Institute of Certified Public Accountants in Israel
לשכת רואי חשבון בישראל

April 4, 2003

CL 134

Ms. Annette Kimmitt
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

E-mail: CommentLetters@iasb.org.uk

Dear Ms. Kimmitt,

Re: <u>Exposure Draft ED3 "Business Combinations"</u>

In response to your invitation to comment on the Exposure Draft of the proposed IFRS "Business Combinations", following are our comments on behalf of the Institute of Certified Public Accountants in Israel.

We believe that the general principles underlying this draft standard – prohibiting use of pooling of interests in business combinations and defining "goodwill" acquired in a business combination as an intangible asset with an indefinite useful life – are appropriate and important.

In connection with questions (1-10) that are attached to the draft IFRS, we would like to comment on the following questions (we concur with the proposed IFRS with regard to the other questions):

רחוב שפר 20
ת.ד. 29281
תל אביב 61292
טל. 03-5161114
פקס. 03-5103105

Provisions for terminating or reducing the activities of the acquiree (paragraph 40(a) and Question 5)

The Exposure Draft proposes that an acquirer recognize 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 recognized in accordance with IAS 37.

This proposal would change existing practice allowed under International Accounting Standards ("IAS") (IAS 22, para. 31) and under US GAAP (EITF Issue 95-3).

We disagree with the proposed change to existing practice for the following reasons:

We believe that the acquirer, by recognizing the need to restructuring prior to acquisition, must have considered it as a part of the purchase price to be accounted for as a liability (from his point of view).

We agree that the restructuring provision described in para. 31 of IAS 22 does not meet the recognition criteria of IAS 37. However, exceptions have been made in IAS 22 and the Exposure Draft to recognize other assets and liabilities not meeting the normal recognition criteria, as discussed in the following paragraph.

The basic premise in IAS 22 is that assets and liabilities of the acquiree that satisfy the recognition criteria of paragraph 26 should be recognized. The recognition criteria in paragraph 26 are based on a fair value approach and differ from the normal recognition criteria for assets and liabilities set forth in other IFRS's. For example, certain internally generated intangible assets are not permitted to be recognized in an ongoing entity, but are recognized as part of a business combination. Similarly, contingent liabilities not meeting the criteria for recognition by the acquiree under IAS 37, would be required to be recognized as a business combination under the proposal.

We believe that an exception should also be made for the restructuring provision if it meets the criteria in para. 31 of IAS 22. From an economic point of view, it is clear that estimated costs of a restructuring clearly influence the price paid by the acquirer.

We note that the Board rejected this argument since the price paid would be influenced by future losses and other unavoidable costs such as costs of investing in new systems. (Basis for Conclusions – para. BC59). Although from an economic point of view, a restructuring provision may not be different from any future losses, we believe that it would be extremely difficult to establish criteria to distinguish future losses that are contemplated as part of the acquisition from those that arise as part of the future ongoing operations. However, we contend that the criteria in para. 31 of IAS 22 are a very narrow exception to allow only certain costs that meet those specified criteria. We believe that this exception is justified due to the frequency of their occurrence in business combinations.

In respect of other future costs, such as investing in new systems, many of these costs might meet the criteria for capitalization under existing IAS, whereas a restructuring provision would be immediately expensed. Clearly then, not allowing a restructuring provision to be recorded as a liability could have a negative impact on the consolidated results of operations in the first reporting period subsequent to the acquisition even before the acquiree could contribute any economic benefits to the consolidation.

Based on the foregoing, we believe that the guidance in para. 31 of IAS 22 should be carried forward to the draft IFRS.

Costs of a business combination (paragraph 26)

Paragraph 26 of the draft IFRS states that the published price at the date of an exchange of a quoted equity instrument provides the best evidence of the instrument's fair value and should be used, except in rare circumstances. In the discussion of "rare circumstances", para. 26 state that a rare circumstance is limited to the situation in which the published price is an unreliable indicator of fair value "only when it has been affected by the thinness of the market".

While we agree with the basic premise in para. 26 that the published price generally provides the best evidence of fair value, we do not believe that it is applicable to all but "rare" situations. The use of the word "rare" implies that only in exceptional circumstances would an acquirer be allowed to use other evidence. We note that in some markets, there can be a substantial number of companies whose shares are thinly traded. Thus, for those markets, use of other valuation methods would not be a "rare" occurrence.

Furthermore, we believe that there are factors other than market thinness that can affect the volatility of the quoted market price. These include undue price fluctuations just prior to the exchange date.

The date of exchange is generally an arbitrary date that is established during the negotiations, sometimes months in advance of the actual exchange (closing). Therefore, the market price on the date of exchange could be affected by a fluctuation caused by an unusual temporary event unrelated to the particular security, such as the threat of a general labor strike.

Accordingly, we believe that para. 26 should be revised to carry forward the guidance in para. 24 of IAS 22 which states (in part):

"… measured at fair value, which is their market price as at the date of the exchange transaction, provided that undue fluctuations or the narrowness of the market do not make the market price an unreliable indicator."

We would also point out that the above is consistent with the language used in para 22 of Statement of Financial Accounting Standards No. 141 and further advances the objective of the Board to seek international convergence.

We are aware that the fair value of financial instruments is generally measured as of a particular date, however, this is completely a different situation in which the cost of acquisition is determined for all the consecutive periods and therefor we further suggest that the Board considers revising para. 26 to allow for possible one time unusual fluctuations, as follows:

“The market price for a reasonable period (say, 3-5 days) before and after the date of the exchange transaction shall be considered in determining the fair value of the equity instrument.”

Costs of a Business Combination (paragraph 28)

Paragraph 28 of the draft IFRS states that costs directly attributable to the business combination are included in the cost of the combination. The examples given in para. 28 relate to fees paid to outsiders. Paragraph 28 further states that “general administrative costs …. and other costs that cannot be directly attributed to the particular combination being accounted for are not included in the cost of the combination…”.

It is not clear from para. 28 whether all general administrative costs are not included, or only those administrative costs that cannot be directly attributable to the particular combination. For example, if an acquisitions department maintains time records for each business combination project, would incremental costs, such as overtime, travel, etc. which can be specifically identified with a particular business combination be included in the cost of the combination or expensed? Similarly, if the acquirer paid a bonus to internal corporate staff due to the success in achieving a particular combination would such amounts be included as a cost of the combination?

We believe that the draft IFRS should be revised to clarify this point, as follows:

“Indirect costs, including general administrative costs that are not directly attributable to a particular business combination, should not be included in the cost of the acquisition. However, specifically identifiable incremental costs that can be attributable to a particular business combination (such as a bonus paid to management for a successful merger) should be included in the cost of the acquisition”.

We would be pleased to give you any further clarifications, if needed.

Sincerely yours,

Adir Inbar, CPA (Isr.)
Chair, Professional Council

Arnon Ratzkovsky, CPA (Isr.)
Chair, Accounting Principles & Financial reporting Committee

Institute of Certified Public Accountants in Israel
לשכת רואי חשבון בישראל

1906/594
April 4, 2003

Ms. Annette Kimmitt
Senior Project Manager
International Accounting Standards Board
30 Cannon street
London EC4M 6XH
United Kingdom

E-mail: CommentLetters@iasb.org.uk

Dear Ms. Kimmitt,

Re: Proposed Amendments to IAS 36, Impairment of Assets, and IAS 38, intangible Assets

We respond to your invitation to comment on the abovementioned proposal, on behalf of the Institute of Certified Public Accountants in Israel.
We believe that the general principles of the abovementioned proposal are appropriate.
Regarding the questions included in the Invitation to Comment for the proposed amendments of both standards, we would like to comment on the following questions (we are concurrent with the proposal regarding the rest of the questions).

IAS 36, IMPAIRMENT OF ASSETS

In respect to the proposed change of IAS 36, impairment of assets, please find our comments below:

A. Question 3 – calculating value in use

a. Regarding the assumptions that form the basis for the cash flow forecasts

In our opinion, the assumptions that form the basis for cash flow projections should take into account the actual cash flows in the past as well as the management's past ability to forecast precisely such cash flows, as said in the proposed paragraph (27(a)(ii).

However, we believe that the said paragraph should be **rephrased**, as the current wording might mislead the readers to think that the reference is **to the management's forecasting skills** (which may be related to audit of financial statements but not to the assumptions themselves.).

To prevent misunderstanding as described above, we recommend rephrasing this paragraph and clarifying that the assumptions should take into account **past deviations from the forecast**, deviations that may have been influenced by the measures available at the time to the management to perform the forecast, the uncertainties that existed at the time and have affected the forecast's accuracy, the tools and the data that have been available to the management, and other factors which affected the forecast. It is our opinion that the assumptions should reflect the objective circumstances rather than the management's forecasting skills and we believe that the phrase "past experience" may resolve the unclarity.

B. Question 4 – allocating goodwill to cash-generating units

The issue of allocating goodwill to cash-generating units is problematic since when acquiring an entity, the goodwill calculated at the time of the acquisition is **the residue that usually cannot be allocated** to the assets and liabilities of the acquired entity unless otherwise indicated on acquisition date. Therefore, any allocation of goodwill is problematic because had it been possible to allocate it, it would not have been treated as goodwill but rather as allocated excess of cost over book value.

For example, the case of a company that has two cash-generating units (two plants, for example) and specific goodwill is recorded at the time of its acquisition. At the time of the acquisition, the goodwill was not allocated to the cash-generating units because it has been impossible to allocate it. It is now required to allocate it to the two plants in order to calculate the impairment.

Whatever method of assigning is used, the result would be an arbitrary one and the outcome that determines whether the asset has been impaired or not will be influenced to a large degree by the allocation method used.

We believe that although non-allocation might sometimes distort the calculation of the impairment of a cash generating unit as a whole, each one of the allocation methods has a potential of distorting the calculation too. In any case, below are our specific comments on this issue:

a. *Disposing of activity inside a cash-generating unit to which goodwill has been allocated*

We agree that when an entity disposes of an activity carried out by a cash-generating unit that has been allocated goodwill, and in order to avoid distorting the result of the disposal, the goodwill allocated to that activity should be included in the carrying amount associated with that activity when calculating the gain or loss on disposal.

However, proposed paragraph 82 does not specify **which relative values should be used – recoverable amount, carrying amount or fair value**. In our opinion, measuring goodwill based on the relative value of the activity that has been discontinued and the proportion of the cash-generating unit that was left **based on their carrying amount** is problematic since they are based on historical values and therefore are not very good for comparison purposes. Consequently, we believe an alternative approach of **relative values based on fair value** should be considered, if such approach could be implemented.

We would like to note that in the example provided following proposed paragraph 81, the sold part was calculated according to its selling price (100) while the remaining part was calculated based on its recoverable amount (300), so that the ratio in the example is 25%. (The example does not state specifically that 100 is also the recoverable amount of the sold part).

b. *Changing unit composition as part of reorganizing the reporting structure*

The invitation to comment asks whether, if an entity reorganizes its reporting structure in a way that changes the composition of the cash-generating units to which goodwill has been allocated, should the goodwill be reallocated to the units affected using the relative value approach. As shown above, we believe that **an explicit definition of the values is necessary** (fair value, recoverable amount or fair value) **to serve as the basis for measuring relative value.**

C. Question 5 – determining whether goodwill is impaired

Measuring losses on goodwill impairment

We agree with the proposal that when an entity becomes aware that the goodwill allocated to a cash-generating unit may have been impaired, the loss due to the impairment of that goodwill will be measured as the surplus of the carrying amount of the goodwill over its implied value, which has been measured according to proposed paragraph 86.

In our opinion, this calculation is more accurate than the wording that preceded the proposal, although it is far more complicated, requiring data that may not be available. However, we believe it is desirable to consider **allowing calculation of the implied value of the goodwill based on the fair value of a group of assets taken together** in order to facilitate the work for the reporting entity. For example, in the case of a cash-generating unit, which is a production plant with two production lines, it would be easier for the reporting entity to calculate the fair value if it is able to refer to each production line as an individual asset rather than breaking it down into individual machines, equipment, etc.

D. Question 7 – estimates used to measure recoverable amount of cash-generating units containing goodwill or intangible assets with indefinite useful life

a. *Disclosure according to proposed paragraph 134*

In our opinion, the disclosure requirements in proposed paragraph 134 are problematic in item (e), which requires detailed disclosure of the management's assumptions. **In some countries, this disclosure requirement might expose the management to legal claims especially where there is no "safe harbour".** In addition, these disclosure requirements are not required under US GAAP.

b. *Disclosing the same information for a cash-generating unit separately in specific cases*

The invitation to comment asks whether the information to be disclosed under proposed paragraph 134 should be disclosed separately for a cash-generating unit within a segment when one or more of the criteria of proposed paragraph 137 are satisfied. In our opinion, since these disclosure requirements are highly detailed and broad, they might create **a substantial reporting task,** which the reporting entities would find difficult and costly to implement.

c. *The item in the financial statements where to record an impairment loss*

We see difficulty and lack of unity among various reporting entities regarding the location (item) in the financial statements in which to record an impairment loss. It would have been useful **to include instructions on this as part of the standard.** The instructions could clarify, for example, where loss on goodwill impairment should be recorded – as part of administration and general expenses or as part of other expenses, and so forth for other assets as well. Such instructions would contribute to the comparability of the financial statements. We also believe that it the IAS should recommend recording loss on goodwill impairment as part of other expenses item.

IAS 38 INTANGIBLE ASSETS

Please find below our comments on the proposed changes on IAS 38 – intangible assets:

A. Question 2 – criteria for initial recognition of intangible assets acquired in business combination separately from goodwill

We agree that in most cases, with the exception of assembled workforce, sufficient information should often exist to measure reliably the value of an intangible asset acquired in a business combination. This, based on the assumption that prior to the business combination, an acquirer carried out examinations and valuations to set the price it is willing to pay under the business combination.

Nonetheless, we believe that making an unequivocal statement as part of the IAS that the fair value of an intangible asset acquired under a business combination can always be reliably measured is too rigid and does not allow for flexibility in those cases in which reliable measurement of that fair value is impossible or unusually difficult.

We believe that in the case of a company being acquired with several in-process research and development projects as well as skilled developer force, the acquirer may agree to pay a specific price for the entire ensemble would find it difficult, for example, to determine the fair value of each research and development project as a standalone process, especially if two or more of the projects share the same know-how or technology.

We propose to indicate that in specific cases it **might be impossible to determine the fair value of each intangible asset acquired separately but only in a group of assets** .

B. <u>Question 4 – the useful life of an intangible asset arising from contractual or other legal rights</u>

The proposed paragraph says that when an intangible asset arises from contractual or other legal rights conveyed for a limited term but are renewable, the useful life should include the renewal period/s only if there is evidence to support renewal by the entity without significant cost.

We believe that **the term "significant cost" should be clarified in the context of the cost of renewal** and indicate that renewal by the entity will be considered as "not incurring significant cost" if the cost of the renewal is at a bargain price relative to the value of the asset in question, rather than the cost being insignificant in itself. In other words, the significance of the cost is measured on a relative, rather than on an absolute basis. For example, if the cost of renewing the rights on a specific asset is USD 2 million, which everyone would agree is a significant cost, but the value of the asset for which the renewal is required is USD 950 million, then it is possible to say that the renewal is made without significant cost. The opposite example would be a renewal at a low, even insignificant cost, which is not worth incurring (for example, due to decreased market demand) and therefore is not likely to take place. In that case, the renewal term would not be included in the useful life of the asset.

<u>Sincerely yours,</u>

Adir Inbar, CPA (Isr.) Chair, Professional Council	Arnon Ratzkovsky, CPA (Isr.) Chair, Accounting Principles & Financial reporting Committee