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Dear Annette

ED 3 'Business Combinations' and Exposure Draft of Proposed Amendments to IASs 36 and 38

I set out below and in the attached note the views of the UK Accounting Standards Board on ED 3 'Business Combinations' and the associated Exposure Draft of Proposed Amendments to IASs 36 'Impairment of Assets' and 38 'Intangible Assets'. As you will be aware, the ASB issued the IASB's draft standard in the UK in the form of a Consultation Paper ('IASB proposals on Business Combinations, Impairment and Intangible Assets') on which it invited comments. Although we have passed to you all the letters we have received in response (other than the ones that are confidential), we have not yet finished analysing those comments and the attached note makes no attempt to summarise the letters or to make comment on them.

As explained more fully in the note, although we support a number of aspects of the proposals, the UK ASB continues to have reservations over whether overall they will lead to an improvement in financial reporting in the UK and Republic of Ireland.

In particular:

- we are concerned that the full business combinations package will not be mandatory by 1 January 2005, and there is currently no timetable for progressing some aspects of Phase II;

- we believe that the purchase method is not appropriate for *all* business combinations. For those where it is not possible to identify an acquirer it is wrong arbitrarily to choose one; for these limited circumstances an alternative requirement should be available such as 'fresh start';

- we would like see the option, or requirement, for the amortisation of goodwill in certain circumstances; and

- we do not agree with the proposed impairment test because we are not convinced it is rigorous enough to result in goodwill being written off as it is consumed.

We hope that our comments will contribute to your discussions.

If you have any questions concerning this letter, or would like further information on the comments made, please contact either Jenny Carter (020 7611 9712) or myself (020 7611 9703).

Yours sincerely

Allan Cook
Technical Director

The UK ASB's comments on ED 3 'Business Combinations' and Exposure Draft of Proposed Amendments to IASs 36 and 38

THE IASB'S DETAILED PROPOSALS ON BUSINESS COMBINATIONS

Scope and timing (Question 1)

1. The IASB has proposed a number of scope exclusions in the draft IFRS, which are due to be considered as part of Phase II of the project. The scope of Phase II is outlined in paragraph BC4.

2. However, to date the IASB has progressed only one aspect of Phase II and has not given a clear indication of its plans for addressing the remaining issues.

3. We considered whether Phase I of the business combinations project would be operable without Phase II. To avoid continual changes in requirements we believe that the IFRS arising from the Phase II project on the application of the purchase method must be available, if not mandatory, before 2005 (and we are pleased to note that this is the IASB's current intention). However, our preference would be for the IFRS arising from ED 3 not to be mandatory without also adopting the Phase II requirements on the application of the purchase method.

4. This still leaves no guidance available from the IASB on the other aspects of Phase II, such as combinations involving entities under common control. We would urge the IASB to address these remaining issues as quickly as possible.

Method of accounting for business combinations (Question 2)

5. The ASB has reservations about requiring the purchase method for *all* business combinations. It believes that there are circumstances where businesses combine where there really is no acquirer – for example, true mergers of equals or the incorporation of several partnerships into a new business entity. In those circumstances it seems inappropriate to report the combination as if there has been an acquirer.

6. For business combinations where there is no acquirer, a possible alternative method is 'fresh start' (or 'new basis') accounting. Under this approach, the net assets of all the combining entities would be measured at current value at the date of the combination. The ASB hopes that the IASB will consider 'fresh start' as a possible alternative to the purchase method, which is permitted or required in certain circumstances, particularly where there is no clear acquirer.

Provisions for terminating or reducing the activities of the acquiree (Question 5)

7. The ASB strongly supports the proposal 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.

Contingent liabilities (Question 6)

8. In the context of a business combination the ASB agrees with the recognition of contingent liabilities at fair value in the acquisition balance sheet.

9. We look forward to participating in the debate on the recognition of contingent liabilities more generally.

Goodwill (Question 8)

10. The ASB believes that, given the difficulties in measuring continuing goodwill, neither annual impairment nor amortisation is likely to result in an unambiguously correct amount for the carrying amount of goodwill. Cost and benefit considerations should therefore be taken into account in judging whether amortisation should be permitted as an alternative to the requirement for an annual impairment review.

11. Given the simplicity and ease of setting up an amortisation schedule, the ASB believes entities should be permitted to use this course rather than be forced to use an annual impairment route in all cases. Of course, amortisation does not remove the need for impairment reviews where there is an indication that an impairment has occurred.

12. At the margin, intangible assets can be very similar to, or indistinguishable from, goodwill and therefore we feel that it is appropriate to align the accounting treatment of intangible assets that are similar to goodwill with the treatment of goodwill. Under the IASB's proposals intangibles with a finite useful life will be treated differently to goodwill with a finite useful life.

13. Whatever decision the IASB reaches over the cost/benefit argument outlined above, where there is clear evidence that the purchased goodwill has a limited useful economic life, perhaps because the acquiree has a time-limited permit to operate, it would seem sensible to write the goodwill off systematically over that period.

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 (negative goodwill) (Question 9)

14. The ASB supports the IASB's proposal to treat negative goodwill as a gain. This appears to be the simplest solution and is consistent with the idea that it may have arisen as a result of a bargain purchase.

THE IASB'S DETAILED PROPOSALS TO AMEND IAS 36 'IMPAIRMENT OF ASSETS'

Frequency of impairment tests (Question 1)

15. Where goodwill is not subject to amortisation we agree that it should be tested annually for impairment.

16. However, as noted above we do not agree that in all cases goodwill should be subject only to impairment, rather than amortisation, and therefore we do not agree with paragraph 8A (b) that goodwill should always be tested for impairment annually.

Determining whether goodwill is impaired (Question 5)

17. We have concerns about whether the IASB's proposed impairment test is sufficiently robust to generate confidence in its ability to identify reductions in the value of acquired goodwill when they occur since the proposed test allows a cushion of any pre-existing goodwill.

18. The UK's FRS 11 'Impairment of fixed assets and goodwill' includes specific requirements for the circumstances where an acquired business is merged with an existing business resulting in an income-generating unit that contains both purchased and (unrecognised) internally generated goodwill. In order to guard against the pre-existing, unrecognised internally generated goodwill acting as a cushion against the impairment of the purchased goodwill, its value should be estimated and added to the carrying value of the income-generating unit, solely for the purposes of performing the impairment review(s). This permits the purchased goodwill to be tested independently for impairment at the time of acquisition.

19. We would encourage the IASB to add such a test (and the associated requirements relating to impairment testing in subsequent years) to its proposals.

20. Also, the ASB believes that the second stage of the IASB's proposed impairment test for goodwill, namely the comparison of the implied value of goodwill with its carrying value, is overly complex and costly, and should be eliminated. As a result impairment of goodwill should be identified and

measured by what is currently referred to as the 'screening mechanism', subject to the adaptation referred to above.

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

21. We are not convinced that the disclosures proposed by the IASB are a more appropriate way of achieving the objective of reliability of estimates. They appear excessive and may include commercially sensitive information.

22. We would urge the IASB to consider alternative ways of meeting its objective and propose two possible solutions:

    a. exchange the range of proposed disclosures for a test similar to the subsequent cash flow test in FRS 11; or
    b. streamline the disclosures, for example by permitting a greater degree of aggregation and/or disclosing a subset of the most significant assumptions and deleting the requirement for sensitivity analysis.

THE IASB'S DETAILED PROPOSALS TO AMEND IAS 38 'INTANGIBLE ASSETS'

Identifiability (Question 1) and Criteria for recognising intangible assets acquired in a business combination separately from goodwill (Question 2)

23. The IASB's proposals for recognising intangible assets in a business combination significantly lower the hurdle for recognition and will result in many more intangible assets being recognised than at present. We are concerned that this, in turn, may lead to problems with identification and measurement.

24. In particular, the assumption that, in a business combination, sufficient information will always exist to measure reliably the fair value of many acquired intangible assets seems dubious, particularly where the intangible assets may be inter-related. There may also be cost and benefit implications to the proposals that require further consideration, in particular for smaller entities.

25. We understand that the IASB has carried out field testing on these proposals and will take the results of that work into account in finalising its proposals.