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ED 3 Business Combinations and Revisions to IAS 36 Impairment of Assets and IAS 38 Intangible Assets

Dear Ms. Kimmitt,

We very much welcome the opportunity to comment on these important proposals and in the following pages indicate for the issues involved our views on "high-quality solutions". These are basically supportive of the proposals, though we do have a different position on the following points:

- Taking purely the purchase consideration as the starting-point for purchase accounting excludes from the total picture of the combination important elements of directly related costs essential to understanding the transaction as a whole. In particular the expected costs of restructuring directly resulting from the combination should still be considered.

- The proposals would bring about, for business combinations only, a significant conceptual change in respect of contingent liabilities and intangible assets. It is undesirable to set up different criteria for the same elements in this manner, particularly as the transformation of probability from a criterion for recognition to a criterion for measurement is so fundamental that it would be quite wrong to introduce it through the back door without due process.

- While on balance we see the merits of an impairment-only approach to subsequent measurement of goodwill and indefinite-life intangibles, we believe that there is also a case for leaving the amortisation approach for goodwill in solutions where a definite life can be estimated analogous to other intangible assets.

- The two-step impairment testing is potentially a very costly process, to be borne either by shareholders or by customers. We appreciate that the proposals do make some efforts to reduce the cost and effort involved through screening, but the simplification must go further if substantial costs are to be avoided, and we make some additional suggestions in this respect.

- Convergence is a major concern, especially for companies having to prepare financial statements under both IFRS and US GAAP. Our comments below focus on the "high-quality solutions", While we believe that the proposals are in several respects better than the current US GAAP rules, the Board will not have done its job (including "work generally for the improvement and harmonisation of ... accounting standards ..." if, having considered the arguments and determined the high-quality solutions, it does not engage in dialogue with the FASB and ensure that both bodies adopt the same solutions. There will be little sympathy for an IFRS which insists on approaches which, through divergence from US GAAP, impose substantial additional costs on preparers. For example, having to perform impairment tests on diverging structures (segment or next lowest level vs. level for monitoring return on investment) would involve the unacceptable duplication of non-value-adding work for US-quoted IFRS preparers. Customers and shareholders have the expectation that the two bodies will require the same "high-quality solutions".

- Disclosure requirements, particularly in revised IAS 36, are in our view excessive and exaggerated, particularly in comparison to FAS 142.

We expand on these points and provide other general comments in the attachments.

Yours sincerely

Novartis International AG

M.B. Cheetham	M. Kaeser
Head of Novartis Group	Head of Novartis Group
Financial Reporting & Accounting	Accounting Principles

EXPOSURE DRAFT 3

BUSINESS COMBINATIONS

Question 1 – Scope

The Exposure Draft proposes:

(a) to exclude from the scope of the IFRS business combinations in which separate entities or operations of entities are brought together to form a joint venture, and business combinations involving entities under common control (see proposed paragraphs 2 and 3 and paragraphs BC9-BC11 of the Basis for Conclusions).

Are these scope exclusions appropriate? If not, why not?

(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?

Response

We agree with the Board's proposals.

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?

Response

For practical purposes we agree with the IASB proposal. We believe that purchase accounting is the appropriate method for business combinations which are real acquisitions. However, for "true" unitings of interest, we shall, pending Phase II of the project, have to live with a vacuum in the interim period in which an acquirer has to be arbitrarily determined. This is unsatisfactory. In view of the rarity of such situations, a solution might be to give some interim guidance on (restrictive) definition of such situations (e.g. through IFRIC) and leave the pooling approach temporarily in place for such rare circumstances. An alternative and preferable solution would be to assign each Phase the same mandatory application date.

Also, we would like to make the point for consideration in Phase II that group restructurings (e.g. transfer of net assets from one subsidiary to another, with the former's subsequent liquidation) should not result in any requirement to restate assets and liabilities to fair value.

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?

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?

Response

a) We agree with the proposed description of the circumstances in which a business combination should be accounted for as a reverse acquisition.

b) The proposed additional guidance together with the illustrative examples is appropriate, but it would be helpful if the IFRS made it clear that the comparative figures presented should be those of the legal subsidiary and not those of the legal parent.

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?

Response

We agree with the proposal. It may, however, be worth mentioning explicitly in the IFRS that the new parent must be the company used for the share capital disclosures.

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?

Response

We fully understand the Board's desire to prevent the abuse of restructuring provisions in accounting for acquisitions but fear that the approach proposed would lead to the omission of useful, relevant information and potentially to misleading financial reporting. The proposals seek to determine values for what has been acquired. However, in doing so, they ignore what is often a very important part of the cost of making the acquisition which the acquirer has decided to incur in order to bring the investment to working condition for its intended use.

Management is accountable for large and strategic investments such as the purchase of existing businesses. Accounting for the business combination should therefore reflect the goodwill arising from the transaction as planned by management. In that respect, we agree with paragraph BC 98 where goodwill is defined and is said to be intended, if every asset and liability is measured appropriately, to reflect the synergies arising from the business combination, i.e. from both entities brought together, not from the acquiree or the acquirer. Furthermore, a business combination is a unique operation, and in our opinion, there is no better measurement of the fair value of the acquisition than the total consideration (cash and other assets, plus costs to be incurred to combine the entities) planned by management to create the synergies that goodwill is intended to reflect. The financial statements we are trying to get right are those of the acquirer (consolidated), not just of the acquiree.

Terminating or reducing the activities of the acquiree generally results from the business combination itself and represents the effect of providing for the synergies as planned by management. To exclude these costs from the total cost of the acquisition leads to inadequate measurements:

a) the costs of restructuring would be shown as part of the operating performance of the combined entity which they are not,
b) goodwill would be underestimated. In some cases, goodwill could even be made negative. An income would be reported, while expense would be deferred until restructuring costs become a liability strictly in accordance with IAS 37.

In our view, this would lead to distortions of both the income statement and the balance sheet. Incongruously the proposals would ignore the expected (highly probable) outflows decided by management for restructuring but would reflect what are by definition improbable outflows by requiring inclusion of contingent liabilities!

The provision created at date of acquisition, based on the event of the acquisition, would be adjusted during the allocation period, with corresponding adjustments to goodwill.

In order to avoid abuse, we recommend that the Board set up criteria against which the restructuring plan should be assessed, in order to make sure that the plan actually results from the combination of the two entities. Similarly, the conditions set out in the present IAS 22, paragraph 31, could be adapted - possibly along the lines of the relevant EITF and SEC guidance - to further prevent abuse: this might encompass, for instance, a limitation of restructuring provisions to costs expected within 12 months of date of acquisition (with the possibility of prolongation in certain specific circumstances such as legal and political delays imposed on restructuring as in some southern European countries).

With the accompanying explanatory disclosures, this approach would provide users with important information which would be more useful than that proposed in the draft where relevance suffers considerably to the advantage of excessive abuse prevention constraints Also, it is worth adding that making excessive restructuring provisions would now in any case not necessarily be to the "optical" advantage of an entity as the resulting higher goodwill would now be subject to impairment testing, and at the other extreme the understatement of goodwill as a result of not recognising these provisions contrary to our recommendation would further inflate any goodwill "cushion" from internally generated goodwill.

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?

Response

No, we do not believe that the proposal is appropriate. We believe that contingent liabilities should be recognised separately only if they satisfy the requirements of IAS 37. Our main concerns with the proposal are:

- non compliance with the requirements of IAS 37
- unreliable measurement
- potential recognition of contingent liabilities with low probability of becoming an actual liability

We think it inappropriate to recognise contingent liabilities in an acquisition, if it is not possible to recognise them under the current requirements of IAS 37. The nature of a contingent liability does not change as a result of an acquisition, and we believe the IAS 37 criteria should still be applied. Although the purchase price of the acquired entity may include an allowance for contingent liabilities (and for contingent assets), we are not convinced that their fair values can always be measured reliably. Certainly, if the proposals are accepted, somewhat clearer guidance on the meaning of "reliable measurement" would be a must.

Many contingent liabilities arise from legal claims (e.g. pharmaceuticals, tobacco or fast food industries) and can result in very large figures according to Appendix B15 (l), which requires the amount of the contingent liability to "reflect all expectations about possible cash flows and not the single most likely or the expected maximum or minimum cash flow". The resulting number does not reflect the potential future cash outflow because it is based on an average expectation covering a wide spectrum of possible outcomes. It is very difficult in reality, sometimes impossible, to quantify the possible outcome of contingent matters such as legal proceedings. (In addition we must stress that disclosure of such values relating to litigation in process may be seriously prejudicial to the entity, especially where the link between amount and individual case is readily apparent).

Once contingent liabilities are recognised separately, the acquirer must measure them at their fair values with changes in fair value recognised in profit or loss (paragraph 46). Such contingent liabilities are explicitly excluded from the scope of IAS 37. We disagree with the proposal, because it results in inconsistent treatment between contingent liabilities acquired in a business combination and other contingent liabilities of the same or a different entity.

In addition, the Board has agreed that the role of probability in the Framework should be considered more generally as part of a later Concepts project. While we welcome this initiative, we believe that meanwhile the recognition criteria for assets and liabilities should not be altered in the case of a business combination. Any shift of the probability criterion from recognition to measurement should not be prejudged: it has not yet been subject to due process. One possibility might be to include contingent liabilities as part of allocating the cost of acquisition if they meet IAS 37 criteria in the allocation period.

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?

Response

In principle we agree with the proposal of the Board requiring the acquiree's identifiable assets and liabilities to be recognised as part of the cost allocation to be measured initially by the acquirer at their fair values at the acquisition date. However, while we acknowledge that the purchase price in general is affected by contingent liabilities and in-process research and development, we believe that assets and liabilities that do not meet the recognition criteria of IAS 37 and IAS 38 should not be recognised as assets and liabilities in a business combination. We refer to our answer to Question 6 that for reasons of comparability and understandability the recognition criteria of the Framework should be applied consistently when accounting for business combinations.

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?

Response

We agree that goodwill acquired in a business combination should be recognised as an asset.

On the question of amortisation vs. regular impairment testing, adoption of an impairment-only approach would have the considerable advantage of removing what is very often the quantitatively largest divergence between IFRS and US GAAP net income and equity. It seems unlikely that the FASB would re-align with IAS 22, and the elimination of this significant difference would remove one excuse for the SEC not proceeding faster with acceptance of IFRS financial statements for foreign registrants. For gaining this pragmatic advantage we could therefore accept adoption of the proposed impairment-only approach **on condition that** the potentially very complex and costly impairment process envisaged is simplified in a few key respects, as described in our comments on the proposed revisions to IAS 36. A reasonable balance with what is practicable, as mentioned in BC 107, and avoidance of undue cost and effort would otherwise not be achieved.

However, we believe that consideration should be given to retaining amortisation for goodwill in situations where a definite life can be estimated, analogous to other intangible assets. In reaching the above conclusions we have also considered the following arguments for amortization which are not adequately reflected in BC 106:

a) As a residual value goodwill is a conceptually difficult, nebulous item. It is difficult to see the benefit of moving from IAS22 to impairment testing of an asset which, in any event, becomes increasingly meaningless as we move forward from the acquisition date.
b) Particularly where acquired businesses are rapidly integrated into the acquirer's existing operations, distinguishing between the value of acquired goodwill and internally generated goodwill becomes practically impossible, but the impact is mingled in the impairment testing approach.
c) Non-monetary assets are still predominantly accounted for on a historical cost basis, which we strongly support. Systematic amortisation (with impairment testing when triggered) as a way of attributing the cost of the asset to the periods in which the entity derives benefit from it is a totally acceptable accounting approach, with many advantages of simplicity and transparency. It is not clear what problems it is currently causing that require such a fundamental and costly change, the benefits of which are also far from clear.
d) While amortisation is to some extent arbitrary, so is the complex alternative that is proposed.
e) Not charging amortisation gives a false picture of the return on investment and creates inconsistency between the treatment of goodwill and other long-lived assets

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?

Response

We believe that one exception should be made to the principle of recording negative goodwill immediately as income, namely where it is identified as reflecting the estimated value of contingent liabilities not reflected in the provisional purchase accounting (see our response to Question 6). This should be released to income during the allocation period as the contingent liabilities met the IAS 37 criteria for recognition. Any balance remaining at the end of the period would be credited to income.

In addition, we would make a plea for less cumbersome and pedantic terminology. We see no value at all in departing from the term "negative goodwill", for the reasons outlined above. If this still proves unacceptable for theoretical reasons, "discount on acquisition" would appear a more than adequate term (21 letters compared to 143!)

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?

(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?

Response

Adjustments to estimates of the total cost of the combination can normally be made within 12 months of the acquisition date. However, in some circumstances (e.g. fair values impacted by regulatory and fiscal requirements which can sometimes take more than 12 months to resolve) extra time is highly desirable for arriving at correct values and we would suggest that some possibility should be left open to permit taking such items into account, on a very restrictive basis, if resolved by the end of next full accounting period.

Thereafter adjustments should only be made to correct an error (as proposed).

Other comments

Materiality

ED 3 contains no opening materiality clause as contained in IAS 22. In the current sensitive, bureaucratic, litigious environment this is a serious omission which could lead to substantial practical problems for preparers. Our overall acceptance of ED 3 is contingent on the inclusion of such a clause or an appropriate, reasonable generic statement of the materiality principle in another standard (cf. February "Update") if it is in force before or at the same time as the IFRS following from ED 3.

Disclosure requirements

Paragraphs 65 to 76 of ED 3 require certain disclosures for past business combinations and business combinations effected during the reporting period or after the balance sheet date but before the issue date of the financial statements.
Although paragraphs 65, 71 and 73 are not explicit as to whether comparative figures are required or not, we believe that paragraph 65 (covering current and future business combinations) as well as paragraph 71 (asking for cumulative information) do not require comparative figures for the information requested. However, paragraph 73 and the following paragraphs are not clear in that respect.
The Board should clarify whether paragraphs 73 to 76 require comparative information or not.

Also, paragraphs 69(a) and (b) requires a full “proforma” reflecting the impact of all acquisitions. This seems an excessive requirement, necessitating the restatement of the relevant pre-acquisition period for the effects of the business combination(s).

Paragraph 70 seems unrealistic in requiring disclosure of all the information in paragraph 66, especially when companies are trying to produce their accounts in a shorter time frame. Items (f) - (i) should be re-considered from the practicability perspective, including circumstances where acquirer and acquiree have different accounting year-ends.

Lastly, the requirement in paragraph 67 for disclosure in aggregate should differentiate between reasonably aggregable information and other items such as names and descriptions of combining entities, acquisition dates, details of operations disposed of, percentages of voting shares acquires where aggregation would make no sense.

PROPOSED AMENDMENTS TO IAS 36

IMPAIRMENT OF ASSETS

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?

Response

We do not agree with the Board's proposal that:

a) indefinite useful life intangibles shall be tested for impairment annually at the end of each annual reporting period; and whenever there is an indication of possible impairment;

b) acquired goodwill shall be tested for impairment annually at any time during an annual reporting period, provided the test is performed at the same time every year; and whenever there is an indication of possible impairment.

We believe that carrying out annual impairment tests at different dates for indefinite useful life intangibles (at the end of each annual reporting period) and for acquired goodwill (at any time during an annual reporting period) is impractical. Testing other intangible assets for impairment is conceptually related to testing goodwill for impairment. Therefore, all annual impairment tests should be performed at the same date at any time during an annual reporting period provided the test is performed at the same time every year (during the last quarter?).

Question 2 – Intangible assets with indefinite useful lives

The Exposure Draft proposes that the recoverable amount of an intangible asset with an indefinite useful life should be measured, and impairment losses (and reversals of impairment losses) for such assets accounted for, in accordance with the requirements in IAS 36 for assets other than goodwill (see paragraphs C10-C11 of the Basis for Conclusions).

Is this appropriate? If not, how should the recoverable amount be measured, and impairment losses (and reversals of impairment losses) be accounted for?

Response

We generally support the Board's proposal, since there is no conceptual reason to make a distinction between intangible assets with indefinite useful life – like trademarks – and acquired goodwill. For the same reason we disagree with the different treatment of intangible assets with indefinite useful life and goodwill in respect of reversals of impairment losses. In other contexts we have highlighted the absence of any clear criteria in the Framework or elsewhere for determining the appropriateness of impairment reversal, which appears arbitrary in the various standards.

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?

(b) should the assumptions on which cash flow projections are based take into account both past actual cash flows and management's past ability to forecast cash flows accurately (see proposed paragraph 27(a)(ii) and paragraphs C66 and C67 of the Basis for Conclusions)? If not, why not?

(c) is the additional guidance in proposed Appendix B to [draft] IAS 36 on using present value techniques in measuring an asset's value in use appropriate? If not, why not? Is it sufficient? If not, what should be added?

Response

a) Paragraph 25A seems appropriate, as does the choice permitted on whether to reflect in the cash flows or in the discount rate. However, we would request the Board to consider permitting companies to perform calculations on either a pre- or a post-tax basis. For practical purposes the latter often fits in much better with the internal data available and with standard evaluation procedures, e.g. for capital allocation purposes, and if correctly applied will produce the same results.

b) It is unclear how to take past actual cash flows and management's past ability (or inability) to forecast cash flows accurately into account, as described in (b). This is a very theoretical requirement, and the Board would have to clarify how it would be done in practice,. Further, more specific guidance on determining the appropriate discount rate (WACC? borrowing rate? risk-free rate adjusted for asset-specific risks?) would be helpful, with additional clarification in Appendix B: the IASB should not assume that all preparers have advanced degrees in Corporate Finance, so clear guidance is necessary to ensure consistent application of the standard.

Considering management's past ability to forecast cash flows accurately in determining what assumptions should be retained as a basis for cash flow projections seems at first sight appealing. However it is not, in our view, appropriate or consistent with ED3's requirements. A main feature of impairment testing is to base cash flow projections on most recent forecasts established by management, and these will reflect latest knowledge.

Moreover, management may in the past have gone through periods when comparisons of forecast and actual figures show no specific pattern. Generally there are quite sound reasons identified to justify the discrepancies (e.g. 9/11 in aeronautics, a new competitor or an old one that has gone out of the market), all justifications that management is able to identify when comparing actual and forecast performances. When should such a justification be retained as being sound, when should it be rejected and last forecasts be adjusted?

The standard also requires that an impairment test should be carried out immediately whenever there is an indication that an asset or cash generating unit might be impaired. One strong internal indicator for such an impairment test to be carried out is that forecast performance is not met.

c) Please refer to paragraph (a) above.

Question 4 – Allocating goodwill to cash-generating units

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

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

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

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

Response

a) The allocation of goodwill should be consistent over time. The lower goodwill is allocated, the less consistent will that allocation be since it becomes more sensitive to any change in the reporting structure. Moreover, the most useful information is provided to users when aggregating cash generating units that constitute businesses with similar characteristics, notwithstanding the fact that they may be monitored independently in internal reporting review. Also, entities with different levels of "granularity" in their internal reporting could end up with significantly different impairments in otherwise identical situations. However, the key factor on this question is for us convergence. For entities reporting under both IFRS and US-GAAP, carrying out the proposed impairment testing on two different structural bases would be a nightmare. Therefore we recommend an approach similar to present US GAAP but leaving management with the discretion to go deeper than the reporting unit below segment if it is believed to give better insight into the underlying economics.

The IFRS also needs to explain the approach expected in matrix organisations and the interrelation of impairment testing with primary and secondary segments. Similarly, if the CGU basis for goodwill allocation as described in paragraphs 73 and 74 is followed, contrary to our recommendation above, the IASB should clarify that the level of management referred to in paragraph 74 is the entity's top (Group) management.

b) In principle we agree with the principle in (b). However, we have experienced circumstances which suggest a more refined approach. In one instance, a CGU acquired a business including goodwill and a factory; the entity's own existing factory in that CGU, being older and less efficient, was disposed of; following the proposed principle would have led to an elimination of acquired goodwill which was essentially still intact. We therefore suggest that an exception should be permitted where goodwill in a CGU can be clearly and unambiguously identified with a retained part of the CGU.

c) Please refer to (a) 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 of the unit be measured?

(b) the use of a screening mechanism for identifying potential goodwill impairments, whereby goodwill allocated to a cash-generating unit would be identified as potentially impaired only when the carrying amount of the unit exceeds its recoverable amount (see proposed paragraph 85 and paragraphs C42-C51 of the Basis for Conclusions).
Is this an appropriate method for identifying potential goodwill impairments? If not, what other method should be used?

(c) that if an entity identifies goodwill allocated to a cash-generating unit as potentially impaired, the amount of any impairment loss for that goodwill should be measured as the excess of the goodwill's carrying amount over its implied value measured in accordance with proposed paragraph 86 (see proposed paragraphs 85 and 86 and paragraphs C28-C40 of the Basis for Conclusions).

Is this an appropriate method for measuring impairment losses for goodwill? If not, what method should be used, and why?

Response

a) We agree.

b) On balance, yes, though the remarks set out below leave significant doubts about whether the regular internal and external costs are really justifiable.

c) As indicated in our comments on ED3, we believe that, for the impairment-only approach to be acceptable, the impairment testing method must be made less costly and complex. We appreciate that the Board's proposed screening method and the use of prior-year valuations of CGU recoverable values in many situations go some way to doing this, but this is not far enough, especially (but certainly not solely) with regard to step 2.

- The Board must realise that making quasi-acquisition valuations can be a very expensive exercise. Especially where regulators, auditors and others push for certainty in valuation, often to protect themselves, there will often be pressure to obtain external appraisals (i.e. real cash out of the door). The situation might easily occur where an entity getting into financial difficulties has to incur heavy costs for external valuations - and thus further worsen its financial situation - as a consequence of shortfalls arising in several CGUs at the same time (e.g. in a substantial economic downturn). Would it be in the shareholders' best interests to know what the implied value of the goodwill is or to find a less costly way of getting a meaningful financial picture of the business? Even when done internally, the testing would involve substantial costs for the entity (i.e. for shareholders and/or customers).

- The value of "implied goodwill" is a piece of information which itself has absolutely no "value in use" whatsoever, other than to perform the impairment test as proposed. "Goodwill" is a residual value at one point in time which thereafter becomes increasingly nebulous and meaningless.

- The fusion of acquired and internally generated goodwill, especially where the acquired business has been fully integrated, would make the figure even more meaningless as well as conceptually inappropriate. While it would be theoretically possible to attempt some splitting of the two elements, it would be completely academic. The Board should concentrate on ensuring that the overall recoverable value of the CGU exceeds its carrying amount and abstain from pointless searches for a "correct" value for an old item of goodwill.

- The testing would be prone to odd results (as has been experienced with FAS 142): for instance, where the individual value of another acquired asset has risen but the overall recoverable value of the CGU has not changed, an impairment of the goodwill could well arise but without the corresponding revaluation of the other asset being permitted, also causing a write-down of the CGU below its value in use.

Consequently, we propose that the second step of the impairment test should be simplified by recording shortfalls of CGUs' recoverable values as an impairment directly against goodwill, without moving to the allocation process of step 2. (This is basically the current IAS approach but with the further strengthening of procedures through annual testing, in compensation of non-amortisation). An alternative which might also be considered could be to simplify the establishment of fair values by a less costly approach, e.g. dealing first with those assets and liabilities of a CGU which have a clear fair value (e.g. monetary items or items with a clear market price) and then allocating the balance of the CGU's recoverable amount proportionately to the other assets and liabilties.

Question 6 – Reversals of impairment losses for goodwill

The Exposure Draft proposes that reversals of impairment losses recognised for goodwill should be prohibited (see proposed paragraph 123 and paragraphs C62-C65 of the Basis for Conclusions).

Is this appropriate? If not, what are the circumstances in which reversals of impairment losses for goodwill should be recognised?

Response

Please refer to our answer to question 8 on ED3.

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

The Exposure Draft proposes requiring a variety of information to be disclosed for each segment, based on an entity's primary reporting format, that includes within its carrying amount goodwill or intangible assets with indefinite useful lives (see proposed paragraph 134 and paragraphs C69-C82 of the Basis for Conclusions).

(a) Should an entity be required to disclose each of the items in proposed paragraph 134? If not, which items should be removed from the disclosure requirements, and why?

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

Response

a) No, we believe the list of required items given in paragraph 134 should be reduced and converged on the disclosure requirements of FAS 142. Some of the required information seems to us excessive and of no value in making financial statements more understandable. For example:

- We believe it is likely that a segment may include different cash-generating units where for some the recoverable amount is net selling price and for others where it is value in use. The information required by paragraph 134 (e) and (f) would then become unwieldy and of little benefit to the reader.

- The number of calculations for CGUs could be significant, resulting in lengthy disclosures of questionable value for users and of substantial cost to preparers.

- We also have doubts on the auditibility of the proposed disclosures and on preparers' ability to produce them on a timely basis.

- The requirement to disclose the excess of recoverable value over carrying value by CGU would necessitate special calculations completely outside normal reporting. Also, the assumption of (e.g.) an overall growth rate for a CGU may well be irrelevant where more accurate bottom-up forecasts are prepared.

- Much of the information is extremely sensitive from both a competitive and a legal (litigation) viewpoint. See below.

- The level of detail is almost that required to audit the impairment testing: if the IASB do not trust the auditors to audit but want companies to divulge sufficient information to permit financial analysts to do the job, they should be taking the problem up with IFAC. Similarly, it is not the role of the company to make forecasts of future values: this is the role of the financial analysts and other users of the financial statements, and ED3 seems to be confusing the two. From experience, in any case, we very much doubt whether users of financial statements are in a position to understand and use information at such a level of detail.

On specific examples of excess, we point out the following:

- disclosure of recoverable value, forecast growth rates and other such information is sensitive in situations where a divestment or a bid from a thrid party may arise (e.g. prejudicial effect on price negotiations);

- disclosure of values relating to CGU's which are the subject of US litigation where the other party can make use of such information in building up his case for damages etc. Such requirements to disclose overall values and business information about segments and individual CGUs go far beyond the information necessary for users to assess the reliability of the goodwill value in the balance sheet. The IASB has completely failed to demonstrate how the proposed disclosures are relevant to this question and also appears to have failed to carry out any critical appraisal for prioritising a "nice-to-have" shopping-list.

b) We agree with the principle as proposed in paragraph 137 but only in respect of items (a), (b) and (c). On items (d) to (f), see above.

Other comment

Future "improvement/enhancement" capital expenditure

Paragraph 37(b) of the ED proposes to exclude capital expenditure from the future cash flow forecasts if it will improve or enhance the asset in ecess of its standard of performance assessed immediately before the expenditure is made. We do not understand how this requirement, as worded in the ED, could be implemented in practice. If this expenditure is to be made at some future date, the asset's standard of performance at that date is unknown, because it could be changed by future events. We are unsure whether the standard of performance to which the Board refers is that which the asset is expected to have at the time the expenditure is expected to be made, based on currently available information. In our view it would be more appropriate and logical to refer to the standard of performance at the date of the impairment calculations.

PROPOSED AMENDMENTS TO IAS 38

INTANGIBLE ASSETS

Question 1 – Identifiability

The Exposure Draft proposes that an asset should be treated as meeting the identifiability criterion in the definition of an intangible asset when it is separable or arises from contractual or other legal rights (see proposed paragraphs 10 and 11 and paragraphs B6-B10 of the Basis for Conclusions).

Are the separability and contractual/other legal rights criteria appropriate for determining whether an asset meets the identifiability criterion in the definition of an intangible asset? If not, what criteria are appropriate, and why?

Response

We agree that these criteria are appropriate.

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

This Exposure Draft proposes clarifying that for an intangible asset acquired in a business combination, the probability recognition criterion will always be satisfied and, with the exception of an assembled workforce, sufficient information should always exist to measure its fair value reliably (see proposed paragraphs 29-32 and paragraphs B11-B15 of the Basis for Conclusions). Therefore, as proposed in ED 3, an Exposure Draft of a proposed International Financial Reporting Standard Business Combinations, an acquirer should recognise, at the acquisition date and separately from goodwill, all of the acquiree's intangible assets, excluding an assembled workforce, that meet the definition of an intangible asset (see proposed paragraphs 36, 43 and 44 of ED 3).

Do you agree that, with the exception of an assembled workforce, sufficient information can reasonably be expected to exist to measure reliably the fair value of an intangible asset acquired in a business combination? If not, why not? The Board would appreciate respondents outlining the specific circumstances in which the fair value of an intangible asset acquired in a business combination could not be measured reliably.

Response

We disagree with the Board's proposed change with regard to the probability criterion. Paragraph 89 of the Framework requires an asset to meet the criteria of the probability test in order to be recognised. The general principle that an asset is recognised when (i) future economic benefits will probably flow to the entity and (ii) the cost or value can be measured reliably, should be consistently applied in all situations including business combinations. The current proposal results in an inconsistent treatment of internally generated and externally acquired intangible assets, because the probability criterion for recognition of an asset as defined in the Framework is now presumed to be fulfilled in the case of a business combination or separate acquisition. We regard the Board's proposal as a major change which should not be introduced in the context of the newly proposed consequential amendments to IAS 38 but instead be considered more generally as part of a separate Concepts project. Please refer also to our response to ED 3 question 6 on contingent liabilities which also disagrees with the premature and inconsistent change in the treatment of the probability criterion.

We further believe that the proposed amendments are not clear enough in respect of how to account for in-process research and development projects (paragraph 36(c) of ED3). The Basis for Conclusions of ED 3 clarifies in BC67 that any item must first meet the definition of an asset to be recognised on the balance sheet. We disagree that an acquired in-process research and development project meets the criterion of "control over a resource" and we fail to see why such acquired in-process research and development would qualify as an asset while internally generated in-process research and development would not. The present situation within IAS and also between IAS and US GAAP is quite incoherent. Under US GAAP, all R&D - whether acquired separately or in a business combination or internally generated - is expensed. After ED 3/IAS 38 revised companies would capitalise R&D acquired separately or in a business combination, while often expensing internally generated R&D as frequently it does not meet the IAS38 recognition criteria. Both standard setters clearly need to think about a more coherent approach to R&D overall. Until that is done we believe that no move should be made in the direction of reflecting probability as a measurement rather than a recognition criterion. Based on experience we would strongly recommend a very cautious approach to any capitalisation. In any case any approach must be adopted by both the IASB and the FASB.

We ask the Board to investigate these issues in a separate Concepts project and to defer any change in the recognition criteria for intangible assets until this project is completed through a due process.

Question 3 – Indefinite useful life

The Exposure Draft proposes to remove from IAS 38 the rebuttable presumption that an intangible asset's useful life cannot exceed twenty years, and to require its useful life to be regarded as indefinite when, based on an analysis of all of the relevant factors, there is no foreseeable limit on the period of time over which the asset is expected to generate net cash inflows for the entity (see proposed paragraphs 85-88 and paragraphs B29-B32 of the Basis for Conclusions).

Is this appropriate? If not, under what circumstances, if any, should an intangible asset be regarded as having an indefinite useful life?

Response

We support the useful life requirements in paragraphs 85 – 90. The existing 20-year useful life presumption is arbitrary and often unrealistic. Although we agree that an indefinite life is usually dependent on future maintenance expenditure, it is difficult to determine how much is required to maintain the asset at its present level of performance (see paragraph 88). This approach therefore introduces another arbitrary element.

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

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

Is this an appropriate basis for determining the useful life of an intangible asset arising from contractual or other legal rights that are conveyed for a limited term that can be renewed? If not, under what circumstances should the useful life include the renewal period(s)?

Response

We support the useful life requirements in paragraphs 91 and 92 but with the addition of the entity's intent and ability to renew, which we believe to be important conditions.

It may be the case that, after the expiry of a patent that cannot be renewed, there is still an intangible asset – e.g. unpatented know how – which already existed at the time of the business combination. However, we find it too difficult to apply an "economic renewal concept" and furthermore it may lead to discretionary interpretations.

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 for Conclusions).

Is this appropriate? If not, how should such assets be accounted for after their initial recognition?

Response

We support the proposal not to amortise an intangible asset with an indefinite life according to paragraphs 103 and 104 in general, subject to a satisfactory impairment testing process (see our response to IAS 36 question 5).

Other comment

Directly attributable expenditures

The deletion of item (d) in paragraph 58 (old paragraph 54), regarding overheads that can be allocated, seems to be a consequential amendment of the improvements proposed to IAS 16 as published by the Board in its Exposure Draft of May 2002. The Board confirmed in its November 2002 deliberations that administration and general overhead costs are excluded from the cost of an item of property, plant and equipment. However, we believe that the overheads referred to in the old paragraph 54 (d) should be regarded as directly attributable costs to generate the asset, for example in the case of Research and Development, and should be reinstated.