losses. Goodwill purchased at acquisition will diminish over time (notwithstanding its replacement with internally generated goodwill) and capitalisation and amortisation reflects this. In some circumstances, goodwill will have a determinable, and relatively short, life and should be amortised. Additionally, we believe there are circumstances where the impairment approach may be impractical, for example when there are a significant number of small parcels of goodwill which would be subject to individual impairment tests and for which amortisation would be more practical. In addition, an approach of capitalisation and amortisation allows for a degree of comparison between entities who grow by acquisition and those who do so organically.

Nevertheless, on the grounds of pragmaticism (in particular, convergence with US GAAP), we agree with the proposal.

<u>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</u>

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

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

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

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

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

We do not believe the proposed approach is appropriate. Negative goodwill can arise in recognition of future losses and should be released over the period of those losses unless it can be clearly demonstrated that it does not relate to those losses.

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

The Exposure Draft proposes that:

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

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

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

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

Yes, we believe the proposed approach to adjustments to estimates is appropriate.

PROPOSED AMENDMENTS TO IAS 36

IMPAIRMENT OF ASSETS

Question 1 – Frequency of impairment tests

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

We agree with the proposed approach, except that we would allow indefinite useful life intangible assets to be tested at any time in the annual reporting period, provided that the test is carried out on the same date each year, in the same way as goodwill.

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?

Yes, we agree that the approach is appropriate.

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?

Broadly, we agree with the approach, but would appreciate additional guidance as to how to take past actual cash flows and management's past ability to forecast accurately into account.

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?

We agree with the proposals. However, we do note that the level of allocation could result in impairment testing at a lower level than in the US, the guidance to which the proposed IFRS is attempting to converge.

Question 5 – Determining whether goodwill is impaired

The Exposure Draft proposes:

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

(b) the use of a screening mechanism for identifying potential goodwill impairments, whereby goodwill allocated to a cash-generating unit would be identified as potentially impaired only when the carrying amount of the unit exceeds its recoverable amount (see proposed paragraph 85 and paragraphs C42-C51 of the Basis for Conclusions).

Is this an appropriate method for identifying potential goodwill impairments? If not, what other method should be used?

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

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

(a) We agree 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.

(b) We agree with this approach, although it does mean that an impairment of goodwill can be masked by unrecognised gains in other assets. In an extreme case, this could mean that an impairment would not be recognised in one year yet would be recognised in a subsequent year offsetting a gain on disposal of an asset. In addition, there is a risk that purchased goodwill is cushioned by existing, unrecognised internally generated goodwill.

(c) We agree with the approach, but we have concerns with the requirement to measure goodwill after measuring the identifiable assets and liabilities that would have been recognised if the current circumstances existed at the date of acquisition. This guidance could mean that a marginal shortfall in the value in use compared to the carrying value could result in a significant impairment in goodwill if, for example, an intangible such as a customer list had been developed in value by management. We also note, that similarly to our comment in question 4 above, there is a lack of convergence with US GAAP in respect of unrecognised intangible assets.

<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?

Yes, we agree with the approach.

<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?

We believe the disclosure requirements in paragraph 134 (e) and (f) are likely to be unwieldy and of little use to readers of financial statements (particularly (e)(i), (e)(iv), (f)(i) and (ii)), especially as a primary segment may include numerous cash generating units.

(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 agree with this principle, subject to the concerns set out above on the extent of information.

PROPOSED AMENDMENTS TO IAS 38

INTANGIBLE ASSETS

Question 1 – Identifiability

The Exposure Draft proposes that an asset should be treated as meeting the identifiability criterion in the definition of an intangible asset when it is separable or arises from contractual or other legal rights (see proposed paragraphs 10 and 11 and paragraphs B6-B10 of the Basis for Conclusions).

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

We believe the separability and contractual/other legal rights criteria are appropriate for determining whether an asset meets the identifiability criterion in the definition of an intangible asset.

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

This Exposure Draft proposes clarifying that for an intangible asset acquired in a business combination, the probability recognition criterion will always be satisfied and, with the exception of an assembled workforce, sufficient information should always exist to measure its fair value reliably (see proposed paragraphs 29-32 and paragraphs B11-B15 of the Basis for Conclusions). Therefore, as proposed in ED 3, an Exposure Draft of a proposed International Financial Reporting Standard Business Combinations, an acquirer should recognise, at the acquisition date and separately from goodwill, all of the acquiree's intangible assets, excluding an assembled workforce, that meet the definition of an intangible asset (see proposed paragraphs 36, 43 and 44 of ED 3).

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

We <u>do not</u> agree with the proposed approach. We believe that the assumption of the probability recognition criterion always being satisfied may result in intangible assets being recognised on differents bases than those set out in IAS 38 if they are acquired in a business combination as opposed to directly. In particular, we believe it will lead to the capitalisation of in-process research and development assets (at a value adjusted for probability) acquired in a business combination which would not be recognised if they were generated internally.

Question 3 – Indefinite useful life

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

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

We support the removal of the rebuttable presumption of a useful life of 20 years, which is an arbitrary and often misinterpreted concept.

<u>Question 4 – Useful life of intangible asset arising from contractual or other legal rights</u>

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

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

We believe this is an appropriate basis for determining useful life.

<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?

We support the proposal.