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Sir David Tweedie
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Dear Sir David,

Re: Exposure draft ED 3 Business Combinations, Proposed Amendments to IAS 36 *Impairment of Assets*, and IAS 38 *Intangible Assets*

FEE is pleased to submit its comments on the Exposure Draft 3 on *Business Combination* and *Proposed Amendments to IAS 36 Impairment of Assets and IAS 38 Intangible Assets*. FEE as a founding organisation of EFRAG has also contributed to the EFRAG commenting process by submitting our views on their preliminary comments. Where we are in agreement with the EFRAG comments we refer to these comments, where we are in disagreement our own views are put forward. In addition we raise some additional comments.

FEE welcomes the efforts to eliminate remaining differences between international and national standards on business combinations. Although we generally support many of the proposals in ED 3 on Business Combinations and the proposed amendments to IAS 36 and IAS 38, there are serious concerns, as explained in our detailed comments. Such issues include the robustness of the impairment test, the reliable measurement of intangibles and the differences in impairment test between goodwill and intangibles that are quite close to goodwill.

In many places in the ED, reference is made to the second phase of the business combinations project. We do not believe that standard setting benefits from a situation where preparers, users and auditors are confronted with a revised standard that is subject to further changes before its effective date. IASB should therefore make very clear which issues – clearly defined and ring-fenced – are to be addressed in the forthcoming revision of the standard as a consequence of further phases of the project and should combine the different exposure draft phases into one standard.

The requirements proposed in the ED are relatively new and IASB should take account of the implementation issues before widening the experiment. Reliable measurement of some intangibles has turned out to be problematical in practice in the US. The EU experience on contributions in kind may also point in the same direction.

We agree with the IASB proposal to abolish the pooling of interest method and we support in this respect EFRAG's comments. In most business combinations, the acquirer is clearly identifiable and the purchase accounting is the appropriate method. In rare cases where it is not possible to identify an acquirer, we would recommend the use of the fresh start accounting method, based on appropriate and clear criteria, as a required method and not an alternative to purchase accounting method. We intend to comment further on this subject when the related phase of the Business Combinations project is published. We would prefer to have it as soon as possible to reduce the disadvantage of using purchase accounting method in the case of mergers during the interim period.

We support EFRAG's comment on the weaknesses, the complexity and the reliability of the proposed impairment test and on the need to improve the test so that it distinguishes between acquired goodwill and pre-existing goodwill.

1) We have the following comments on the questions raised in the draft standard on Business Combinations.

Question 1: Scope

We support EFRAG's comments and agree with the Board's proposal.

Question 2: Method of accounting for business combinations

We agree with IASB proposal to eliminate the use of the pooling of interest method and to require the application of the purchase method for all business combinations as long as the IASB makes it clear that an appropriate accounting method, for example fresh start accounting, will be considered as soon as possible. We would recommend that this method should not be an alternative to the purchase method, but rather a requirement only for the rare cases where it is not possible to identify the acquirer. We believe that the use of this method should be based on clear criteria. Where it is impossible to identify the acquirer (real merger), the purchase accounting should only be an interim solution. We support in this respect the comment raised by EFRAG.

Question 3: Reverse acquisitions

We support EFRAG's comment and agree with the IASB proposal to clarify the circumstances in which a business combination could be classified as a reverse acquisition. We believe the issue of reverse acquisition is better addressed in the Exposure Draft than in the existing standard IAS 22.

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

We agree with EFRAG's answer and with the IASB proposal.

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

We agree with EFRAG's answer and with the IASB proposal not to apply different recognition criteria for restructuring provisions. We regard this proposed requirement as more consistent with the general definition of a liability. The provision should be recognized only if the obligation existed prior to the acquisition.

FEE would propose that IASB modifies paragraph 40(a) by inserting "which should be" between "restructuring" and "recognized" to take into consideration entities that were not applying IAS before the acquisition but should have recorded a liability under IAS 37.
We would also like to point out that the proposed treatment does create a difference with US GAAP (EITF 95-3) if no convergence changes are made to SFAS.

Question 6: Contingent liabilities

FEE disagrees with EFRAG and supports the IASB proposal for the reasons given in the Basis for Conclusions.
The treatment of a contingent liability could be different in the case where an entity has paid to assume it than if it is incurred. This situation is not dissimilar to others in which assets are recognized as a result of a business combination but would not have been recognized had they been internally generated. For example, it is the case for goodwill or other intangible assets. Considering that the existence of a contingent liability has an effect on determining the price of an acquisition, it seems appropriate to recognize it at fair value. However, this creates an inconsistency with the recognition criteria in IAS 37 and the Framework and, therefore, IAS 37 should be modified.

We understand from BC 85 that the Board will reconsider the recognition of contingent assets as part of a further phase of the project on Business Combinations. Our initial thoughts are that contingent assets should be revised in the same project as contingent liabilities. Otherwise, it results in an asymmetrical accounting treatment in connection with business combinations. We envisage use of the same recognition criteria for contingent assets as for contingent liabilities in the case of business combinations.

<u>Question 7</u>: Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

We agree with EFRAG and the proposal of the Board.

<u>Question 8</u>: Goodwill

We agree with EFRAG and IASB that goodwill acquired should be treated as an asset. We prefer the term "treated" to "recognised" as an asset since we disagree with the Board's conclusion that goodwill meets the definition of an asset (BC 99). Goodwill cannot be sold separately and is not controlled by the entity.

From a theoretical point of view the proposed impairment only approach would have the advantage that it better reflects the actual diminution in value of goodwill than an arbitrary amortisation.

However, FEE agrees with EFRAG that goodwill should not be subject to an "impairment only" regime and disagrees with the IASB proposal. The impairment only approach does not achieve a balance between reliability and practicability, for the following reasons: impairment tests are complex and subject to high degree of subjectivity and uncertainty; the cost of impairment tests may not be justified; and goodwill and identified intangibles, which are similar in nature, will be subject to different accounting treatments. In our view, the value of purchased goodwill does decrease in the long run despite short or medium term fluctuations and most of the elements of what constitutes true goodwill, such as the assembled workforce, do not have infinite lives. Purchased goodwill is continuously replaced with internally generated goodwill. Hence, while entities that acquired business units containing goodwill in the marketplace are permitted to partly recognise internally generated goodwill, entities whose business units have internally grown are not. Therefore, we prefer the approach as currently required in IAS 22 being amortisation combined with impairment test. Systematic amortisation acknowledges the diminution in value over time, although arbitrary. However, in case of an impairment only approach one has to determine the present value of the expected cash flow which implies the estimation of the useful life of goodwill. The amortisation of goodwill has the advantage of being easier to apply and well established. Furthermore, the proposal of the ED is not entirely consistent with the manner in which other assets that are less 'ambiguous' and more reliably measurable than goodwill are accounted for.

FEE noted with interest the alternative approach proposed by EFRAG as an appropriate balance between reliability and relevance.

<u>Question 9</u>: 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

a) We support the IASB proposal to reassess the identification and measurement of the assets, liabilities and cost of the combination in the case of "negative goodwill".

b) FEE agrees with EFRAG's comments and prefers retaining the accounting for negative goodwill as stated in IAS 22. We also agree with the IASB that situations where an 'excess' remains should exist rarely and may be due to errors in assessment of the fair value of assets and liabilities acquired or due to a bargain purchase. However, in those cases the treatment of negative goodwill should mirror that of the treatment of positive goodwill. The excess of the purchase price over the assets and liabilities acquired can be either positive, reflecting expectation of future gains, or negative, reflecting expectation of future losses, which cannot always be reflected in the fair value of the acquiree's identifiable assets and (contingent) liabilities. Also, the depreciation of negative goodwill should follow the same logic as the positive goodwill. The Board should reconsider the implications of this different accounting treatment, keeping in mind that both goodwill and 'excess' normally are only residuals, neither 'pure' assets nor (contingent) liabilities.

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

We support the IASB proposal and agree with EFRAG's comments.

Other comments:

We support the other comments raised by EFRAG.

Appendix B-15 of the Exposure Draft provides guidance on the measurement at fair value of the identifiable assets, liabilities and contingent liabilities acquired. We propose that this guidance refer to existing standards in which proper information is given on how to reach fair value, for some assets or liabilities listed in B-15.

2) We have the following comments on the questions raised in the proposed amendments to IAS 36, *Impairment of assets*.

Question 1: Frequency of impairment tests

We agree with EFRAG's comment that annual impairment tests for indefinite useful life intangible assets and for acquired goodwill should be performed at the same time during a financial year but not necessarily at year-end because both test are conceptually related. In this respect, we disagree with the IASB proposal.

Question 2: Intangible assets with indefinite useful lives

We disagree with EFRAG and with IASB. It is inappropriate to have different treatments for intangible assets with indefinite useful lives and for goodwill in those circumstances where goodwill has an indefinite useful life. The reversals of impairment losses should not be different for goodwill and indefinite intangible assets because the separation between the two is difficult when testing for impairment. Also, such treatment will entail a lack of convergence with US GAAP since SFAS does not permit the reversal of impairment losses for intangible assets with indefinite useful lives.

Question 3: Measuring value in use

We agree with the IASB proposals of additional guidance on measuring the value in use of as assets. We do not concur with EFRAG's comment on (b).

Question 4: Allocating goodwill to cash-generating units

We agree with EFRAG and the IASB proposal.

We acknowledge that the lowest level at which management monitors the return on the investment could be equivalent to the Reporting unit as defined by US GAAP in SFAS 142 paragraph 30. If impairment tests according to IFRS are performed at a different level than according to US GAAP, there is little point in adopting the US approach for business combinations as a level playing field would not result. We suggest that IASB reconsiders this in the ongoing convergence project with FASB.

We would also suggest to IASB to clarify which level of management (operational vs executive, for example) it is referring to in paragraph 74.

Question 5: Determining whether goodwill is impaired

We disagree with the IASB proposal and support EFRAG's comments. We agree with EFRAG that a two-step impairment test for goodwill is neither necessary nor justified. The application of the screening test (paragraph 85) is consistent with IAS 36 and ensures that no cash-generating unit (including goodwill) is carried at more that its recoverable amount. No further testing is required. Where recoverable amount is lower than the aggregate carrying value, we believe it is appropriate to assume that any impairment firstly relates to goodwill. The second step of the proposed test, the calculation of implied value of goodwill (paragraph 86), is inconsistent with the principle of IAS 36 that assets are written down to recoverable amount. We agree with the Basis of Conclusions C47 that a one-step test would be less costly, simpler and consistent with IAS 36. Moreover, we consider that the addition of a second step, which is justified as a more rigorous test for the current value of goodwill, is at the expense of misstating other assets.

<u>Question 6</u>: Reversals of impairment losses for goodwill

We support EFRAG's response and agree with IASB. We recommend that the same rule be applied to intangibles with indefinite useful lives.

<u>Question 7</u>: Estimates used to measure recoverable amounts of cash-generating units containing goodwill or intangible assets with indefinite useful lives.

We agree with the requirement in paragraph 134 and disagree with EFRAG.

3) We have the following comments on the answers to the questions raised in the proposed amendments to IAS 38, Intangibles Assets.

<u>Question 1</u>: Identifiably

We agree with EFRAG's answer and the IASB proposal.

<u>Question 2</u>: Criteria for recognising intangible assets acquired in a business combination separately from goodwill

We disagree with EFRAG and support the IASB proposal to recognize all intangible assets acquired in a business combination that meet the definition of an intangible asset, considering the probability recognition criterion is always satisfied. We believe that the recognition of intangible assets could be based on different criteria for a business combination than for internally generated intangible assets. The probability criterion is respected if the assets are part of a business acquisition because the purchase price is influenced by the existence of such intangible assets.

However, we believe there are a number of issues where the Board appears to have taken insufficient account of experience of applying equivalent standard in the US. Firstly, we believe that the fair value of some intangibles could be difficult to measure reliably. The Board should not assume that sufficient information always exist to measure, as it is not the case.

Also, in practice, it has been very difficult to identify separately intangible assets such as trade dress, order backlog, database. These 'softer' assets are invariably difficult to consider in isolation. Indeed, in many cases it is difficult to consider the value of such assets in isolation from the other related intangibles. Moreover, the inability to separate one intangible from another related intangible can lead to duplication of values. Whilst the list of assets in SFAS 141 and ED 3 contains certain items which are readily identifiable, e.g. trademarks, patents and proprietary technology, it also contains certain assets which, although listed separately, all derive value from the same income stream. Attempts to split this one income stream into these different asset types are likely to result in subjective and unreliable numbers. We believe that the different headings should be combined and the entire customer relationship treated as a single intangible asset.

Finally the Illustrative Examples section of ED 3 provides guidance on the types of intangible assets acquired in a business combination "that are recognised under [draft] IFRS X Business Combinations separately from goodwill". In practice, the equivalent guidance in SFAS 141 appears to have been widely treated as a mandatory list. The Board should at least make it very clear that the list of intangibles is suggestive only and is in no way mandatory or comprehensive.

<u>Question 3</u>: Indefinite useful life

We support EFRAG's response and the IASB proposal. We agree with the removal of the presumption that an intangible asset's useful life cannot exceed twenty years.

<u>Question 4</u>: Useful life of intangible asset arising from contractual or other legal rights.

We support EFRAG's response and the IASB proposal.

<u>Question 5</u>: Non-amortisation of intangible assets

From a theoretical point of view, the proposed impairment only approach would have the advantage that it better reflects the diminution in value of indefinite life intangible assets, if any. However, FEE believes that indefinite life intangible assets should not be subject to an "impairment only" regime and disagrees with the IASB proposal.

<u>Other comments</u>

It appears to be an inconsistency within IAS 38 regarding acquired customer lists. Paragraph 15 argues, by reference to the definition of assets in paragraph 7, that such a list is not an intangible asset because of insufficient control over the economic benefit. However, Appendix A gives such a list as an example of intangible asset.

We would be pleased to discuss any aspect of this letter with you.

Yours sincerely,

David Devlin
President