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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
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Dear Sir David,

The global organization of Ernst and Young is pleased to comment on the Exposure Drafts, ED 3, *Business Combinations*, Amendments to IAS 36, *Impairment of Assets*, and Amendments to IAS 38, *Intangible Assets*.

We fully support the Board's objectives in the business combinations project as they are set out in the Invitations to Comment. However, notwithstanding our support for the project and our support for many of the proposed changes to the current IAS 22, there are two key areas in which we disagree with the approach the Board has taken—the elimination of the amortisation model in IAS 22 and the requirement for a two-step impairment test.

We agree with the Board's conclusion that annual impairment testing of goodwill may better reflect the value of purchased goodwill as an asset. However, we believe that purchased goodwill is a wasting asset, and the non-amortisation approach required under ED 3 implicitly would result in the recognition of internally generated goodwill to offset the diminution of value of purchased goodwill. Because, the recognition of internally generated goodwill is prohibited under IAS 38, we observe that the proposed non-amortisation model is inconsistent with current IAS 38 as well as with the proposed amendments to IAS 38. We believe that although not perfect, the current requirements of IAS 22, are well-established and well understood and do not give rise to any major implementation problems and do not believe that the Board has put forward a sufficiently robust case to change the current amortization model.

In addition, we believe that the cost of performing an annual impairment test will outweigh the benefits derived from it. As a result, as more fully discussed in Appendix 1 in our response to Question 8, we disagree with the prohibition against the amortisation of goodwill and recommend that the Board adopt an amortization model.

Notwithstanding our fundamental view that the Board should retain the amortisation model currently required in IAS 22, we question the practicality and cost benefit of the two-step impairment model as proposed in the ED. We observe through our experience implementing the two-step impairment test required under SFAS 142 that entities have difficulty in assigning assets to reporting units (cash generating units for purpose of ED 3) particularly in matrix-managed organizations. Also, in most cases, the fair value exercise needed for step 1 is a costly endeavor as often, it is not possible to reference observable market prices. This issue becomes more acute in step 2 where tangible and intangible assets in many cases will have to be fair valued based upon cash flow discounting methods. ED 3 increases the cost of this exercise relative to SFAS 142 in that the cash generating units will typically be more numerous under ED 3 than reporting units under SFAS 142. Finally, as we discuss in our response to Question 2 of Appendix 3, we question the accuracy and reliability of the fair values obtained for purposes of these tests without more detailed guidance than is currently available under either IAS or U.S. GAAP. We suggest retaining the one-step impairment model under the current IAS 36.

Other comments:

We generally support the Board's proposal to eliminate the use of the pooling of interests method of accounting for uniting of interests. An acquirer can be identified in almost all business combinations. However, as more fully discussed in our response to Question 2 of Appendix 1 to this letter, there are rare circumstances in which no one party can be said to acquire the other, and there are other rare circumstances in which there is no acquirer, by definition. As a result, until these transactions and circumstances are addressed in Phase 2 of the business combinations project, the Board should retain the pooling of interests method of accounting as presently defined in IAS 22, for these rare cases.

Convergence with US GAAP is one of the Board's stated objectives of its business combination project, and we fully support this objective. However, we do not believe in convergence for the sake of convergence, and we believe that the IASB should converge with the standards of another country only when those standards are superior. As discussed above, we disagree with Board's proposal for the non-amortisation of purchased goodwill and the resulting two-step impairment test. Although we recognise that the Board's proposal is consistent with FASB Statement No. 141, *Business* Combinations, and Statement No. 142, *Goodwill and Other Intangible Assets,* in this circumstance, we believe that amortisation of goodwill and a one-step impairment test are superior accounting treatments to those proposed by the IASB and required by Statement No. 142.

In addition, we observe that in seeking to converge with U.S. GAAP, ED 3 introduces inconsistencies with the IASB Framework and other IFRS standards (for example, with respect to the recognition of contingent liabilities and intangible assets acquired through business combinations). If this ED is adopted in its current form, as a matter of priority, the Board should reconsider the Framework to address these inconsistencies. We also observe that there are a number of other areas in which convergence with FASB Statements No. 141 and 142 is not being achieved. Because of the Board's stated objective of convergence with the FASB on this important project, the Basis for Conclusions should address and support this lack of convergence.

Finally, we observe that there are many interdependent issues in the initial and subsequent accounting for business combinations that are presently being addressed in two different phases of the Board's project. Several of the issues being addressed in Phase 2 are critical to the successful adoption of the Standard contemplated in Phase 1 within ED 3. We therefore strongly urge the Board to address outstanding issues in Phase 2 in an expeditious manner and ultimately to issue only one final Standard on business combinations. We understand that some aspects of ED 3 may have to be re-exposed as a result of conclusions reached in Phase 2, therefore underscoring the need for timely progress, in concert with the FASB on the joint aspects of the business combinations project.

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Our responses to the specific questions that are included in the Invitations to Comment are included in the Appendices to this letter.

We would be pleased to discuss our views with the Board or staff at its convenience. Please contact Danita Ostling at 0207 951 8772

Yours very truly,

Ernst & Young

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 Board's proposal 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 on the basis that those were already excluded from the scope of IAS 22 and that they will be included in the scope of Phase 2 of the project.

b. We consider that the definition of business combinations involving entities under common control is helpful and constitutes an improvement over IAS 22 where such transactions were excluded from the scope but not defined. We also consider that the explanations given in the Basis for Conclusion paragraphs BC 14 and BC 15 are helpful but believe additional guidance should be given on the meaning of the word "transitory" used in the definition.

We refer you to our response to Question 2 of Appendix 1 where we support the retention of the pooling of interests method of accounting until the accounting for business combinations involving entities under common control and other transactions not included in the scope of the existing IAS 22 or ED 3 is addressed.

We note that ED 3 introduces the concept of "operation of an entity" in the definition of a business combination but does not define this concept. For a clear understanding of the scope of the standard and for a consistent application of the standard, we believe that the Board should include the definition of an "operation of an entity" because the accounting for asset transactions differs significantly from that for business combinations. We also stress the need for convergence between the IAS definition of an "operation of an entity" and the US GAAP definition of a "business".

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 believe that in almost all business combinations (other than the formation of joint ventures) an acquirer can be identified. However, we believe that there are indeed certain cases where either an acquirer cannot be identified or by the very nature of the transactions there is no acquirer. Such instances are as follows:

- some combinations in which separate entities are brought together by contract to form a dual-listed corporation;
- multiparty combinations such as roll-ups which may not be acquisitions.

In such cases, we believe that the pooling of interests method should be retained under the current IAS 22 until the Board has addressed these situations in Business Combinations Phase 2.

<u>Question 3 – Reverse acquisitions</u>

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

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

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

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

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

a. We agree with the Board's description of the circumstances in which a business combination should be accounted for as a reverse acquisition as we agree that the standard should not include any departures from the control concept to identify an acquirer.

b. We regard the proposed additional guidance as necessary and appropriate.

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

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

Is this appropriate? If not, why not?

We agree with the Board that a business combination in which a new entity is formed to issue equity instruments to effect the combination is, in substance, not different from a transaction in which one of the combining entities that existed before the combination obtains control of the other combining entity. We therefore consider it appropriate that such preexisting entity be adjudged the acquirer.

However, we also believe that in some rare cases, it may be impossible to identify which of the preexisting entities is the acquirer. There may also be cases where by the very nature of the transaction there is no acquirer. In such cases, we believe that the accounting method to be used should be consistent with the method used for other business combinations in which an acquirer cannot be identified (see our answer to Question 2 of Appendix 1).

<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 Board 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. We also agree with the Board's comment in Basis for Conclusions paragraph BC80 that provisions for terminating or reducing the activities of an acquiree that are recognised under the current IAS 22 paragraph 31 are not contingent liabilities of the acquiree because they are not the result of past events.

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 agree with the Board's proposal to recognise the acquiree's contingent liabilities at their fair value upon acquisition, provided their fair values can be measured reliably. We also agree with the Board's comment in Basis for Conclusions paragraph BC82 that this represents an inconsistency to the recognition criteria applying to liabilities and contingent liabilities in IAS 37 and the Framework. We therefore support the Board's intent to reconsider the role of probability in the Framework and under IAS 37 as part of a later concept project.

However, we think that, consistent with the treatment of contingent liabilities, the Board should require an acquirer to recognise an acquiree's contingent assets at their fair value as part of allocating the cost of a business combination, provided their fair values can be measured reliably. We believe that there is no conceptual justification to include contingent liabilities but not contingent assets in the cost allocation process of a business combination, as both will likely have an impact on the purchase price and will meet the definition of an asset or liability (assuming they can be reliably measured) as they result from events occurring prior to the acquisition date.

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 of the Board to measure identifiable assets and liabilities acquired in a business combination at their fair values at the date of acquisition and, as a consequence, to measure minority interests at their proportion of net fair values of identifiable net assets as we consider that:

- the "mixed" measurement reported under existing IAS 22 benchmark treatment is inconsistent with the consolidation approach adopted in IAS 27;
- the allowed alternative treatment provides information which enables users to better assess the cash generating abilities of the identifiable assets acquired in a business combination.

Additionally, we urge the Board to pursue the development of further guidance on the accounting for minority interests, including the acquisition of minority interests in situations where control already exists and in cases of "deemed disposals".

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 with the Board's conclusions contained in paragraphs BC 96 through BC 102 that goodwill should qualify as an asset. However, we believe that the Board should revisit the Framework and IAS 38 and determine if amendments are required to support the recognition of goodwill as an asset.

The Board proposes to ban the amortisation of goodwill and require an annual impairment test to be carried out on goodwill. The Board thinks this better reflects loss in value than an arbitrary amortization period. Although this may very well be true, we do not believe that the Board considers purchased goodwill to have an indefinite life, particularly as all intangible assets have been identified and valued. Instead, we believe that the non-amortisation approach acknowledges that goodwill is a wasting asset but that it essentially allows for the capitalisation of internally generated goodwill to replace the wasting amount of purchased goodwill. Consistent with the belief that goodwill is indeed an asset, we see the merit in acknowledging that purchased goodwill should not be arbitrarily amortised to expense. However, we do not agree with outcome of the proposed solution, which is to write down purchased goodwill only if it is not replaced by internally generated goodwill when the capitalisation of internally generated goodwill is otherwise prohibited under IAS 38.

In addition, our experience with the impairment test required under SFAS 142 under U.S. GAAP has proven the exercise to be costly and highly subjective. In our view, aside from the inconsistency discussed above, an impairment approach for goodwill can only work if it is practical and can be applied in a way that delivers consistent, comparable and reliable results. We do not believe the impairment test proposed by ED 3 and the SFAS 142 test are practical and will provide such results. Therefore, while we understand that a straight-line amortisation approach is by its very nature arbitrary, we view an amortisation approach to be more cost beneficial and also more consistent with the prohibition outside of ED 3 of capitalising internally generated goodwill.

In our view, the costs of an acquired business must be allocated as much as possible to assets and liabilities of the acquiree, including intangibles. The goodwill that remains should be analysed to determine what it is comprised of (i.e., assembled workforce, surplus income, synergies, accounting model imperfections). If the goodwill can be ascribed to a particular component that could not be recognized as an intangible asset under IAS 38, this component of goodwill should be amortised over the component's useful life. It is our understanding from valuation experts that excess cash flows from synergies, surplus income and assembled workforce extending beyond 15 years generally do not have a significant effect on the value of a business and such economic benefits have a limited life. Therefore, we generally would not expect amortisation periods exceeding this period. Those components of goodwill that cannot be ascribed to any particular item should be amortized over a short period, for example 5 years. In this model there should be no mandatory annual impairment tests, rather impairment tests would only be performed if there is an indication of impairment as is currently the case under IAS 36.

If, however, the Board decides to adopt a non-amortisation approach for goodwill, we strongly recommend a one-step impairment model (see our comments to Question 5 of 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 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?

Generally, we believe that if the purchase method is correctly applied, negative goodwill occurs only in rare situations. However, even when acquirers have appropriately ascribed fair value to identifiable assets as well as contingent liabilities and onerous contracts, there may be situations where negative goodwill will exist under the standard. Such instances may indeed result from other than a bargain purchase. For instance, it may result from expected future losses that were not accounted for as part of the value in use of identifiable assets because such assets must be accounted for at fair value under the proposed standard. It may also result from deferred taxes that are not measured at fair value under the existing purchase accounting rules. Even if the acquisition was at a bargain price, we do not believe that income should arise purely as a result of acquiring assets. Therefore, we do not believe that negative goodwill represents an instant profit and we propose to retain the current requirements of IAS 22.

<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?

We agree with the Board's proposal to require recognition of adjustments to provisionally determined fair values within twelve months of the acquisition date, which will also lead to convergence with US GAAP.

<u>Other comments</u>

Scope of IAS 22/ED 3 versus ED 2 – The scope of ED 2 excludes share-based payments made as part of the assets acquired in a business combination. ED 2 does not clarify where the boundary lies between share-based payment transactions (falling within ED 2) and the cost of acquisition (falling within ED 3, Business Combinations) when share-based payments are made to the previous owners of an acquired business who then remain with the acquired entity for some period following the acquisition. As discussed more fully in our response letter to ED 2 (Question 1), this is a major (and increasing) area of controversy in practice that, in our view, requires guidance that is more specific.

<u>Question 1 – Frequency of impairment tests</u>

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?

As discussed in our responses to Question 8 of Appendix 1 and Question 3 of Appendix 3, we propose to retain an amortisation approach for goodwill and all intangible assets, in which case we believe that impairment tests are necessary only when there are indications of impairment as is currently required under IAS 36.

If, however, the Board decides to adopt a non-amortisation approach for goodwill and intangible assets with indefinite useful lives, we do not agree with the Board's proposal relating to the frequency and timing of impairment tests for intangible assets with indefinite useful lives and acquired goodwill and have the following comments:

Frequency of impairment tests

We agree with the Board's proposal relating to the frequency of impairment testing intangible assets with indefinite useful lives and acquired goodwill, i.e. annually and whenever there is an indication of possible impairment (including, for intangible assets with indefinite useful lives, when reassessing the useful life of an asset as finite rather than indefinite). Although this could be very burdensome for preparers, we regard such frequency as acceptable in view of draft paragraphs 20A (intangibles assets with indefinite useful life) and 96 (cash generating units to which goodwill has been allocated) which permit the most recent detailed calculation of the recoverable amounts made in a preceding period to be used in the current period's impairment test, providing certain criteria are met.

Timing of impairment test

We do not agree with the Board's proposal in draft paragraphs 8A and 93 which require that an indefinite life intangible asset should be tested for impairment at the end of each annual reporting period and that goodwill acquired in a business combination be tested for impairment annually at any time during an annual reporting period, provided the test is performed at the same time every year. We believe that requiring annual impairment tests at different dates for indefinite useful life intangibles (at end of each annual reporting period) and for acquired goodwill (at anytime during an annual reporting period) is impractical. We agree with the Board's proposition to permit the annual impairment test for goodwill to be performed at anytime during the annual reporting period in order to reduce the cost of applying the test, however we believe that the Board should grant the same permission for the annual impairment tests of intangible assets with indefinite useful lives. We believe that the impairment testing of a cash generating unit to which goodwill is allocated may otherwise force preparers to prepare two annual impairment tests for the same cash generating units even when there is no indication that such assets are impaired.

<u>Question 2 – Intangible assets with indefinite useful lives</u>

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?

As discussed in our response to Question 3 of Appendix 3, we do not believe that there are intangible assets with indefinite useful lives in the absence of subsequent expenditures by the acquiree to maintain the value of the asset. Rather we believe that intangible assets are wasting assets and that while they may retain their fair value at subsequent balance sheet dates, this is a result of the capitalisation of internally generated intangible assets that cannot typically be capitalised under IAS 38. Therefore, we believe that all in intangible assets should be ascribed a useful life and amortised over this period. The unamortised asset should be subject to the impairment test if necessary under the existing IAS 36. However, IAS 36 should be amended so that future recoveries should not result in the reversal of impairment losses.

If, however, the Board decides to adopt an approach under which intangible assets could have indefinite lives and therefore implicitly allows the capitalisation of internally generated intangible assets, we do not see any argument against recording a reversal of impairment losses for such intangibles limited to the amount of the original purchased goodwill.

In any case, we are concerned that requiring different treatments of impairment losses and reversal of impairment losses for goodwill and for intangible assets with indefinite useful lives may lead to accounting arbitrage especially as reversals of impairment losses are not allowed for goodwill. Assuming the Board ultimately decides on an approach under which intangible assets could have a indefinite life, we recommend that the Board reconsiders its approach and requires the same treatment for impairment losses and reversals of impairment losses for goodwill and intangible assets with indefinite useful lives. We believe that allowing for the recovery of the impairment charge is a superior concept versus that contained in U.S. GAAP as it is more consistent with implicitly allowing for the capitalisation of internally generated intangible assets and goodwill.

<u>Question 3 – Measuring value in use</u>

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?***

a. We agree that an asset's value in use should reflect the elements listed in draft paragraph 25A and that an entity should be permitted to reflect these elements either as adjustments to the future cash flows (expected cash flow approach) or adjustments to the discount rate (traditional approach). We believe it would not be acceptable to impose the expected cash flow approach at this point, as the matter will be further considered in the Board's project on Measurement.

b. We agree with the Board that cash flows projections used in measuring value in use must in principle be based on reasonable and supportable assumptions that take into account both past actual cash flows and management's past ability to forecast cash flows accurately; however, we ask the Board to clarify how this can be done in practice by providing more guidance.

c. We agree that the additional guidance proposed in Appendix B on using present value techniques in measuring an asset's value in use is appropriate.

<u>Question 4 – Allocating goodwill to cash-generating units</u>

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

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

b. ***If an entity disposes of an operation within a cash-generating unit to which goodwill has been allocated, should the goodwill associated with that operation be included in the carrying amount of the operation when determining the gain or loss on disposal (see proposed paragraph 81 and paragraphs C21-C23 of the Basis for Conclusions)? If not, why not? If so, should the amount of the goodwill be measured on the basis of the relative values of the operation disposed of and the portion of the unit retained or on some other basis?***

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

a. As discussed previously, we propose to retain an amortisation approach for goodwill and intangible assets, in which case we believe the impairment testing for goodwill should follow the existing provisions of IAS 36.

   If, however, the Board decides to adopt a non-amortisation approach for goodwill and intangible assets with indefinite useful lives, we have the following comments:

   The Board proposes that the annual impairment test for goodwill be done at the lowest level at which management monitors the return on investment in assets that include goodwill. We disagree with this approach because in many cases it may lead to very large numbers of cash generating units having to go through the impairment test of goodwill. Moreover, it would lead to a difference with US GAAP in an area for which we think US GAAP has a superior solution to the one proposed. We agree with the Board that the level at which goodwill should be tested for impairment cannot be larger than a segment based on the entity's primary reporting format. However, we believe that the cash generating unit should be defined at the lowest level at which the *reporting entity's* management monitors the return on assets that include the goodwill acknowledging that in many cases this may indeed be the segments as determined in accordance with IAS 14.

b. For the reasons explained in the Basis for Conclusion, we agree with the Board's proposal that, if an entity disposes of an operation within a cash generating unit to which goodwill has been allocated, the goodwill associated with that operation should be:

   - included in the carrying amount of the operation when determining the gain or loss on disposal; and

   - measured on the basis of the relative values of the operation disposed of and the portion of the cash generating unit retained.

c. For the reasons explained in the Basis for Conclusion, we agree with the Board's proposal, that when an entity reorganises its reporting structure in a way that changes the composition of cash generating units to which goodwill has been allocated, the goodwill should be reallocated to the units affected using a relative value approach similar to the one used when an entity disposes of an operation within a cash generating unit.

<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?

As discussed previously, we advocate the retention of an amortisation model for goodwill and intangible assets with an impairment model as currently required in IAS 36.

If, however, the Board decides to adopt a non-amortisation approach for goodwill and intangible assets with indefinite useful lives, we view the two-step approach proposed by the Board as impractical without additional implementation guidance. In particular, we question the ability to perform this test in cases where an acquired group is broken up and integrated with the acquirer's business immediately after acquisition with an appropriate level of consistency and objectivity. Also, it has been our experience in applying SFAS 142 that there are practical difficulties in assigning assets and liabilities to a reporting unit (cash generating units for purposes of ED 3) including the identification of appropriate reporting units (cash generating units) for entities that use a matrix organisational structure, overlaying legal, functional and geographic operations. In addition, entities have experienced difficulties assigning corporate assets to multiple reporting units (cash generating units). In our view, these issues, among others, need to be addressed before the two-step impairment model can be successfully applied in practice. Other issues requiring additional guidance include:

- how a cumulative translation adjustment in the assessment of goodwill impairment has to be considered when foreign entities comprise all or part of the cash generating unit

- how goodwill included in a cash generating unit with a negative carrying value should be tested for impairment

- determining discount rates.

Finally, given the difficulties discussed above, we believe that the cost of performing a mandatory impairment test as required under ED 3 outweighs the benefits of a non-amortisation approach. If an entity has multiple cash generating units, or a thinly traded stock, there may be a need to estimate fair value through valuation techniques. The use of these techniques generally requires significant estimations of such factors as future revenues, rates of growth, terminal value multiples, appropriate risk-adjusted discount rates, etc. The amount of estimates and assumptions required calls into question the accuracy of the fair values determined.

Additionally, compiling the information necessary to prepare a valuation is a significant undertaking and burden on an entity's accounting and financial personnel. This burden becomes more pronounced if step 1 of the test is failed and a company is required to perform the step 2 analysis and estimate the fair values of the various assets and liabilities comprising a cash generating unit. We do not believe that these considerable costs are worth the added benefit of the non-amortisation approach especially when the result of this costly effort relies heavily on many subjective estimates and assumptions.

Therefore, we urge the Board to develop a simpler, one-step impairment test until the difficulties of implementing the proposed two-step approach are addressed with detailed application guidance such that it can be applied in a more cost efficient and consistent manner.

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?

We agree with the Board that the reversal of impairment losses recognised for goodwill should be prohibited, provided that the Board adopts an amortisation model for goodwill.

If, however, the Board decides to adopt a non-amortisation approach for goodwill and therefore allows the capitalisation of internally generated goodwill, we do not see any argument against recording a reversal of impairment losses for goodwill limited to the amount of the original purchased goodwill.

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?***

a. As discussed previously, we propose to retain the existing impairment testing model for goodwill and intangible assets, and consequently, we do not believe that the additional disclosures as proposed are necessary.

However, if the Board decides to adopt the proposed two-step impairment test, we have the following comments:

- we believe that the proposed detailed list of items should be replaced by a requirement to disclose a brief description of the expected timing of future cash flows, an indication of the uncertainties about the timing of these cash flows and, where necessary major assumptions made concerning future events;
- we agree that information that assists users in evaluating the reliability of financial information is itself relevant but we believe that the level of disclosure required in paragraph 134 would, for almost all preparers, require an undue cost and effort especially for all segments or cash generating units for which the recoverable value is materially above the carrying value;
- certain disclosures required by paragraph 134 (e) and (f) are excessive and meaningless at segment level and would need to be presented at cash generating unit level as assumptions may vary from one cash generating unit to the other. Furthermore if all assumptions are equal for a group of cash generating units there should have been no reason not to group them in one cash generating unit for the purpose of goodwill impairment testing.

b. Again, assuming the Board adopts a two-step impairment test, for the reasons indicated above we believe that certain information required by paragraph 134 of the Exposure Draft can only be meaningful and/or computed at a cash generating unit level. However we consider that the number of cash generating units concerned should be very limited and that the criteria contained in paragraph 137 of the Exposure Draft should be modified accordingly.

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 agree with the Board that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill.

We also agree that "identifiability" is not defined nor clearly articulated in the current IAS 38 and needed to be clarified. We believe that the introduction of the concept that contractual or other legal rights indicate that the entity controls the economic future benefits related to an asset and therefore supports the identifiability of the intangible asset is helpful when combined with the separability criteria.

However, as noted in our response to Question 2 of Appendix 3, we have reservations regarding the reliability of determining the fair value of identified intangible assets separately from goodwill.

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 do not agree with the presumption that the probability recognition criterion of IAS 38 will always be satisfied for an intangible asset acquired in a business combination. For example, an acquirer may be willing to pay 30 for an intangible asset that provides the acquirer with a 30% probability of generating future economic benefits of 100. The fact that the acquirer factored the probability into the purchase price of the intangible does not indicate that it is probable that the resource will indeed generate future economic benefits. This is indeed the case with the rights to research and the reason it is prohibited from being recognized as an asset if internally generated. The ED in paragraph 47 of IAS 38 states that for internally generated research "an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits." We agree with this. However, another entity may be willing to pay to acquire the rights to this research, the price of which would likely be determined based on the probability determined that the research would generate future economic benefits. This probability may well be below 50%. The fact that an entity was willing to pay for the rights based on probability does not necessarily mean that the probability criterion of IAS 38 will be satisfied. However, given our belief that such contingent assets are ascribed a fair value when an acquirer determines what it is willing to pay for another entity and consistent with our believe that contingent liabilities should be recognized in a business combination, we do not object to the recognition of these intangible assets even when the probability criteria of IAS 38 has not been met.

We do not agree that sufficient information can reasonably be expected to exist to measure reliably the fair value of an intangible asset in all cases where intangible assets are identified. In many cases, there is no observable market for determining the fair value of such assets in which case the acquirer must resort to determining fair value based on expected future cash flows discounted at an appropriate risk adjusted rate. First, the fact that there is no observable market for these assets is likely to be the result of the fact that these intangible assets only generate cash flows when utilised in conjunction with other tangible and intangible assets of the acquired. In fact, these assets do not necessarily have value if valued separately. In these cases, how does an acquirer attribute what is essentially one cash flow stream to the variety of intangible and tangible assets that are generating the cash flow stream? In such cases, we see the attribution of a single cash flow stream to the component assets that gave rise to it as largely arbitrary. Indeed it also raises the concern that the same cash flow will be double counted by using it to value different identified intangible assets and thereby artificially reducing the value of the residual goodwill. Second, the very nature of valuing these intangible assets based upon the projection of future cash flow entails estimates and assumptions as to the amount, probability and timing of cash flows as well as the rate that should be used to discount. In the case of intangible assets where there is no readily determinable market value, it will be difficult to validate the assumptions and estimates used in these models. As a result, we are not convinced that all intangible assets separately identified in a business combination will indeed be able to be reliably measured. Therefore, we urge the Board to initiate a project to better define fair value and to provide more detailed guidance on how one should determine fair value in the absence of quoted market values. Without additional guidance on this critical issue, we do not believe that the fair value that acquirers derive for separately identified intangible assets is likely to be reliable enough to provide for the superior quality of reporting that ED 3 is meant to provide.

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?

Consistent with our views on the non-amortisation approach for goodwill contained in Question 8 of Appendix 1, we do not agree with the Board's argument that an intangible asset can be regarded as having an indefinite useful life. We believe that all intangible assets are wasting assets and, accordingly, should be amortised over their useful lives. The fact that at subsequent balance sheet dates the fair value of purchased intangible assets may retain their value is, in our view, the result subsequent expenditures that maintain the asset's fair value. Therefore, in our view, concluding that there are intangible assets with indefinite useful lives implicitly allows for the capitalisation of internally generated intangible assets that might not otherwise be eligible for capitalisation under IAS 38. As such, we do not believe that any intangible assets should be regarded as having an indefinite useful life.

<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 agree.

<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?

As discussed in our answer to Question 3 of Appendix 3, we do not believe that there are any intangible assets with indefinite useful lives. As such, we believe that all intangible assets should be amortised over their useful lives. We believe that there should be a rebuttable presumption that such useful lives should not exceed 20 years.

<u>Other comments</u>

Paragraph 70 of revised IAS 38 describes an alternative treatment according to which intangible assets, including intangible assets with indefinite useful lives, can be carried at revalued amounts. If our suggested model is not accepted, because goodwill cannot be revalued, we believe that such alternative treatment for intangible assets with indefinite useful lives will create room for accounting arbitrage. We therefore recommend that the revaluation of intangible assets with indefinite useful lives should be prohibited in the revised standard.