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By air-mail and e-mail <CommentLetters@iasb.org.uk>

Our. Ref.: C/FASC 4 April 2003

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Exposure Draft
ED 3 *Business Combinations*

The Hong Kong Society of Accountants (HKSA) welcomes the opportunity to provide you with our comments on the Exposure Draft ED 3 Business Combinations.

We set out in the attachment our response to the questions raised in your Invitation to Comment. We would wish to highlight for the Board's consideration our responses to questions 1(a) and 8. In our response to question 1, we would encourage the Board to address business combinations and reorganisations involving entities under common control as part of Phase 2. We would also recommend that the proposed IFRS resulting from Phases 1 and 2 have the same application date.

In our response to question 8, we express our reservations about the proposed approach with regard to the non-amortisation of goodwill in certain circumstances. We believe that the Board has not adequately addressed the conceptual rationale for such an approach, especially as it concerns the gradual replacement of purchased goodwill with internally-generated goodwill which we believe occurs even when it is deemed that the goodwill purchased might have an indefinite life. We also draw your attention to our comment under question 8 as to whether the non-amortisation approach proposed for goodwill and intangible assets can be extended to apply to tangible fixed assets.

The HKSA has a policy of converging its Statements of Standard Accounting Practice with the International Accounting Standards Board's Standards. The standard setting due process applied in Hong Kong (details of which are available on the HKSA's website) acts to support this policy. The HKSA's Financial Accounting Standards Committee (FASC) issued an Invitation to Comment on the exposure draft with a comment period concurrent with that set by the IASB. Accordingly, the accompanying comments may reflect the views not only of members of the FASC but also of constituents in Hong Kong who provided comments to the HKSA.

If you have any questions on our comments, please contact our Deputy Director - Accounting, Mr. Simon Riley, in the first instance.

Yours faithfully

WINNIE C.W. CHEUNG
SENIOR DIRECTOR
PROFESSIONAL & TECHNICAL DEVELOPMENT
HONG KONG SOCIETY OF ACCOUNTANTS

WCC/SR/al

Hong Kong Society of Accountants' comments on the Exposure Draft ED 3 Business Combinations

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?

Ideally, all issues relevant to the business combinations project would be dealt with at the same time. However, we agree that it is appropriate for Phase 1 to exclude business combinations that result in the formation of a joint venture from the scope of the proposed IFRS because certain issues may need to be delayed until Phase 2 so that Phase 1 can move forward quickly. But we believe that the accounting for the formation of a joint venture should be considered in Phase 2. We suggest that the Board consider at the same time all transactions or combinations that result in the formation of a new entity rather than an acquisition. These include rare business combinations where an acquirer cannot be identified, entities brought together by contract, the combination of mutual entities, the combination of more than two entities and the transfer of state owned assets to private ownership.

We encourage the Board to publish an exposure draft for phase 2 at the soonest possible time. Phase 2 should address combinations and reorganisations involving entities under common control. The proposed standards that result from both Phase 1 and Phase 2 of the business combinations project should have the same mandatory application date. This will reduce the burden of multiple accounting changes. Both proposed standards should allow for early application.

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

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

We generally agree that the guidance provided is helpful for the purpose of identifying which transactions are excluded from phase 1.

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 agree that an acquirer can be identified in virtually all business combinations not involving entities under common control, and therefore we believe the proposition in question 2 is appropriate.

The inability to identify an acquirer may mean that the substance of the transaction is the creation of a new entity rather than a continuation of the combining entities or the dominance of the combining entities by a single entity. We suggest that the Board considers these types of transactions in Phase 2 along with business combinations and other reorganisations between entities under common control.

We believe the pooling of interests method would be inappropriate in the extremely rare circumstances in which an acquirer cannot be identified. The pooling of interests method should only be used for transactions where the ultimate shareholder remains the same and there is no change in the relative rights or interests of any shareholder or minority. Fresh start accounting may be a viable alternative. In any case, we believe that true mergers of equals are so rare that it should not be necessary for the proposed IFRS to provide for such situations.

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?

Yes. The acquirer should be identified as the party that has obtained the power to govern the financial and operating policies of the combined entity at the date of the business combination. This is frequently the entity whose shareholders own more than half the voting rights after the combination, but this is not always the case and the proposed standard should be clear that all relevant facts and circumstances should be considered.

(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?

We agree this guidance is generally appropriate.

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

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

Is this appropriate? If not, why not?

Consistent with our response to question 2, we agree that the proposition in question 4 is appropriate. The accounting treatment should reflect the substance of the business combination and not be driven by the legal form of a particular transaction.

We believe that the accounting treatment for an acquisition should be neutral irrespective of whether a new entity is formed. On occasions, a business combination may be underway before the new entity legally exists. In such situations, the business combination or reorganisation may be achieved in stages, possibly over the course of more than one financial year, because control cannot pass to the newly formed legal entity before that entity exists.

The proposed standard does not explain how to account for the transaction between the new entity and the entity identified as the acquirer. This is merely a reorganisation of the interests of the acquirer and purchase accounting should not be applied. This principle should be made clear in the proposed IFRS.

Question 5 – Provisions for terminating or reducing the activities of the acquiree

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

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

We agree that a provision for the costs of terminating or reducing the activities of the acquired entity should be recognised in the purchase price allocation only when the acquired entity has an existing liability recognised in accordance with IAS 37. Because of the potential for abuse of the IFRS depending on whether a takeover is friendly or not, we suggest that the proposed standard require that the acquired entity's restructuring plan was in existence before the commencement of negotiations for the business combination and that management of the acquirer is demonstrably committed to executing the restructuring plan. We also suggest that liabilities where settlement becomes probable as a result of the change in control of the acquired entity are included in the purchase price allocation only if the contingent liability existed before the commencement of negotiations for the business combination.

Paragraph 40 of the proposed standard should be revised to be clear that a restructuring plan that was conditional on the occurrence of the transaction should not be recognised in the purchase price allocation. Recognition should be permitted only if the acquired entity is unconditionally committed to the plan prior to the date of acquisition. We also believe that the costs of a restructuring plan should be excluded specifically from the payments covered by paragraph 41 of the proposed standard.

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?

In principle, we agree with the proposition in question 6.

A bona fide contingent liability (that is, one that fails IAS 37 recognition criteria as a 'full' liability) should have the effect of reducing the purchase consideration relative to the acquirer's share of the fair value of the net assets – the extent to which the purchase consideration is reduced should theoretically reflect that risk assumed by the acquirer in the contingent liability crystallising – appropriate to effectively offset the reduced purchase premium against the good will that would have otherwise arisen rather than recognise a liability at an estimated weight-average valuation. We do have a practical concern with the proposition in question 6 as regards the extent to which a risk-weighted measurement of the contingent liability may be reliable.

If the Board proceeds with the proposition in question 6, we would also believe that contingent assets should be recognised in a business combination provided their fair values can be measured reliably. The proposed standard should also include guidance on accounting for such contingent assets until they meet the criteria for recognition as an asset or are de-recognised.

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?

Yes. We agree with the proposal that the minority's interest in the assets and liabilities of the acquired entity should be stated at fair value.

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 express our strong reservations with the proposition in question 8.

The appropriate accounting treatment for goodwill is an issue on which the achievement of a long-standing conceptually sound global consensus may yet be some way off. The proposals in ED 3 represent the third major shift in goodwill accounting in the IAS/IFRS literature in little more than a decade.

We are concerned that the approach in ED 3 is a rule-based solution that lacks strong conceptual support, and which is designed to accommodate those who may well have a case for arguing that the current IAS 22 treatment for the amortisation of goodwill through the income statement gives rise to an arbitrary drag on reported earnings.

The concept that an intangible asset should be left on the balance sheet unamortised and subject only to impairment is a substantial shift away from the current conceptual framework published by the IASB. If the IASB were making a case for treating goodwill in such a manner, we would question why the same approach could not also be applied to tangible non-current assets.

The approach proposed in ED 3 is also conceptually inconsistent with the prohibition on recognising internally generated goodwill and we find the IASB's Basis of Conclusion paragraph BC.107 weak in justifying why such internally generated goodwill should remain on the balance sheet, especially as it takes a 'nature of the goodwill' approach (BC.96).

After a while, purchased goodwill is replaced by internally generated goodwill (through one's own management of an enterprise, advertising, etc). To subject purchased goodwill to an impairment test obscures the fact that the goodwill increasingly becomes generated internally – the acquirer manages to maintain the goodwill within an enterprise and no income statement expense arises although the source of the goodwill appearing on the balance sheet has changed from purchased to internally generated over time.

We would like to propose the following alternative approach:

1. Goodwill should be amortised over a prudent estimate of the period for which it has value. In determining this period, the rate at which purchased goodwill is replaced by internally generated goodwill should be estimated and taken into account. A guide to

this might be a reasonable expectation of the cost of future activities the business will undertake in order to preserve the (original) value of the purchased goodwill;

2. The net book value of goodwill after amortisation should be subject to an impairment test on the basis proposed in the ED.

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?

We disagree with the proposition in question 9.

We express our concern about the proposed recognition of all negative goodwill immediately through the income statement. This would give rise to imprudent accounting, for example, in cases where an entity has acquired an illiquid asset such as land as part of a bargain purchase upon which an ostensibly distributable profit would be recognised.

We believe that the "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", which will become colloquially known as "negative goodwill", should be either allocated across the fair values of the assets acquired or dealt with in accordance with the stratified approach presently applying in IAS 22. If an asset has a supposed fair value of 15 and yet is acquired even in an arms' length bargain purchase scenario for 10, we believe that the 10 is a more reliable indicator of fair value at the time of acquisition than the 15. While we agree in the most part with Basis of Conclusion paragraph BC.110, we would not necessarily share the Board's view that such an excess is rare.

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

The Exposure Draft proposes that:

(a) **if the initial accounting for a business combination can be determined 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 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 recognised within twelve months of the acquisition date (see proposed paragraphs 60 and 61 and paragraphs BC123-BC126 of the Basis Conclusions).**

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

Yes. We agree that this is reasonable period to complete the purchase price allocation.

(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 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, in general. We agree with the general principle that adjustments to the initial accounting should be recognised only to correct an error, but we suggest that a change in accounting policy should also result in a change to the initial accounting that should be recognised retrospectively.

We do not agree that the initial accounting should be adjusted when deferred tax assets not recognised at the date of acquisition are recognised subsequently. The subsequent recognition of such assets is no different to the revision of any other estimate, so we believe there is no need for a special requirement. Should paragraph 64 be retained in the proposed standard, the text should be clear that the guidance applies only to assets recognised after the end of the hindsight period and that that reduction in the carrying amount of goodwill is not a tax expense.

By air-mail and e-mail <CommentLetters@iasb.org.uk>

Our. Ref.: C/FASC 4 April 2003

International Accounting Standards Board
30 Cannon Street London
EC4M 6XH
United Kingdom

Dear Sir/Madam,

Exposure Draft of Proposed Amendments to
IAS 36 Impairment of Assets
IAS 38 Intangible Assets

The Hong Kong Society of Accountants (HKSA) welcomes the opportunity to provide you with our comments on the Exposure Draft of Proposed Amendments to IAS 36 Impairment of Assets & IAS 38 Intangible Assets.

We set out in the attachment our response to the questions raised in your Invitation to Comment. We would wish to highlight for the Board's consideration our responses to questions 3(c) and 7 on ED/IAS 36.

In our response to question 3(c), we note that the proposed IAS does not mandate the use of a discount rate based on Weighted Average Cost of Capital (WACC) but rather indicates that WACC may be one of the choices as a starting point in making such an estimate. We also note the proposals would require using a discount rate reflecting current market assessments of (a) the time value of money (represented by the current market risk-free rate of interest and (b) the risks specific to the assets for which future cash flow estimates have not been adjusted. In response to comments received from our constituency, however, we relay to the Board concerns about practical difficulties in determining an appropriate discount rate and that the guidance proposed in Appendix B may be interpreted as requiring companies to use a WACC-based discount rate rather than a rate that is more reflective of (a) and (b) above.

In our response to question 7, we express our reservations about the degree of disclosure proposed in paragraph 134 of ED/IAS 36. We feel that the proposal is excessive, onerous and unreasonable and out of keeping with what should be disclosed in financial statements. Much of the disclosure proposed is, we believe, genuinely commercially sensitive. We also highlight our belief that the proposed disclosure lacks meaning, is tantamount to requiring the financial statements to disclose prospective information and is probably something best left to the realm of management discussion and analysis. We urge the Board to drop the disclosure proposed particularly in paragraph 134 (d), (e) and (f).

The HKSA has a policy of converging its Statements of Standard Accounting Practice with the International Accounting Standards Board's Standards. The standard setting due process applied in Hong Kong (details of which are available on the HKSA's website) acts to support this policy. The HKSA's Financial Accounting Standards Committee (FASC) issued an Invitation to Comment on the exposure draft with a comment period concurrent with that set by the IASB. Accordingly, the accompanying comments may reflect the views not only of members of the FASC but also of constituents in Hong Kong who provided comments to the HKSA.

If you have any questions on our comments, please contact our Deputy Director - Accounting, Mr. Simon Riley, in the first instance.

Yours faithfully

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Hong Kong Society of Accountants' comments on the Exposure Draft of Proposed Amendments to IAS 36 Impairment of Assets & IAS 38 Intangible Assets

IAS 36

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 (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?

Yes. The impairment testing procedures are potentially complex and time consuming, so we believe entities should have the flexibility to complete the procedures at any time during the financial year. The conclusions should be revisited if necessary as a result of significant events occurring after the testing has been completed. We note that paragraph 93 provides this flexibility and we believe there should be an equivalent requirement applying in respect of all intangible assets, not solely goodwill associated with cash-generating units.

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 (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. There is no conceptual basis to apply a different basis to measure the recoverable amount of intangible assets with indefinite and finite useful lives. The guidance in IAS 36 should be applied to both.

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

Yes to both issues in (a). We agree that it might be difficult in some circumstances to identify a risk-adjusted discount rate that reflects all relevant risks and the proposals present a practical solution to this problem. We also agree that an entity should be permitted to reflect those elements either as adjustments to the future cash flows or adjustments to the discount rate, but obviously not both.

(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 (proposed paragraph 27(a)(ii) and paragraphs C66 and C67 of the Basis for Conclusions)? If not, why not?

Yes. We believe it is critical that appropriate account is taken of management's ability to prepare accurate forecasts, based on the accuracy of previous projections. The accuracy of impairment testing may be undermined by overly optimistic cash flow projections. The proposal is a practical way of addressing this issue without adding further complexity to the model.

(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?

We note that Appendix B does not mandate the use of a Weighted Average Cost of Capital (WACC) based discount rate but rather indicates that WACC may be one of the choices as a starting point in making such an estimate. We believe there may be practical difficulties in determining an appropriate discount rate and that the guidance proposed in Appendix B is not entirely appropriate. We have three broad concerns about the guidance proposed in Appendix B:

1. The guidance given on determining which discount rates may lead to uncertainty and divergence in practice;

2. The proposal to use discount rates based on WACC may not be appropriate in all circumstances; and

3. There are significant practical difficulties in using a WACC-based discount rate.

It is noted that under draft IAS 36.48, the proposals would require using a discount rate reflecting current market assessments of (a) the time value of money (represented by the current market risk-free rate of interest and (b) the risks specific to the assets for which future cash flow estimates have not been adjusted, but some readers may interpret paragraph 49 and Appendix B as requiring companies to use a WACC discount rate for the cash-generating unit evaluated. Others may note, however, the reference in Appendix B paragraph B17 to borrowing costs and consider there is flexibility to discount at borrowing costs rather than WACC. The final standard should remove this uncertainty.

The borrowing rate may be more appropriate than WACC in certain circumstances for discounting expected future cash flows:

- We agree that WACC is the appropriate rate for a company to use when considering a new investment. But the determination of an impairment provision is not the same as a new investment decision. Rather, impairment is the estimation of the future losses that a business will make on a project or asset and the immediate charging of these losses to the income statement. It is therefore appropriate to calculate the impairment at the company's prospective cost of debt.

- If impairment provisions are calculated based on the cost of debt, in future periods the impaired project will (if present assumptions prove to be correct) result in a nil impact on the income statement. That is to say that the profit from the impaired asset or project will match the cost of borrowing recognised as an expense in the income statement. If, on the other hand, a WACC-based discount rate is used to calculate impairment then the project will make a profit in future periods due to the excess of the WACC rate over the borrowing rate. It would appear counter-intuitive to us to require the initial recognition of a larger (WACC-based) provision that is subsequently released through future income statements despite no apparent change in circumstances.

The calculation of WACC is based on highly subjective judgements. Preparers and auditors are likely to have considerable difficulty deciding issues such as what is the appropriate risk free rate of debt (particularly for businesses operating in developing countries); what is the appropriate ratio of debt to equity; and what is the appropriate Beta for a project, cash-generating unit or individual asset. This problem does not arise to the same extent when a borrowing rate is used rather than WACC.

We believe that the guidance would be more practical for mature markets where the requisite information is more likely to be available. In developing markets, however, such information may not be so readily available. We would recommend that the guidance given in the proposed Standard take into account this situation and that this matter be flagged for the IASB's project on discounting.

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 (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?

Yes. We agree with this proposal.

Paragraph 73 requires that goodwill is allocated to one or more cash generating units. The guidance does not explain how goodwill should be allocated to cash generating units or specify whether goodwill should be allocated to existing cash generating units that are not combined with acquired cash generating units. We suggest that the proposed standard should also provide guidance on the allocation of goodwill and to require that the goodwill is allocated to existing cash generating units if they are expected to benefit from the business combination. We also suggest that the illustrative examples in Appendix A are extended to cover the allocation of goodwill in the context of a business combination.

(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 (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?

Yes. We agree that goodwill associated with such an operation should be taken into account when determining the gain or loss on disposal. We agree in principle that the allocation should be based on relative values but we would suggest that the proposed standard clarify the meaning of "values" as being the net selling price of the portion being sold and the recoverable amount of the portion being retained.

We believe the proposals in paragraph 81 might create 'counter-intuitive' results in some circumstances such as when an acquired operation might be included in a cash-generating unit for impairment testing purposes but not fully integrated for operational purposes. On the disposal of an operation, some of the goodwill will be allocated to the operations that are retained and this may distort the gain or loss recognised on disposal. We suggest that the proposed approach in paragraph 81 apply only when the operations concerned have been fully integrated within one cash-generating unit.

(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 (proposed paragraph 82 and paragraphs C24 and C25 of the Basis for Conclusions)? If not, what approach should be used?**

Yes. We agree with this proposal, subject to the comments in (b) above.

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 (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?

Yes. We agree with this proposal.

(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 (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?

Yes. We agree with this proposal as a practical solution. The impairment test would be more rigorous if the screening mechanism was not used, but we believe the costs of calculating the implied value of goodwill every year are likely to outweigh the benefits of a more robust impairment test.

(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 (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?

Yes. We agree with this proposal.

Under paragraph 86, acquired intangible assets that fail the recognition criteria are excluded from the calculation of the implied value of goodwill. Goodwill impairment is therefore measured on the same basis as that applying when the goodwill arose. There may be occasion, however, when the guidance will be difficult to apply in practice, for example, when a cash-generating unit encompasses operations acquired in different business combinations. We recommend that the proposed standard provide further guidance on the practical implications arising from this situation.

Question 6 – Reversals of impairment losses for goodwill

The Exposure Draft proposes that reversals of impairment losses recognised for goodwill should be prohibited (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?

The conceptually correct answer, we believe, would be to disagree with the proposition in question 6. The reversal of an impairment charge for goodwill might be identified as a result of changes in the key assumptions used to calculate the impairment. But we agree that in many cases it will be impossible to distinguish between the elements of a reversal attributable to purchased goodwill and the elements attributable to internally generated goodwill. Even if there might be limited circumstances when this distinction could be made, we believe it would be impracticable for the IASB to develop guidance and, therefore, we would agree that the proposed standard should prohibit all reversals of impairment losses recognised for 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 (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?

No. We believe the suggested disclosures – particularly in paragraph 134 (d), (e) and (f) – are excessive, onerous and unreasonable. We express our strong reservation as to how these proposed disclosures could be supported from a cost:benefit perspective. The extent of the disclosure, we believe, would detract from the general understandability and fair presentation of the financial statements – especially when one considers that the mere flexing of one variable is proposed to be presented in a sensitivity analysis that ignores the inter-dependencies with the other variables. In addition, the provisions proposed in paragraph 134 (d), (e) & (f) would result in the disclosure of information we believe to be genuinely commercially sensitive.

We strongly urge the Board to remove proposed paragraphs 134 (d), (e) & (f) from the final version of the Standard. The proposed disclosure is tantamount to requiring the financial statements to disclose prospective information. We believe such information is not appropriately included within the financial statements and ought to be left to the realm of management discussion and analysis.

(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?

Yes, subject to our comments on question 7(a) above. We agree with this proposal, although significant differences between the assumptions used for different operations within the same segment might cast doubt on the appropriate identification of the segments.

<u>IAS 38</u>

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 (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 there is a need for more robust guidance on the identification and recognition of separate intangible assets. Financial statements provide more useful information about the value of the resources and benefits acquired in a business combination when all of the separate intangible assets are identified and measured.

We agree that the separability and contractual/other legal rights criteria are appropriate for determining whether an asset can be identified separately. However, we are concerned that the guidance applied to a business combination is inconsistent with the guidance for the recognition of intangible assets acquired separately. We are also concerned that the guidance might be difficult to apply in practice, particularly in connection with customer relationships.

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

The Exposure Draft proposes clarifying that for an intangible asset acquired 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 (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 (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 agree that a business combination provides a reliable measure of the total fair value of the business acquired, but we do not agree that sufficient information will always exist to measure the fair value of individual items. The intangible assets acquired will often include a number of different, but closely related assets and we do not believe it will always be possible to separate the cash flows to measure such assets reliably.

On acquisition, it should usually be possible to assign values to the assets and liabilities acquired but this is not necessarily the same as being able to fair value those items subsequently. We believe that additional guidance is required to establish a basis for determining the fair value of both tangible assets and intangible assets acquired in a business combination. Such guidance should result in a consistent approach for fair value measurement, enhance the comparability of financial statements and result in valuations that are more objective and reliable.

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 (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?

Yes. We agree with the proposal to remove the presumption that the useful life of an intangible asset cannot exceed twenty years.

We agree in principle that an intangible asset should be regarded as having an indefinite live when there is no reasonably foreseen limit on the period it is expected to generate net cash inflows and that this criteria be subject to review periodically. However, we believe the proposed standard should include additional guidance on the circumstances in which an indefinite life is appropriate and that legal, contractual, regulatory, competitive and similar factors should be considered in determining the expected life, indefinite or otherwise. We suggest that the principles that underpin the guidance in the Appendices to IAS 38 should be included in the proposed standard.

Even though it may not be directly relevant to the accounting and financial reporting of intangible assets, we would be appreciative to the Board if it could explain in the Basis for Conclusions to IAS 38 whether there are any strong conceptual reasons for not extending the indefinite life approach to tangible fixed assets, possibly along similar lines as the United Kingdom FRS 15 in relation to infrastructure assets.

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

The Exposure Draft proposes that if an intangible asset arises from contractual or other legal rights that are conveyed for a limited term that can be renewed, the useful life shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost (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)?

Yes. We support the general principles behind the proposal. However, we believe further guidance is required.

We believe the proposed standard should specify that the useful life should include the renewal period only if the rights can be renewed at the option of the entity and without significant cost.

Question 5 – Non-amortisation of intangible assets with indefinite useful lives

The Exposure Draft proposes that an intangible asset with an indefinite useful life should not be amortised (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?

Yes. We agree with this proposal.

The transitional provisions require that the useful life of intangible assets is reassessed at the date the proposed standard is first adopted. This includes intangible assets that were previously assessed to have a useful life of less than 20 years. We believe the proposed standard should include a rebuttable presumption that an asset that previously assessed to have a useful life of less than twenty years may not be assigned an indefinite useful life.