**CL 121**

INTERNATIONAL ASSOCIATION OF FINANCIAL EXECUTIVES INSTITUTES

DCP/CRG/IASB-BUSCOMB

International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH

8 April 2003

Dear Sir,

**BUSINESS COMBINATIONS, IMPAIRMENTS AND INTANGIBLE ASSETS**

Set out below are our responses to the questions in the exposure drafts on the above topics.

ED3

Q1: Agree subject to:

- There is a point on minority interests which will need to be considered once Phase II of the project deals with combinations involving entities under common control and the possible use of "fresh start" accounting. It is important that Group reconstructions, which do not involve changes for minority shareholders, do not result in a requirement to restate assets and liabilities to fair values.

- The amendment to the joint control definition in IAS28 and 31 goes too far as we would suggest unanimous consent on all financial and operating decisions is not necessary for joint control to exist, only unanimous consent on strategic decisions.

Q2: We agree that "nearly all" business combinations involve an acquirer and "true mergers" are rare. Therefore on pragmatic grounds and for harmonisation we agree that "pooling of interests" should not be allowed, although we are not convinced by the arguments in BC31 and BC32. However, we await the developments on "fresh start" accounting in Phase II as we are also not convinced of the logic for it. We would expect the criteria for the use of this to be tight and therefore its use even rarer than "pooling of interests".

Q3: Agree.

Q4: Agree

Q5: On balance, we would prefer to retain the approach in IAS22 as the approach in ED3 seems to be driven by the "anti-abuse" requirements of IAS37 rather than reflecting the nature of the transactions which have occurred i.e. the probable economic effects of the acquirer's plans on the acquisition accounting.

Q6: While we agree that contingent liabilities need to be considered in allocating the cost of a business combination we have a number of fundamental problems with the content of ED3.

- The allocation of cost and the use of fair values as defined in ED3 is more problematic for liabilities and contingent liabilities than for assets; the very nature of an acquisition means there is no specific consideration that can be directly attributed to them.

- This leads in Appendix B to the approach on liabilities in B15(j) and B15(k) which is however inconsistent with B15(1) on contingent liabilities; this inconsistency also appears in the draft standard in paragraphs 36(b) for liabilities (probable and reliable) .v. 36(d) for contingent liabilities (only reliable).

- Following on from this, there is the ongoing inconsistency between contingent liabilities incurred in a business combination and other contingent liabilities accounted for under IAS37. There is the reference in BC82 to this as a future topic for a later project but that will not help the problem in current reporting.

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

- Many contingent liabilities can arise from legal claims and these can illustrate some of the problems:

  - any estimates can be very unreliable.
  - the potential cash outflow is unlikely to be reflected by using some form of average expectation.
  - given the above two, default to what a third party would charge to take on the contingency is highly questionable as it

    - is very unlikely to approximate the potential cash flow implications for either the acquiree or acquirer.
    - is likely to be very expensive compared to retaining the contingency internally.
    - in some cases it will not be obtainable at any realistic price.
    - ED3 makes use of the argument that the contingent liability is reflected in the price but it is not reflected on this basis. Moreover, if the acquiree and the acquirer face the same type of litigation prior to the business combination it is quite possible that the acquirer sees no real additional cost and therefore no impact on the purchase price. However, in these circumstances ED3 would lead to the recognition of a potentially material liability.

  - it seems odd that where both the acquiree and the acquirer consider any liability remote and do not recognise a liability, the transfer of that same contingent liability between them creates a liability to be recognised.

- Finally one must ask what is the purpose of the amounts recognised in the accounts -it must be to reflect liabilities at amounts which are (a) relevant to how the business operates and (b) relevant to users in reaching decisions on the business. This is not what comes out of ED3.

Q7: We agree with the implications for minority interests but the establishment of the fair values is subject to our point on Q6.

Q8: While we agree that goodwill should be recognised as an “asset” we do not agree that amortisation should be replaced by an annual impairment test. We comment separately on the complex but subjective and questionable impairment testing mechanism under IAS36 below. However, the more complex the impairment testing is made to address potential problems, the more we believe that required annual (or more frequent) impairment testing is an onerous requirement relative to any perceived benefit from non amortisation.

In measuring what is a conceptually difficult item as a residual value, we are persuaded by the arguments in BC 106 and find the key point to be the lead in to BC107. We cannot see the benefit of moving from IAS22 to impairment testing of an asset which, in any event, becomes increasingly meaningless as we move forward from the acquisition date. Moreover, the distinction between the value of acquired goodwill and internally generated goodwill becomes increasingly impossible to identify but the impact is mingled in the impairment testing approach.

The use of systematic amortisation, with impairment testing when triggered, is a simple and transparent method to reflect the fact that in most cases purchased goodwill diminishes over time. It is not clear what problems it is currently causing that require such a fundamental change. Before imposing what is a fundamental and costly change, the IASB needs to clearly identify why it is necessary and why the benefits outweigh the costs. It is not even as though the proposed approach gives a neat and theoretically correct answer. It cannot be just to tighten up impairment testing because that could be done while retaining the IAS22 approach. Amortisation may be somewhat arbitrary but then so is the complex alternative that is proposed.

The only result of this proposed change will be to involve preparers and auditors in annual (or more frequent) time consuming work to justify an increasingly meaningless carrying value unrelated to either acquired or internally generated goodwill. Both at the time of business combinations and annually (or more frequently), companies will not only have to devote additional internal resource but also employ specialist external advisors. Given the difficulties in measuring continuing goodwill, cost and benefit considerations should be key in this area of somewhat arbitrary measurement and amortisation should remain an allowed approach as under IAS22

Q9: We would prefer the retention of the existing requirements of IAS22 which seems more consistent with the treatment of positive goodwill. Such alternatives to the approach recommended in ED3 are rejected by the Board on the basis that they are arbitrary and so not representationally faithful. However, the conclusion that must be drawn from paragraph BC 118 is that the approach in ED3 is also arbitrary and it is unclear why it is deemed to be superior to IAS22

Ql0: Agree subject to the time frame for adjustments being the next full annual financial statements rather than 12 months from the acquisition date. This would allow slightly more time which could be relevant where, for example, fair values were subject to regulatory requirements which can sometimes take more than 12 months to resolve.

Other points:

(i) Deferred tax asset: we do not understand the reason for the exception in paragraph 64 and it seems to result in an expense in operating profit to offset a credit in the tax charge which seems illogical. However we note from the Basis for Conclusions that this paragraph will be reviewed in Phase II of the project.

(ii) Disclosures:

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

(b) Paragraph 70 seems unrealistic in requiring all the information in paragraph 66, especially when companies are trying to produce their accounts in a shorter time frame.

We note the let out of “undue cost and effort” but would it not just be more realistic and appropriate to have disclosure requirements in a standard which reflect a reasonable balance of cost/utility and which most companies are likely to be able to comply with.

<u>IAS36</u>

Q1: As noted under the comments on ED3 we do not agree with the replacement of amortisation by annual (or more frequent) impairment testing. However, as regards this specific question on IAS36 we would expect that for practical reasons in many cases it would be appropriate for companies to carry out the annual test on intangibles and goodwill at the same time but this would not be at the year end.

Q2: Agree that the treatment should be the same.

Q3: Even with some of the flexibility allowed, as in paragraph 26A, these requirements illustrate the extent of the work required when all intangibles and goodwill are made subject to annual (or more frequent) impairment tests regardless of any trigger. Moreover, the information prepared for management reporting/budgets etc. will need amendment to comply with these requirements e.g. normal budgets/forecasts are very unlikely to be based on information consistent with paragraphs 3 8(b) or 47.

Q4: Agree.

Q5: Given the questions over the cost/benefit of the complexities introduced by ED3/revised IAS36 (annual tests, paragraph 86(b) etc.) one has to support the attempts to moderate the burden such as the screening test and paragraph 96. However, we would still see these simplifications as minor compared to the following points on the change itself:

- As recognised in C47 of the Basis for Conclusions, the "need" for the complexity is driven by the removal of the amortisation option (see comments on ED3).
- The arbitrary and questionable basis of the approach given that it is not possible to deal with internally generated goodwill.
- Even if a company does not need to go to the 2nd stage, the 1st stage screening will still involve internal and external cost on a regular basis. As noted before this really needs to be properly justified which is not the case in the IASB proposals.
- The 2nd stage test will lead to some odd results

    - it is possible that write downs will be made which lead to a carrying value below the value in use.
    - any write down will have little to do with the running down of purchased goodwill because of the way it is calculated.
    - internally generated goodwill avoids write down of purchased goodwill.

Q6: We note the logic for this as set out in the Basis for Conclusions but it only reinforces the problem we have with the change to impairment rather than amortisation.

Q7: We disagree with the excessive list of disclosures, especially where there is no impairment, and in particular paragraph 134(d) (e) (f) and paragraph 137. The proposal is to replace the systematic amortisation approach with a subjective and questionable impairment approach and then require extensive and costly disclosures including sensitive forecast information to "enable" certain users to try to second guess management and auditors on the basis of data which, in any event, will not be in line with the company's own internal forecasts. It is difficult to see how this is either justified on any cost/benefit basis or adding to the reliability and understandability of financial statements.

IAS38

QI: Agree.

Q2: We are not convinced that the separate identification of a series of intangible assets in a business combination will actually provide more useful and reliable information, with costs incurred on the subjective valuations placed on customer related intangibles or internally generated R&D.

Q3: Agree in the context of the overall approach being suggested by the IASB although our general point remains that we believe amortisation is more appropriate in most circumstances.

Q4: As for Q3.

Q5: As for Q3.

<u>Other</u>

IAS34 The inclusion in paragraph 16(i) of the additional requirement for information as in paragraphs 65-72 of ED3 is excessive and potentially unrealistic in the case of interim reporting. It will often not be possible to comply with this, especially where the reporting timetable for the interim is relatively tight which is what users would presumably rather have.

Yours faithfully

DAVID POTTER
Chairman, C.I.A.S.