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Sir David Tweedie
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30 Cannon Street
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4 April 2003

Dear Sir David

Exposure Draft ED 3 Business Combinations
Amendments to IAS 36 Impairment of Assets
Amendments to IAS 38 Intangible Assets

We are responding to your invitation to comment on the above exposure drafts on behalf of the worldwide organisation and Global IAS Board of PricewaterhouseCoopers. We have responded to the questions posed in ED 3 Business Combinations ("ED3" or "the proposed standard") and related amendments in IAS 36 Impairment of Assets ("IAS 36") and IAS 38 Intangible Assets ("IAS 38"). We have also included other comments on certain aspects of the proposed standard and the amendments to IAS 36 and some detailed comments on reverse acquisition accounting in Appendix A.

There are several areas of overarching importance that the Board needs to address. The areas where we have particular concern are: 1) the phased approach to the business combinations project, 2) the need for international valuation standards, 3) the concerns inherent in adopting an impairment model, 4) the recognition of contingent assets and liabilities, 5) the need to consider the limited period of 'field testing' that the similar FASB standards have had and 6) convergence with US GAAP.

Phased Approach to Business Combinations

We would prefer that all issues relevant to the business combinations project are dealt with at the same time. However, we agree that the phased approach is a pragmatic solution to moving rapidly forward on certain issues. The phased approach, however, makes it mandatory that:

- The Board adheres to the current timetable for timely completion of Phase II;
- The proposed standards resulting from Phase I and Phase II have the same mandatory adoption date;

- The proposed standards allow early adoption only if they are adopted at the same time; and
- Phase II must address the accounting for the formation of a joint venture and other transactions excluded from the scope of ED 3 and provide guidance on accounting for common control transactions.

Valuation Standards

We appreciate that the IASB has no direct mandate to write valuation standards. However, the proposed standard and the amendments to IAS 36 and IAS 38 are all heavily reliant on the determination of fair values for recognition and measurement of intangible assets. Intangible assets must be appropriately recognised at acquisition. Application of the impairment model requires frequent valuations of cash generating units and intangible assets in the two-step impairment test and when assessing the recoverable amount of intangible assets with indefinite lives.

There is no commonly accepted or published guidance available on valuation standards that can be robustly applied across multiple cultures, languages, business practices and legal environments. The IASB, with its partner standard setters, should lead the drive for principle based valuation standards that can be consistently applied in diverse legal and economic conditions.

The Impairment Model

The cost less impairment model of accounting for goodwill and intangible assets is a conceptually better model and when robustly and consistently applied provides more relevant information for users. We support the recognition of more intangible assets and believe the accounting should be the same if assets are purchased individually or in a business combination. We agree that some intangible assets have an indefinite life and it is appropriate to account for such assets at cost less impairment. We also agree that goodwill does not have a determinable useful life and should be accounted for as an asset at cost less impairment.

However, the robust application of the proposed model is dependent on the ability of preparers to accurately estimate cash flows. The Board should consider whether the conceptual improvements of the proposals are cost beneficial to users of financial statements. We are concerned that the necessary skills to apply the model so as to produce reliable and consistent financial reporting will not be present in sufficient quantity in an international group of diverse users.

Contingent Assets and Liabilities

There is no conceptual basis for a difference between the recognition criteria for contingent liabilities in a business combination and those arising in any reporting entity. The recognition criteria for a contingent liability in the proposed standard are in conflict with the criteria in IAS 37 and inconsistent with the IAS Framework. Further, the proposed standard does not allow the recognition of contingent assets in a business combination. This means that contingent assets are subsumed in goodwill when conceptually they should be separately recognised. Thus there appears to be a conflict within the proposed standard and between the proposed standard and the existing standards and Framework.

The Board should address the recognition of contingent assets and liabilities as part of Phase II. However, there should not be a measurement anomaly such that these are only recognised in a business combination. Should the Board conclude that recognition of contingent assets and liabilities at fair value is appropriate in connection with a business combination, then the Framework and IAS 37 should be amended to require recognition of all contingent assets and liabilities on the same basis.

Limited Field Testing

The proposed standard and amendments will converge IAS significantly with US GAAP in the area of business combinations. The model adopted by FASB has been applied by all listed companies in the USA but the majority of preparers are only in their second annual reporting cycle of application. During this period a single set of economic conditions have prevailed and there have been low levels of new merger and acquisition activity. The IASB should therefore keep the impact of the proposed standard under review as it is implemented and respond quickly if it becomes clear that any aspect of the guidance is not working in practice.

Convergence

We have not identified in our comment letter where the proposals will leave or create differences between IFRS and US GAAP. These differences will be difficult for users to understand when the approaches are conceptually similar. We encourage IASB to work closely with FASB to identify and eliminate all differences.

If you have any questions in relation to this letter please do not hesitate to contact Jochen Pape, Chair of the PwC Global IAS Board (49 211 981 2905), or Mary Dolson (44 207 804 2930).

Yours faithfully

PricewaterhouseCoopers

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ED 3 Business combinations
Responses to detailed questions
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?

Answer

Yes, we agree that the formation of joint ventures and business combinations involving entities under common control should be excluded from the scope of the proposed standard.

We would prefer that all issues relevant to the business combinations project were dealt with at the same time. The current timetable for Phase I and Phase II of the business combinations project will have the standards mandatory for accounting periods ending on 31 December 2005. Adherence to this timetable is essential for the phased approach to the business combinations project to be acceptable. Therefore, we agree that both of the issues identified should be excluded from the scope of the proposed standard, but both issues should be resolved in Phase II.

Accounting for the formation of a joint venture should be considered with similar issues in Phase II. The substance of a transaction that creates a joint venture is the creation of a new entity. The scope of Phase II should cover all transactions or combinations other than acquisitions that result in the formation of a new entity. These include those 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. The Board should explore fresh start accounting and other alternatives to determine which approach produces the most useful information.

The absence of IFRS guidance dealing with business combinations involving entities under common control has given rise to divergent practice. Similar transactions are accounted for differently, causing a lack of comparability between entities. Guidance is urgently required in this area and should be considered in Phase II. The accounting treatment applied to business combinations involving entities under common control should reflect the conclusion of the debate to determine whether the economic entity or parent company model is more appropriate for consolidated financial reporting.

We note that the Board does not expect Phase II to result in fundamental changes to the approach proposed in Phase I. However, there are decisions already taken in Phase II that address items excluded from the scope of Phase I or alter the proposals in Phase I. For example, the accounting treatment that is applied to the acquisition of minority interests and step acquisitions and the treatment of the direct costs incurred in connection with a business combination. These decisions could result in multiple accounting changes within a short period. The proposed standards that result from Phase I and Phase II should have the same mandatory adoption date. This will eliminate the need for multiple accounting changes. Both proposed standards should allow for early adoption, so long as both standards are adopted at the same time.

(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?

Answer

Yes, we agree that the definition of business combinations involving entities under common control and the additional guidance are helpful. Guidance on accounting for such transactions must be included in Phase II.

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?

Answer

No. We agree that an acquirer can be identified in virtually all business combinations. However, there are extremely rare circumstances in which an acquirer cannot be identified. An example might be a “roll-up” type transaction that combines three or more entities of virtually equal size and no one management team or group of shareholders obtains control or dominates the combination process or the combined entity. The arbitrary identification of an acquirer in these circumstances with new basis recognised only for those entities deemed to have been acquired will not provide meaningful financial information.

The substance of a transaction in which an acquirer cannot be identified is often 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. The pooling of interests method is not appropriate in these circumstances. We agree that the pooling of interests method should be eliminated and not applied to any transactions within the scope of the proposed standard.

The elimination of the pooling of interests method should not be delayed until the Board has been able to consider the accounting treatment that should be applied in the rare circumstances in which an acquirer cannot be identified. We therefore support the approach in the proposed standard as a short term solution, but the Board should consider these transactions in Phase II.

The proposal that the purchase method is applied to all business combinations requires that the proposed standard include robust guidance for determining the acquirer. We have commented further in this area in our response to Question 4.

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?

Answer

Yes. The acquirer is 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. We agree that in circumstances where the legal subsidiary has the power to govern the financial and operating policies of the legal parent, the legal subsidiary should be identified as the accounting parent. We have commented further on the guidance for identifying the acquirer in our response to Question 4.

The transaction used as an example of a reverse acquisition in paragraph 21 of the proposed standard has the substance of a capital raising transaction and would be accounted for as such. The example would be more helpful if it illustrated a reverse acquisition involving two substantive operating companies. The example should be included in the Illustrative Examples rather than in the body of the standard.

(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?

Answer

Yes, we agree this guidance is generally appropriate, but we have some detailed observations that are included as Appendix A.

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?

Answer

Yes, we agree that this is appropriate except for those extremely rare cases where an acquirer cannot be identified. (See our response to Question 2).

Determining the acquirer will be critical when purchase accounting is applied to every transaction. All of the relevant facts and circumstances should be considered to determine which of the combining entities is the acquirer. The accounting treatment should reflect the substance of the business combination and not be driven by the legal form of a particular transaction.

We agree with the proposals in paragraph 17 of the proposed standard that the acquirer is the entity that obtains control of the other combining entities. We also agree with the proposal in paragraph 19 that control is presumed to arise when one of the combining entities acquires more than half the voting rights of the other combining entities, which is consistent with the guidance in IAS 27. The guidance in the remainder of paragraph 19 and in paragraphs 20 and 21 is confusing.

Paragraph 19 lists four ways in which control might arise when one of the combining entities does not acquire more than half the voting rights of the other combining entities. Paragraph 20 lists three further factors that should be considered to determine the acquirer, but does not state that these factors should be considered only when there is no indication that one of the combining entities has control. There is further guidance in paragraph 21, which suggests that the acquirer is usually the entity that has issued equity instruments or the largest entity. Readers might assume that these factors should be considered only in the context of a reverse acquisition.

The proposed standard should be clear that the existence of control determines the acquirer. Therefore the guidance in paragraphs 20 and 21 should be applied only when one of the combining entities has not obtained control in one of the ways listed in paragraph 19. The factors in paragraph 20 should be extended to include other relevant issues, such as the terms on which the purchase consideration is exchanged, the entity that initiated the transaction and the existence of a large block of voting shares when none of the combining entities has more than half the voting rights. Paragraph 20 should be clear that all relevant facts and circumstances should be considered to determine the acquirer when none of the combining entities has obtained control.

The guidance in paragraphs 20 and 21 is written from the perspective of business combinations involving only two entities. Identifying the acquirer is often difficult in complex transactions involving more than two entities when none of the combining entities obtains more than half the voting rights of the other entities. The proposed standard should include guidance for identifying the acquirer in these circumstances.

The proposed standard does not explain how to account for the transaction between the new entity and the entity identified as the acquirer when a new entity is incorporated as a vehicle to accomplish a business combination. 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 standard.

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?

Answer

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.

The proposed standard should also require that the acquired entity's restructuring plan was in existence before the commencement of negotiations for the business combination. Management of the acquirer must be demonstrably committed to executing the restructuring plan at or before the date of acquisition. Paragraph 40 of the proposed standard should be revised to clarify that a restructuring plan that was conditional on the occurrence of the transaction shall not be recognised in the purchase price allocation.

A restructuring plan that does not meet the criteria described above should be excluded from the purchase price allocation.

We agree with the proposal in paragraph 41 that payments the acquired entity is contractually obliged to make if it is acquired in a business combination should be included in the purchase price allocation. However, such liabilities should be included only if the contractual terms existed before commencement of negotiations for the business combination. The costs of a restructuring plan that is contingent on the business combination 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?

Answer

We agree with the principle behind this proposal. However, we are concerned that the proposal introduces a measurement anomaly between contingent liabilities that are first recognised by the acquirer in connection with a business combination and other contingent liabilities recognised in accordance with IAS 37.

There is no conceptual basis for a difference between the criteria used to recognise a contingent liability of the acquired entity in a business combination and the criteria used by the acquired entity to recognise a contingent liability in its own financial statements. The purchase consideration in a business combination might provide more robust evidence of the fair value of a contingent liability, but this does not justify using different recognition criteria. The guidance for recognising contingent liabilities in connection with a business combination should be consistent with the guidance for recognising contingent liabilities, so the guidance in the proposed standard should not be implemented unless similar guidance is included in IAS 37.

The recognition of a contingent liability in connection with a business combination is also inconsistent with the definition of a liability in the IAS Framework. We note that there are other assets and liabilities are not recognised at fair value at the time of a business combination, for example, deferred tax

We are also concerned that the proposal would require the recognition of contingent liabilities in a business combination provided their fair values can be measured reliably, but would not permit the recognition of contingent assets. Contingent assets that would not be recognised because they do not pass the "virtually certain" test in IAS 37 might include litigation and claims for tax refunds, volume based bonus receipts and additional sales proceeds that are contingent on the subsequent sale of goods by the purchaser.

New guidance for the recognition of contingent assets and contingent liabilities should be introduced at the same time. The guidance for recognising contingent assets and contingent liabilities in connection with a business combination should not be revised unless similar changes are made to the IAS Framework and IAS 37 at the same time. These issues should be considered together in Phase II.

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?

Answer

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. However, we believe that the Board should be clear that this conclusion does not pre-suppose the conclusion of the broader debate that is required on whether the economic entity or parent company model is more appropriate for consolidated financial reporting. The Board should confirm this in the Basis for Conclusions for the proposed standard.

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?

Answer

Yes. Goodwill represents a future economic benefit whose components cannot be recognised separately but whose total value can be measured reliably and should be recognised as an asset.

We also agree that goodwill should be accounted for at cost less impairment losses. Goodwill is more likely to lose value as a result of changing economic conditions or the actions of an acquirer than as a result of the passage of time. A robust and consistently applied impairment model reflects this and therefore provides a better representation of any loss in value.

Goodwill is a residual and it is unlikely that entities will be able to estimate with accuracy the useful life of economic benefits that cannot be identified separately. The allocation of a useful life to goodwill is arbitrary and the resulting amortisation charge has little meaning.

We acknowledge that the impairment approach blurs the distinction between purchased goodwill and internally generated goodwill. However, this distinction is blurred immediately after the acquisition regardless of whether the impairment or the amortisation model is used and we believe the impairment model reflects the way goodwill loses value more accurately than an amortisation model that allocates an arbitrary useful life to goodwill.

We support the proposals for an impairment model, but we have some reservations about the application of the model in practice in the absence of comprehensive valuation standards. The proposed impairment model requires assets and cash generating units to be valued in two situations. Firstly the separate assets and liabilities acquired must be valued to determine the amount of goodwill on each business combination. The proposed amendments to IAS 38 will require the recognition and measurement of assets that might not have been recognised in business combinations in the past because entities argued that they could not be measured reliably. Secondly, the recoverable amount of each cash generating unit must be determined each year to test for impairment and if impairment is identified, all of the assets and liabilities of that cash generating unit must be valued.

The absence of definitive valuation guidance means the initial determination of goodwill and the annual impairment test involve a significant element of judgement. The impairment model will be applied in a wide variety of economic situations in different countries. The lack of clear valuation standards will result in entities in similar situations potentially arriving at different valuations and therefore different impairment charges.

The Board should work with other standard setters and the valuation profession to develop a standard that illustrates the methods that may be used to determine the fair value of tangible and intangible assets and the recoverable amount of a cash generating unit in the context of financial reporting under IFRS. A common valuation standard will lead to consistent valuations and increase the comparability between entities.

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?

Answer

No. We do not agree with the proposed treatment of the excess of the fair value of the assets and liabilities over acquisition cost. A business combination transaction, negotiated at arms' length between unrelated parties, is not an event that should give rise to income. We agree that the excess of the fair values over acquisition cost does not meet the definition of a liability in the IAS Framework, but the excess relates in many cases to uncertainties in the measurement of assets and liabilities or to potential liabilities of the acquired entity that do not meet the criteria for recognition. This might be interpreted as an increase in economic benefits for the acquirer, but we do not agree that these benefits should be recognised immediately.

We agree that there are few true bargain purchases and an excess of fair value of assets and liabilities over acquisition cost arises infrequently in practice. We also note that the proposal that contingent liabilities are recognised at fair value in the purchase price allocation will reduce the circumstances in which an excess of fair value arises. However, it is not reasonable to assume that the benefits of a bargain purchase would be realised immediately, so there is no justification for immediate recognition of income.

The treatment of the excess of the fair value of the assets and liabilities over acquisition cost will be considered by the FASB as part of phase II of its business combinations project. The existing guidance in IAS 22 should be retained at this stage and a common solution developed in consultation with the FASB in Phase II.

We believe that paragraph 55(a) is unnecessary and presumes that preparers of financial statements do not possess the common sense to re-assess identifiable assets and liabilities in such a situation.

The term “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” is cumbersome and complex. The term “negative goodwill” should be retained, as we believe it is well understood and will continue to be used in practice.

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

The Exposure Draft proposes that:

(a) if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer should account for the combination using those provisional values. Any adjustment to those values as a result of completing the initial accounting is to be recognised within twelve months of the acquisition date (see proposed paragraphs 60 and 61 and paragraphs BC123-BC126 of the Basis for Conclusions). Is twelve months from the acquisition date sufficient time for completing the accounting for a business combination? If not, what period would be sufficient, and why?

Answer

Yes. We agree that this is a reasonable period to complete the purchase price allocation. However, the proposed standard should be revised to be clear that provisional values should be adjusted only as a result of the acquirer obtaining further information about fair values at the date of acquisition. Adjustments that reflect changes in circumstances after the date of acquisition should be charged or credited in the income statement.

The proposed standard does not include guidance on the accounting treatment required when provisional values are adjusted in the subsequent period. The guidance in SIC 22 should be included in the proposed standard. The proposed standard should include an illustrative example to explain the adjustments required in these circumstances.

(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?

Answer

Yes, we agree with the general principle that adjustments to the initial accounting should be recognised only to correct an error. The proposed standard should also include an illustrative example to explain the adjustments required in these circumstances.

We do not agree with the proposal in paragraph 64 that the initial accounting should be adjusted when deferred tax assets of the acquired entity not recognised at the date of acquisition are recognised after the initial accounting is finalised. The subsequent recognition of such assets is no different to the revision of any other estimate, so there is no need for a special requirement applicable only to deferred taxes. The effect of recognising a deferred tax asset of the acquired entity in periods after the initial accounting is complete should be credited in the income statement.

Should paragraph 64 be retained in the proposed standard, the text should be clear that the guidance applies only to assets recognised after the initial accounting is complete and that that reduction in the carrying amount of goodwill is not a tax expense.

Other comments on ED 3

Paragraphs 2-6

Definition

The definition of a business combination is the bringing together of entities or operations of entities into one reporting entity. The glossary does not define “entity” or “operations of entities” and does not explain whether there are circumstances in which a legal entity (for example a company or a partnership) would not be an entity for the purposes of the proposed standard. This might be the case for example, when a new entity is used to acquire separate assets rather than operations. The proposed standard should include further clarification of the terms “entity” and “operations of entities” and should require that purchase accounting is applied only when the acquired entity or operation is a business.

The definition of a business combination in the proposed standard will encompass the acquisition of entities that own a single asset such as a building or the in progress research and development or a group of assets, such as tax losses. The application of this guidance might lead to the recognition of goodwill when the substance of the transaction is the acquisition of an asset or group of assets. The proposed standard should require the accounting treatment to reflect the substance of such a transaction and should provide guidance on how to distinguish the acquisition of an operation from the acquisition of assets. The accounting should produce the same result as if the asset or group of assets had been acquired separately.

Paragraphs 4,5 and 6 list examples of transactions that would fall within the definition of a business combination. The paragraphs are confusing and the purpose is unclear. The definition of a business combination in the glossary is sufficient, subject to our comments above. Examples of transactions that fall within the definition should be included in the Illustrative Examples unless the proposed standard requires a particular accounting treatment for a particular transaction.

Paragraph 6 states that a business combination may involve the purchase of the net assets, including any goodwill, of another entity. Goodwill is the residual that results from the purchase price allocation so we do not agree that goodwill can be purchased in this way.

Paragraph 15

The assets and liabilities of the acquirer should not be affected by the business combination or the purchase price allocation. The sentence in IAS 22.39(i) that requires the acquirer to recognise its own deferred tax assets has been removed, but the corresponding paragraph in IAS 12 (IAS12.67) has not been amended. IAS 12.67 should be amended to be clear that any changes in the acquirer’s deferred tax assets as a result of the business combination are dealt with in the income statement.

Paragraph 24

The date when "each investment is recognised in the financial statements of the acquirer" is the date of exchange when a business combination is achieved in stages. This should be clarified by reference to IAS 28.17, where the investment was previously an associate and IAS 39.27 when investment was previously accounted for in accordance with that standard.

Paragraph 24/38

The acquisition date is the date on which the acquirer obtains control. The word "effectively" is not necessary and should be removed – the acquirer has control or it does not. The inclusion of an adverb introduces ambiguity and produces inconsistency.

Paragraph 26

The published price at the date of exchange is an unreliable indicator of the fair value of the purchase consideration only when it has been affected by "the thinness of the market". The proposed standard should provide further guidance on what is meant by "thinness of the market".

The cost of acquisition when there is no published price for equity instruments given in consideration is determined by reference to the fair value of the acquired entity or the acquirer. Entities often struggle to interpret "estimated by reference to their proportional interest in the fair value of the acquirer or their proportional in the fair value of the acquiree obtained, whichever is more evident." An illustrative example would be helpful.

Consideration might be given in the form of share options, warrants or similar instruments. The measurement of such instruments in a business combination is excluded from the scope of ED 2 and is not dealt with specifically in the proposed standard. The proposed standard should require that share options, warrants or similar instruments given in consideration are measured at fair value using an option pricing model in accordance with the guidance in ED 2.

Paragraph 28

The proposed standard requires that costs directly attributable to the business combination should be added to the purchase cost. There should be further guidance that only costs that are incremental and external as well as being directly attributable should be added to the cost of a business combination.

Paragraph 31

There is no guidance on the measurement of equity instruments given as consideration where the issue of the instruments is deferred or the number of instruments to be issued is contingent on future events. The measurement of such instruments is excluded from the scope of ED 2. The proposed standard should require these instruments to be measured using an option pricing model and assumptions that reflect the probability of instruments being issued.

Paragraph 34

The proposed standard requires that the cost of a business combination is not increased when the acquirer guarantees the value of non-monetary consideration or is required to make a subsequent payment to the seller as compensation for a reduction in the value of non-monetary consideration. The consideration in these circumstances should be measured as (i) the consideration initially given (measured at fair value at date of exchange) and (ii) the obligation to pay further consideration if the value of the consideration given initially falls (measured at fair value separately). The obligation to issue further consideration should be measured subsequently at fair value.

Paragraph 57

When a business combination is achieved in stages, each exchange transaction is treated separately for the purposes of determining goodwill. This will often require an entity to use information about the fair value of identifiable assets and liabilities that cannot be obtained without significant effort. This might be the case, for example, when an initial interest of 15% was acquired five years before the parent acquired a further 45% to obtain control. Determining the fair value of the identifiable assets and liabilities of the acquired entity at the date when the initial interest was acquired is likely to require significant cost and effort. The proposed standard should provide practical guidance in connection with this situation.

Paragraph 58

Any adjustment to the fair value of assets, liabilities and contingent liabilities that relates to a previously held interest is accounted for as a revaluation. The proposed standard should clarify that the subsequent accounting for the revaluation reserve is consistent with the guidance in IAS 16.

Paragraph 59

The statement in this paragraph is a statement of the obvious, so the purpose of the paragraph is not clear.

Paragraph 60/61

Adjustments to the provisional accounting for a business combination may be made within twelve months of the acquisition date. The proposed standard does not explain the accounting required when adjustments to the initial accounting are made in the subsequent period. The guidance in SIC 22 should be included in the proposed standard. The proposed standard should also include an illustrative example to explain the adjustments required in these circumstances.

Paragraph 62/63

A change in accounting policy made within twelve months of the date of acquisition in accordance with IAS 8 might result in adjustments to the amounts recorded in connection with the initial accounting for a business combination. The proposed standard should clarify that the impact of a change in accounting policy in these circumstances should be reflected in an adjustment to the initial accounting.

Paragraph 64

Goodwill is adjusted whenever a deferred tax asset not recognised at the date of the business combination is recognised subsequently. We do not agree that adjustments to deferred tax should be treated differently to any other adjustments to the identifiable assets and liabilities acquired. This paragraph should be deleted from the proposed standard and any adjustments to deferred tax should be dealt with in accordance with paragraphs 62 and 63.

Paragraph 66(f)

This paragraph requires disclosure of the carrying amount of the assets and liabilities of the acquired entity, determined in accordance with IFRS, immediately before the acquisition. The acquirer records these assets and liabilities at fair value in the consolidated financial statements, so the relevance of disclosing the book value values before they are adjusted to fair value is not clear. Determining the carrying amounts might be onerous when the acquired entity does not prepare its separate financial statements in accordance with IFRS. The requirement to disclose the fair value of the acquired identifiable assets and liabilities is appropriate, but the requirement to disclose the pre-combination carrying amounts should be deleted from the proposed standard.

Paragraph 69

The disclosure of revenue and profit/loss for the period as though the acquisition had taken place at the beginning of the period will be affected by the assumptions and adjustments made to determine the amounts disclosed. The proposed standard should require that the key assumptions are disclosed.

Paragraph 77

The proposed standard will be applied to business combinations where the agreement date is on or after the date on which the proposed standard is issued. ED 1 requires entities that adopt IFRS for the first time to apply the same accounting policies for all periods presented. This could result in entities adopting IFRS for the first time being required to adopt the proposed standard before existing IFRS users. The proposed standard should clarify how its requirements will interact with ED 1 when the proposed standard is issued during the period covered by an entity's first IFRS financial statements.

Paragraph 79

The proposed standard does not deal with the treatment of goodwill previously eliminated in equity when the cash generating unit or operation to which that goodwill relates is sold. The transitional guidance in IAS 22 does not address this issue, which arises frequently in practice. The proposed standard should be amended to require that goodwill previously eliminated in equity is included in calculating the gain or loss on disposal of the cash generating unit to which it relates.

The explanation of the transitional requirements for previously recognised goodwill is confusing. The proposed standard should clarify that the net book value of goodwill relating to previous business combinations is carried forward as an asset without further amortisation and tested for impairment in accordance with IAS 36.

Paragraph 81

The proposed standard does not include transitional guidance for the treatment of intangible assets that were not recognised at the time of previous business combinations, but would meet the criteria for recognition as separate assets in accordance with the revisions to IAS 38. The proposed standard should clarify that such assets should not be recognised retrospectively.

Paragraphs 82/83

The application of the guidance in the proposed standard to investments in associates presents a number of practical issues. For example, the investor and the associate might adopt the proposed standard on different dates because they have different accounting reference periods, the investor might recognise separate intangible assets with indefinite lives as part of the purchase price allocation that the associate would have no reason to test for impairment and the associate might recognise impairment losses in connection with goodwill recognised in its own books. The proposed standard should provide further guidance on the specific practical issues that arise when it is applied to investments in associates.

Appendix B15 (h)

Net employee benefit obligations or assets are recognised as identifiable assets or liabilities. The proposed standard should clarify that the actuarial assumptions used to value the defined benefit obligation should be those of the acquirer.

Illustrative examples of an acquisition in stages

The initial investment in the acquired entity must be restated to cost. The proposed standard should specify that this adjustment should be made against the same line item - equity or income statement – as the original adjustment.

Illustrative examples of changes in the fair values assigned to assets and liabilities

The example requires changes in values assigned to the acquiree's identifiable assets to be adjusted against goodwill as the correction of an error. However, the example is not clear whether this adjustment would be treated as a change in estimate to the provisional fair values if it occurred within the twelve period allowed to finalise the fair values. The proposed standard should be amended to be clear that errors in the purchase price allocation, in the context of IAS 8, occur only after the twelve month period for determining fair values.

Consequential changes to IAS 31

We do not agree with the proposed change in the definition of a joint venture. Joint control does not require consensus among the venturers in connection with all operating and financial decisions. The existing definition in IAS 31 should be retained. Should the Board wish to reconsider accounting for joint ventures, it should do so as a separate project.

Consequential amendments to IAS 12

The tax base of goodwill is nil when amortisation is not tax deductible and there is no tax deduction for goodwill in connection with a disposal. Paragraphs 15 and 21A require that no deferred tax liability is recognised in these circumstances. There are some jurisdictions in which goodwill amortisation is not tax deductible, but a deduction is obtained in connection with a disposal. Goodwill has a tax base in these circumstances, but no deferred tax is recognised, regardless of management's intentions for recovering the asset. The guidance in IAS 12.52 should be clarified.

Similar guidance should be included in paragraph 24 of IAS 12, since there are circumstances in which the tax basis of an asset is higher than the book value.

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IAS 36 Impairment of Assets
Responses to detailed questions
Question 1 – Frequency of impairment tests

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

Answer

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 within the period if necessary as a result of significant events that occur after the testing has been completed.

IAS 36.8A requires that the recoverable amount of an intangible asset with an indefinite life should be determined at the end of each year and that purchased goodwill should be tested for impairment annually. This proposal would result in most cases in the cash generating unit to which an indefinite lived intangible asset belonged being tested twice in each year. The proposed standard should be revised to require that intangible assets with indefinite lives are tested for impairment annually and to be clear that this test can be carried out at the same time as any goodwill allocated to the same cash generating unit.

IAS 36.8A could be interpreted to mean that intangible assets with indefinite useful lives should always be tested for impairment separately. The proposed standard should also be revised to be clear that intangible assets with indefinite useful lives that do not generate cash flows independently of other assets are tested for impairment as part of the cash generated unit to which they are allocated

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 of IAS 36 for assets other than goodwill (see proposed 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?

Answer

Yes. There is no conceptual basis to apply different bases 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 (see proposed paragraph 26A and paragraphs C66 and C67 of the Basis for Conclusions)? If not, which approach should be required?

Answer

Yes. We agree that that it might be more appropriate to reflect some risks in the cash flows and some risks in the discount rate. The proposals are a practical approach to this problem.

(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?

Answer

Yes. We agree 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 proposed in Appendix B to (draft) IAS 36 on using present value techniques in measuring an asset's value appropriate? If not, why not? Is it sufficient? If not, what should be added

Answer

Yes. This guidance and the simple practical examples are helpful and appropriate. However, Appendix B permits an entity to use either the traditional approach or the expected cash flows approach. The option might result in different present value techniques being applied to similar circumstances. The proposed standard should require entities to use the expected cash flow technique.

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, providing 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?

Answer

Yes. We agree with this proposal. However, the proposed standard should define "management" as the segment level management of the reporting entity.

Paragraph 73 requires that goodwill is allocated to one or more cash generating units. The guidance does not explain the basis that should be used to allocate goodwill to cash generating units and does not specify whether goodwill should be allocated to existing cash generating units that are not combined with acquired cash generating units. The proposed standard should be amended to provide additional guidance on the allocation of goodwill and to require that goodwill be allocated to existing cash generating units if they are expected to benefit from the business combination. The illustrative examples in Appendix A should be 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 / 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 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?

Answer

Yes. We agree that goodwill associated with an operation that has been sold should be included in the carrying amount used to determine the gain or loss on disposal and that the allocation should be based on relative values. However, the proposed standard should clarify the meaning of "values" as the net selling price of the portion being sold and the recoverable amount of the portion being retained.

The proposals in paragraph 81 could create an anomalous result in some circumstances. An acquired operation might be included in a cash generating unit for impairment testing purposes but not integrated for operational purposes. When the acquired operation is sold, some of the goodwill arising on acquisition will be allocated to the operations that are retained. This would distort the gain or loss on disposal. The proposed standard should be revised to require that the approach in paragraph 81 is applied only when the operations concerned have been integrated.

(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?

Answer

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 (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 be measured?

Answer

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 the 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?

Answer

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.

(c) That if any 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 the 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?

Answer

Yes. We agree with this proposal.

Paragraph 86 requires that intangible assets acquired in a business combination but not recognised at that time are excluded from the calculation of the implied value of goodwill. This is a practical requirement that means goodwill is not impaired only because different recognition criteria are applied to intangible assets.

The guidance will apply to intangible assets acquired in a business combination but not recognised either because recognition was not required under IAS 22 or because recognition was not required under the entity's previous GAAP and ED 1, "First time application of IFRS", does not require previous business combinations to be restated. The guidance will not apply to intangible assets generated internally subsequent to the acquisition and not recognised in accordance with IAS 38. The standard should explain these circumstances and provide some illustrative examples.

The guidance might also be difficult to apply in practice, for example, when a cash generating unit includes a number of operations acquired in different business combinations over a number of years or when the acquirer and the acquired entity have relationships with the same customer. The proposed standard should provide further guidance on the practical implications in complex situations, together with some illustrative examples.

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 circumstances in which reversals of impairment losses for goodwill should be recognised?

Answer

Yes. 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. However, 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. There might be circumstances in which this distinction could be made, but we have not in practice seen any examples of an entity seeking to reverse an impairment loss for goodwill so we agree with the proposed guidance.

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?

Answer

No. We believe the suggested disclosures, particularly those required by paragraph 134 (e) and (f) are excessive and onerous. The disclosures required by these paragraphs should be restricted to those assumptions and judgements that have a significant risk of causing a material adjustment to the financial statements and any assumption where management has departed from the guidance in the proposed standard. This would be consistent with the proposals in IAS 1.108 and IAS 1.110. When a particular assumption has a significant risk or departs from the guidance in the proposed standard, we agree that the disclosures suggested in the proposed standard should be given.

Much of the disclosure required by the proposed standard would allow users of the financial statements to calculate alternative measures of performance, including alternative measures of net income. The provision of more limited disclosures in connection with material judgements allows users to evaluate the key assumptions without generating a range of alternative performance measures.

Management will use the guidance in the proposed standard to prepare the financial statements, so the requirement for significant disclosures that confirm compliance with the standard, particularly in areas that are not material, undermines management's responsibilities. The provision of more limited disclosures in areas where management has departed from the guidance in the proposed standard allows users to identify these issues without undermining management's responsibility for the financial statements as a whole.

The collection of the information to support the proposed disclosures will be time consuming and expensive. The Board should consider whether the costs of providing this disclosure outweigh the benefits. There is also a risk that the disclosure of too much information will obscure the key issues arising from the consideration of impairment. The provision of more limited but focused disclosures mitigates both of these problems.

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

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Answer

We agree that the focused disclosures suggested above should be made for a cash generating unit within a segment if the suggested criteria for disclosure are met.

Other comments on the proposed revisions to IAS 36

Paragraph 37

The calculation of value in use is based on cash flows that do not reflect the impact of planned restructuring or capital expenditure that enhances the performance of the cash generating unit. The calculation of value in use shortly after an acquisition and before such expenditure has been incurred might give rise to an impairment charge. This is not a usually an issue under the current guidance in IAS 36, because an impairment test is required only when there is an indication of impairment. However, the proposed changes will require the impairment test to be performed annually.

The proposed standard should permit the calculation of value in use to reflect the impact of planned restructuring and capital expenditure in the period immediately following the acquisition.

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IAS 38 Intangible assets
Responses to detailed questions
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 paragraph 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?

Answer

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.

Inconsistency between IAS 38 and ED 3

The Illustrative Examples in ED 3 contain a number of items that would be recognised separately from goodwill because they are separable, for example non-contractual customer relationships and customer orders where the customer can cancel without penalty. IAS 38.15 states that an entity usually has insufficient control over the economic benefits from a customer relationship to meet the definition of an intangible asset. This suggests that the intangible asset inherent in a customer relationship would be recognised separately if it was acquired in a business combination, but not if it were acquired in a separate transaction.

We agree that the benefits inherent in customer relationships should be recognised as separate intangible assets in connection with a business combination, but we believe similar guidance should be applied to intangible assets acquired separately. The Board should revise the guidance on control in IAS 38 so there is a clear articulation of the reasons why non-contractual customer relationships and similar items satisfy the definition of an intangible asset, whether they are acquired in a business combination or separately.

Application in practice

A number of items that are not commonly bought and sold would be recognised separately from goodwill because they are separable, for example customer lists, customer relationships and unpatented technology. Where there is no market, fair value is established using other methods, such expected cash flows. There is no guidance on valuation methods in the proposed standard, which means different methods will be used for similar situations. The Board should consider including additional valuation guidance in the proposed standard. We comment further on valuation methods in our answer to Question 2 and in our cover letter.

A number of similar items are recognised individually because they are theoretically separable. For example customer orders, production backlogs, contractual customer relationships and non-contractual customer relationships are closely related but are recognised separately. We believe it is often difficult in practice to identify and value separately the cash flows that relate to each of these items.

The requirement to recognise separately the different elements of a customer relationship also creates a number of practical issues. For example:

- does a contractual relationship exist only if a contract is in force at the date of the business combination;
- are cancellable sales and purchase orders contracts appropriately treated as binding;
- does the fair value of a contractual relationship include an amount reflecting the probability that the contract will be renewed; and
- what benefits are included in non-contractual customer relationships, if the fair value of contractual relationships reflects the benefits from contracts not in force at the date of acquisition and the expected benefits from contract renewal?

The absence of guidance dealing with these and similar issues is likely to lead to significant differences in interpretation. The Board should consider these issues and the proposed standard should include guidance dealing with the specific features of valuing customer relationships listed above. The proposed standard should also clarify the accounting required when the cash flows relating to similar assets cannot be separated and valued individually.

Assembled workforce

The separate recognition of a non-contractual customer relationship is inconsistent with the prohibition on the recognition of an assembled workforce. The fair value of both items reflects the benefits arising from the relationship between the entity and different groups of people and there is no substantive difference in the way a customer relationship and an assembled workforce are controlled by the entity. This proposal will mean that a different accounting treatment is applied to two similar items. The fair value of an assembled workforce is often determined as part of the process used to determine the fair value of other intangible assets.

The Board should reconsider the decision to prohibit the recognition of a separate intangible asset in connection with an assembled work force.

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 – B 15 of the Basis for Conclusion). Therefore as proposed, in ED 3, 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 ED3).

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.

Answer

We agree that a business combination provides a reliable measure of the total fair value of the business acquired, and we agree in principle that the fair value of most intangible assets can be measured reliably. However, some intangible assets can be measured more reliably than others. Intangible assets that are regularly traded or exchangeable are easier to measure than assets without those characteristics. The intangible assets acquired will often include a number of different, but closely related assets for which the underlying cash flows are sometimes difficult to identify and measure separately.

There is no definitive guidance on the procedures that should be used to measure the fair value of the tangible and intangible assets acquired in a business combination. This means that different valuation techniques will be used to measure similar assets, potentially resulting in a different fair value. This impairs the comparability of financial statements and may result in valuations that are subjective and unreliable. The absence of clear valuation guidance particularly affects the measurement of those intangible assets that are more difficult to value, such as customer relationships.

The proposals in ED 3 and the revisions to IAS 36 and IAS 38 require a different accounting treatment for goodwill and various categories of intangible assets. These differences make it essential that a consistent and generally accepted approach to valuation is applied by every entity.

The Board should address the issue of valuation guidance as matter of urgency. The Board should work with other standard setters and the valuation profession to develop a standard that illustrates the methods that may be used to determine the fair value of tangible and intangible assets and the recoverable amount of a cash generating unit in the context of financial reporting under IFRS. A common valuation standard will lead to consistent valuations and increase the comparability between entities.

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 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?

Answer

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

We also agree that an intangible asset should be regarded as having an indefinite live when there is no foreseeable limit on the period it is expected to generate net cash inflows. However, we believe the proposed standard should include additional guidance on the circumstances in which an indefinite life is appropriate. Further guidance on the factors that should be considered, might include legal, contractual, regulatory, competitive and similar factors. The principles that underpin the guidance that is reflected in the Appendices to IAS 38 should be included in the proposed standard.

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

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

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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)?

Answer

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

The proposed standard should specify that the useful life should include the renewal period only if the rights are available for renewal, can be renewed at the option of the entity and without significant cost.

This proposal is inconsistent with the basis used to measure intangible assets at the date of a business combination. The Illustrative Examples to the proposed standard do not explain whether the fair value of a contractual customer relationship includes an amount that reflects the probability that the contract will be renewed. The possibility of renewal would have a fair value regardless of the costs required to renew. This means the useful life of a customer relationship could be inconsistent with the basis used to determine the fair value of the relationship.

The proposed standard should clarify the basis used to determine the fair value of a customer relationship and how this interacts with the determination of the useful life.

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 (see proposed paragraphs 103 and 104 and paragraphs B36-B38 of the Basis of 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. The proposed standard should state that it would be very difficult for an entity to demonstrate that an asset has an indefinite useful life when it was previously assessed to have a useful life of less than twenty years.

APPENDIX A

Reverse acquisitions – Additional guidance on the accounting for reverse acquisitions (paragraph B1-B14)

We agree that the guidance is for reverse acquisitions generally appropriate, but we have some detailed observations.

Paragraph B7(b) – The consolidated financial statements shall reflect the accumulated profits of the legal subsidiary. Other equity balances such as the share premium account should not represent a continuation of the legal subsidiary. Legal reserves should be the reserves of the legal parent.

Paragraph B7(c) - This paragraph should be clear that the equity structure referred to in the last sentence includes the legal reserves of the legal parent.

Paragraph B7 (c) – The explanation of the equity structure of the combined entity after the business combination is not clear. The example in Draft Illustrative Examples should be expanded to include a statement of shareholders' equity and including a reference in paragraph B7 to the example.

Draft Illustrative Example – Paragraph B7 states that the consolidated financial statements represent a continuation of the financial statements of the legal subsidiary. The consolidated balance sheet on page 13 of the Draft Illustrative Example however allocates a share of the accumulated profits to the minority shareholders in the accounting acquirer. The equity of the accounting acquirer is restated. The example should be expanded to deal with the treatment of minority interests in a reverse acquisition in more detail.