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**CL 86**

7 April 2003

Dear Ms Kimmitt

**ED3 Business Combinations**

The Association of Chartered Certified Accountants (ACCA) is pleased to have this opportunity to comment on the above exposure draft. It was considered by ACCA's Financial Reporting Committee recently and I am writing to give you their views.

**Question 1 - Scope**

We agree that the proposed scope exclusions for entities under common control and for joint ventures are appropriate, because the ED is promoting an acquisition accounting only model which would not be appropriate for such cases. These topics are, however, potentially significant and should be addressed. We understand the accounting for business combinations of entities under common control will be dealt with in Phase II of the project. It is therefore difficult for us to consider this ED as adequate when important aspects of business combinations remain to be dealt with. We hope that the two phases of this project will eventually be merged together to form a single standard.

The definition of joint control in IAS28 and IAS31 should be left as it is for now. The proposal in ED3 could represent a significant change and seems to imply a rather narrower definition of joint control than at present. The risk is that certain entities or arrangements that are in substance joint ventures could avoid inclusion within the ambit of those standards.

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**Question 2 – Method of accounting for business combinations**

We agree that the pooling method of accounting should be discontinued, even for the limited circumstances where it could be currently applied.

The case for applying acquisition accounting where no acquirer can be identified is less persuasive. In most business combinations it will be evident which is the acquiring company. In some, however, it will not be clear-cut. Paragraph 20 of the ED lists some examples of indicators. It seems quite possible that these indicators could point (in rare cases) at neither of the combining parties. More commonly perhaps, they could point in more than one direction. For example, Company A's fair value is greater than B's and the shareholders of A will predominate, while at the same time the management of B might be the dominant force in the new business. The ED gives no guidance on how to judge the various factors and indicators in paragraph 20, nor what other sorts of factors might be relevant. The impression given is that in some cases the choice of which to nominate as the acquirer might be arbitrary. This does not seem a satisfactory outcome for an accounting standard, especially when the choice could have a material effect on the post-combination accounts.

For cases where no acquirer could be identified satisfactorily we consider that fresh start accounting would be the best solution. The standard should set out a series of key indicators to identify the acquiring party. If these are reasonably conclusive, then the purchase accounting method should be followed. If the indicators are inconclusive (that is they do not identify either party or might identify either one), then the fresh start method should be used. We note that fresh start accounting may be included in Phase II of the business combinations project. As with the matters raised in Question 1 above, we find it unsatisfactory to comment definitively on what is only a partial standard.

If fresh start accounting is not going to be available, then we would prefer to see that there was an objective test for determining the acquirer in these cases of difficulty - for example whichever entity had the higher market capitalisation before the combination.

### Question 3 – Reverse acquisitions

We support the idea of accounting for reverse acquisitions, based on the substance of the transaction. We believe, however, that the proposed description of the circumstances in which a business combination should be accounted for as a reverse acquisition, should be amended. Paragraph 21 would identify as the acquirer whichever of the combining entities obtains control over the other. In a typical reverse acquisition, however, the legal subsidiary will not obtain control over the legal parent. The shareholders of the legal subsidiary may obtain control, but not the subsidiary itself.

The Board should consider whether IAS27 adequately deals with reverse acquisitions. In these cases the parent company for the purposes of IAS27 would be the acquired entity as far as ED3 is concerned and vice versa. We are not clear that all the consolidation procedures in paragraph 15 of IAS27 will work properly.

We regard the proposed additional guidance together with the illustrative examples as likely to be helpful.

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

We agree with the general principle that the acquirer should be identified on the basis of the evidence of the substance of the transaction. As noted in answer to Question 2, we support fresh start accounting in cases where it is difficult to identify the acquirer. Failing that, there should be an objective test to avoid the choice of acquirer being entirely arbitrary in these cases.

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

We agree with the IASB proposal. The conditions for recognising provisions on a business combination should be consistent with those in IAS 37. There must be an obligation in the acquired company at the date of acquisition.

**Question 6 – Contingent liabilities**

We consider that the recognition of contingent assets and liabilities on a business combination should remain consistent with their recognition under IAS 37, and so we do not support the proposal.

There does, however, seem a case for IASB reconsidering IAS37 in these areas. It does not seem right that the probabilities of future transfers of economic benefits should affect the initial recognition tests of liabilities; they should affect their measurement only. A number of anomalies arise under the current system as a consequence. For example, if there was a single claim for a $1 million with a 40% probability then no liability at all would be recognised. If, however, there was a series of claims adding up to the same sum and with the same overall probability, a provision of $400,000 would be recognised. If in the case of the single claim the probability was 60%, then $600,000 would be included as a liability because an outflow would now be more likely than not.

Equally we find illogical that the recognition criteria for a contingent assets includes virtual certainty of inflow of benefits, even though IAS39 when dealing with financial assets sets no such threshold and probabilities affect their measurement only.

**Question 7 – Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed**

We agree with the proposal to value any minority interest at their proportion of the net fair values ascribed on acquisition, and to eliminate the alternative currently allowed in IAS22 (i.e. to use pre-acquisition carrying values).

**Question 8 – Goodwill**

We agree that goodwill acquired in a business combination should be treated as an asset. We are not convinced that the ED is right to prohibit amortisation and allow impairments to be the only way in which the value of goodwill is diminished.

We note that there are a number of arguments in favour of amortisation on the one hand and a number in favour of an impairment-only regime on the other. These are set out in paragraphs BC106 and 107 in the Basis for Conclusions and in the dissenting opinions of two IASB members.

The critical argument put forward in the ED concerns the relevance and usefulness of the information provided. The usefulness of goodwill write down information may be limited whichever option is chosen. This is because of

- the inherent difficulties in identifying acquired entities some years later, after they have been restructured and reorganised
- the impairment tests being subjective and so capable of producing a wide range of answers
- amortisation periods being arbitrary and the annual charge consequently being selected from a wide range of possible values.

While we agree that the information provided by an impairment regime might be more relevant than that from an amortisation charge, the majority of cases of significant impairments will be recognised because the alternative regime is not just one of amortisation, but also of impairment (when there are indications that impairment may have taken place). We conclude, therefore, that on the relevance of information there is little to choose between the two methods, with the impairment only approach having a slight advantage.

Turning to other criteria than relevance, we find a similar position, but with the advantage reversed in favour of amortisation.

a) Comparability between entities is not likely to be accomplished very satisfactorily by either method (i) because of the measurement difficulties noted above and (ii) because impairment only creates new anomalies on the recognition of internally generated intangibles between entities growing organically and those growing by acquisition.

b) If the informational benefits of an impairment only regime are marginal at best, the costs of compliance are certainly higher where there has to be an annual impairment test for all goodwill.

c) Conceptually, amortised cost is a measurement basis more consistent with other long life non-monetary assets than impaired cost. Impairment tests are almost inevitably not going to discriminate between the loss in value of the purchased goodwill and the replacement by internally generated goodwill.

Our preference is therefore that a choice should remain for now between the two approaches. We normally favour the elimination of alternative treatments in accounting standards on the grounds of greater comparability. In this case, however, we are not sure that comparability is going to be improved by adopting one or the other methods. Where one of the options is not demonstrably better than the other, then the standard would have to make an arbitrary choice between them. This does not seem a very satisfactory position. An option would still leave those companies wanting to converge more closely with US GAAP the ability to do so. An optional regime has worked reasonably well in the UK over the last few years.

**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**

We do not agree with this proposal to recognise negative goodwill immediately as a profit.

We agree, however, that the valuation of the assets and liabilities acquired should be reconsidered very carefully if it appears that their fair value exceeds the consideration paid for them. There should be a presumption that this situation should not generally arise, and therefore that their fair value should be reduced to reflect, for example, the need to incur future costs. Even when reassessed, negative goodwill may still occasionally remain. We accept, for example, that if contingent liabilities are not recognised (see Question 6 above) and if restructuring provisions will be able to be recognised less frequently (see Question 5 above), the probability of negative goodwill emerging is increased. We favour continuing the existing treatment for negative goodwill under IAS22.

Negative goodwill would not meet the definition of a liability itself, although it may (as noted above) represent unrecognised obligations or future costs inherent in the valuation of the assets of the business. Where positive goodwill exists, then any negative goodwill should be netted against that amount. If that is not the case, then any balance should be a separate category included with liabilities.

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

We agree with the proposals in the ED in this respect.

**Other comments**

a) Determining fair values of assets and liabilities (Paragraphs B15 and 16 on pages 72 to 74)

Guidance on reaching fair values for assets and liabilities acquired would be better stated by setting out a basic principle of recognition and measurement according to the relevant IAS/IFRS, and then providing additional guidance on any exceptions. The guidance in ED3 is much less comprehensive compared to the guidance in IAS39 on reaching the fair value of financial instruments. Derivatives, for instance, are not specifically referred to, nor are executory contracts specifically excluded (as they are in the scope of IAS37).

b) Transitional arrangements (paragraphs 77 to 83)

We agree that a full restatement should not be required in this case. We note that the treatment of a business combination as a uniting of interests up to the date of application of the IFRS, will be allowed and not required to be restated as an acquisition. Negative goodwill, however, will have to be credited to income by way of a prior year adjustment. This seems inconsistent and in our view, if the rules are changed on negative goodwill, then any inherited balances should be written off according to the existing rules.

If there are any matters arising from the above on which further clarification would be helpful, please be in touch with me.

Yours sincerely

Richard Martin
Secretary to the Financial Reporting Committee

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7 April 2003

Dear Ms Kimmitt

**Amendments to IAS36 Impairment of assets**

The Association of Chartered Certified Accountants (ACCA) is pleased to have this opportunity to comment on the above exposure draft. It was considered by ACCA's Financial Reporting Committee recently and I am writing to give you their views.

**Question 1 – Frequency of impairment tests**

We agree that both indefinite-life intangibles and acquired goodwill should be tested for impairment annually, unless they are being amortised. We also consider that where the expected life of intangibles exceeds 20 years an annual impairment test should be required.

We do not see any reason to require impairment tests on intangible assets to be done at the end of the year, while those on goodwill may be done at any consistent point during the year. In both cases we consider they could be done at any consistent point in the year. In practice the impairment test on all such unamortised assets relating to a business entity or segment may be best done at the same time, as the same future cash flows may be supporting all of the assets in question.

## Question 2 – Intangible assets with indefinite useful lives

Intangible assets acquired in a business combination are difficult to separate from goodwill in principle and in practice. To do so involves subjective choices and estimates. As far as possible therefore they should be accounted for in the same way, including an annual impairment test where no amortisation is being charged.

## Question 3 – Measuring value in use

We agree with the proposals in this regard.

The new guidance in paragraph 25A of the standard seems helpful. Appendix B, however, which is intended to expand on this area appears not to deal with the question of how any risk premium might be estimated or other factors identified.

We also consider that the ability of management to forecast cash flows will generally be a factor to be included, but not always so. Where there has been a major change of management for instance, then past ability may not be relevant to the future.

## Question 4 – Allocating goodwill to cash-generating units

We agree with the ED's proposals.

## Question 5 – Determining whether goodwill is impaired

We do not agree with the implied value measurement basis for goodwill impairment in paragraph 85. We regard this as increasing the complexity of the proposals, while still allowing in many cases the purchased goodwill to be replaced with subsequent internally generated goodwill. We would prefer the screening mechanism from paragraph 85 to be used as the measurement basis. This would also have the advantage of treating indefinite-life intangibles in the same way as goodwill (see Question 2 above).

## Question 6 – Reversals of impairment losses for goodwill

We agree that the reversal of goodwill impairment should not be allowed because purchased goodwill cannot be distinguished from subsequent internally generated goodwill. The same restriction should apply to purchased indefinite-life intangible assets.

**Question 7 – Estimates used to measure recoverable amounts of cash-generating units containing goodwill or intangible assets with indefinite useful lives**

We do not agree with the extent of the disclosures proposed. It appears that the intention is to allow users to replicate the impairment calculation. We do not think that this should be the principle applied in general to disclosures or in this case. To do so would expand significantly the level of information provided and make financial statements considerably longer, but arguably less understandable and usable. The reader of accounts is in danger of being swamped by detailed disclosures so that important information may be overlooked. We would limit the disclosures to paragraph 134 (a) to (d) and 137 (a) and (b). We note the contrasting level of disclosure requirements in paragraph 131 compared to paragraph 134.

We agree with the principle as proposed in paragraph 137, but once again have concerns about the very extensive disclosure requirements in paragraph 134 (e)
and (f).

If there are any matters arising from the above on which further clarification would be helpful, please be in touch with me.

Yours sincerely

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Dear Ms Kimmitt

**Amendments to IAS38 Intangible assets**

The Association of Chartered Certified Accountants (ACCA) is pleased to have this opportunity to comment on the above exposure draft. It was considered by ACCA's Financial Reporting Committee recently and I am writing to give you their views.

**Question 1 – Identifiability**

We agree with the guidance proposed for determining whether an asset meets the identifiability criterion in the definition of an intangible asset.

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

We support the principle that separate intangible assets should be recognised where possible, rather than subsumed into goodwill. This helps to reduce the effect of problems noted in our comments on ED3 of either an arbitrary life for goodwill amortisation or of the subjective nature of some of the impairment testing.

We agree that an assembled workforce should not be recognised as an asset, but that acquired research and development could be.

The guidance in the appendix of illustrative examples to ED3 contains a number of possible intangible assets, some of which would not commonly be recognised at present. In our view this should not be thought of as a definitive list. For some of these possible intangible items there will be no reliable values. Some of these items might be better recognised and measured in combination with others; for example some of the customer related items - customer lists, non-contractual relationships and databases - where the future cash flows on which their values depend may be the same or very closely inter-related.

**Question 3 – Indefinite useful life**

We agree that the presumed maximum 20 year life should be removed.

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

We agree with the proposals.

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

The accounting for indefinite-life intangibles and for goodwill should be essentially the same. We would therefore extend the option for amortisation or for impairment only (see our answer to Question 8 on ED3) to indefinite-life intangible assets.

If there are any matters arising from the above on which further clarification would be helpful, please be in touch with me.

Yours sincerely

Richard Martin
Secretary to the Financial Reporting Committee