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Memorandum of comment submitted to the International Accounting Standards Board in April 2003 concerning Exposure Draft 3, 'Business Combinations', and 'Amendments to IAS 36, Impairment of Assets, and IAS 38, Intangible Assets', published by the Board for comment in December 2002

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to the International Accounting Standards Board ('the Board') regarding the proposals *ED 3, 'Business Combinations'* and '*Amendments to IAS 36, Impairment of Assets, and IAS 38, Intangible Assets'*, published by the Board for comment in December 2002.

2. We have reviewed the exposure drafts and set out below a number of comments. We deal first with significant matters before commenting on the specific issues raised in the exposure drafts and then on points of detail.

MAJOR POINTS

Summary

3. We welcome publication of ED 3 and the related amendments to existing International Accounting Standards (IAS). However, we have a number of grave reservations regarding the detailed proposals, as follows:

   - **Goodwill** - we reject the introduction of an "impairment only" approach to goodwill (paragraphs 4-7);
   - **Impairment testing** - we do not support a two-step approach to impairment testing of goodwill (paragraphs 8-11);
   - **Identified intangibles** - in principle, we agree that the usefulness of financial statements would be enhanced by an increase in the range of intangible assets which are identified and measured at fair value, and we urge the Board to undertake at an early date a comprehensive review of the approach to accounting for intangibles generally. However, we have major reservations regarding the practicality of the Board's detailed proposals for accounting for intangibles in the context of a business combination (paragraphs 12-13); and
   - **Inconsistencies in accounting standards** - whilst we welcome the general approach to fair valuing acquired assets and liabilities, acquired contingent liabilities should not be included at fair value until the Board has reconsidered IAS 37 generally. Similarly, in-process research and development should not be included at fair value until the Board has reconsidered IAS 38 generally (paragraphs 14-18).

   We also have significant concerns regarding the phasing of the business combinations project (paragraphs 19-21). We discuss each of our major concerns in more detail below.

Impairment-only Approach to Goodwill

4. We agree that goodwill acquired in a business combination should be recognised as an asset. However, we strongly disagree that all goodwill should be subject to an "impairment only" regime. This approach is

appropriate only where two conditions exist: firstly, goodwill can be shown not to have a finite life; and secondly, the prescribed impairment test can be shown to be both reliable and justified in terms of cost/benefit.

5. We note the Board's comments that the primary challenge it faced in deliberating the subsequent accounting for goodwill was achieving an acceptable level of reliability in the form of representational faithfulness, while at the same time striking some balance with what is practicable. We explain below (in our response to ED 3 Question 8) why an "impairment only" approach does not achieve this balance.

6. We believe that an "impairment only" approach should apply where the life of goodwill is difficult to assess and, moreover, the annual impairment tests are both feasible and cost effective. In practice, the focus of analysts is larger listed companies, and we recognise that in this context accounting information generated by appropriate annual impairment testing has more predictive value - albeit, generally of a confirmatory nature - than goodwill amortisation charges. However, any benefit of annual impairment testing to users of the financial statements of most smaller companies - both quoted and unquoted - would be heavily outweighed by the cost and effort involved. We therefore strongly recommend that the Board permits amortisation over a finite life on clearly-defined cost/benefit grounds.

7. We recognise that it is not uncommon for goodwill to represent either an overpayment for the acquired business or expected synergies that prove, in the event, to be unrealised. Accordingly, where a policy of amortisation is adopted on cost/benefit grounds, we would recommend that the reporting entity is required to test the value of goodwill for impairment at the end of the first full financial year following an acquisition. Entities would continue to assess at each balance sheet date whether there is any indication that goodwill is impaired.

<u>Two-step Impairment Test of Goodwill</u>

8. The Board proposes a two-step impairment test for goodwill, involving a screening test (step 1) and a test of the implied value of goodwill (step 2). We consider that a two-step impairment test for goodwill is neither necessary nor justified.

9. The application of the screening test is consistent with IAS 36 and ensures that no cash-generating unit (including goodwill) is carried at more than 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 relates firstly to goodwill. The second step of the proposed test (writing goodwill down to its current implied value) is inconsistent with the principle of IAS 36 that assets are written down to recoverable amount. This is explained below in our response to IAS 36 Question 5.

10. We note that the Board acknowledges in the Basis of Conclusions that a one-step test would be less costly, simpler and consistent with IAS 36. We agree. 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.

11. We also note that the proposals draw on certain aspects of US GAAP, and explain below (in our response to ED 3 Question 5) why the result is an unsatisfactory hybrid between fair values and value-in-use.

Identified Intangibles

12. In principle, we believe that the identification of intangibles acquired in a business combination enables users of financial statements to better understand the economics of the transaction, and provides a basis for management to subsequently explain their stewardship of those assets. This components approach also facilitates a more reasoned estimation of the useful life of each identified intangible asset, and is thus more reliable than an approach under which all non-separable intangible assets are simply subsumed within goodwill.

13. However, there are a number of issues on which the Board appears to have taken insufficient account of experience of applying the equivalent standards in the USA. The 'indicative' list of identified intangibles has been applied very literally in the US, often to immaterial items, and in practice it has been very difficult to identify separately assets such as trade dress, order or production backlog, customer relationships (both contractual and non-contractual) and databases. These "softer" assets are invariably difficult to consider in isolation. Moreover, the inability to separate one intangible from another related intangible can lead to duplication of values, particularly in the area of customer-related intangibles. These issues are considered in more detail below in our response to IAS 38 Question 3.

Contingent Liabilities

14. The Board proposes that contingent liabilities acquired in a business combination should be fair valued and argues that their fair values are generally measurable. This differs from the approach of IAS 37 whereby contingent liabilities are not recognised unless their existence is probable ***and*** their value measurable. The Board has stated that it will reconsider the approach of IAS 37, and the definition of a liability, as part of its 'Concepts project'.

15. We agree in principle that contingent assets and liabilities should be recognised in financial statements at fair value. However, we do not agree with the proposal in ED 3 to fair value contingent liabilities outside of the wider scope of the Concepts project. We strongly believe that it would be confusing to recognise and measure contingent liabilities on two different bases. Consequently, the Board should continue to recognise contingent liabilities in a business combination in accordance with IAS 37 until that standard is amended as part of the Concepts project.

16. We would have similar concerns if, as part of Phase II and in advance of the Concepts project, contingent assets were similarly dealt with on a basis that is inconsistent with the requirements of IAS 37. We strongly believe that the changes to the accounting treatment of contingent assets and liabilities should be introduced simultaneously, and that the accounting should not depend on whether recognition takes place as a result of a business combination.

In-process Research and Development (IPR&D)

17. We do not support the proposal to fair value IPR&D where this leads to divergence in the subsequent accounting treatment of IPR&D acquired in a business combination (which is initially at fair value) and other IPR&D, recognised in accordance with IAS 38.

18. The Board has indicated that IAS 38 may be revised, but not as part of this project. Consequently, we consider that IPR&D acquired in a business combination should continue to be recognised in accordance with IAS 38 (and therefore mostly subsumed within goodwill) until such time as IAS 38 is revised.

Phasing of the Business Combinations Project

19. The publication of ED 3 and amendments to IAS 36 and IAS 38 represent Phase I of the Board's project on business combinations. We understand that Phase II of the project will address accounting areas that have been scoped out of Phase I, such as common control transactions, contingent assets and accounting for minority interests.

20. Companies should not have to first change to a Phase I standard and then - before 2005 - to a potentially different Phase II standard. We therefore urge the Board not to proceed to an International Financial Reporting Standard (IFRS) based on Phase I of the project before it has published its proposals on Phase II and sought comment on the overall package. Based on the information published to date, we have concerns regarding the Board's work on Phase II, especially the proposal to gross-up goodwill and minority interests by notional amounts. We look forward to commenting on the Board's detailed proposals.

21. It is also essential that key issues deferred until Phase II are addressed in time for implementation in 2005. We refer in particular to consideration of fresh start accounting and the accounting treatment of common control transactions and by joint ventures. Failure to address these key issues on a timely basis may undermine comparability and damage the credibility of the Board's standards.

ANSWERS TO IASB QUESTIONS

ED 3 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?

22. We support the scope exclusions and revised definitions and guidance. However, based on the information released by the Board regarding Phase II of the project, we have significant concerns over the proposed accounting treatments of transactions involving changes in minority interest. In order to ensure consistency, we believe that the Board should not proceed to an IFRS based on Phase I before it has published its proposals under Phase II and sought comment on the overall package.

23. It is also essential that key issues deferred until Phase II are addressed in time for implementation in 2005. We refer in particular to consideration of fresh start accounting and the accounting treatment of common control transactions and by joint ventures. Failure to address these issues on a timely basis may undermine comparability and damage the credibility of the Board's standards.

24. It is not clear that a new shell holding company formed to hold shares in an existing holding company, the shares of which are held by the previous owners of that holding company, would fall within the common control scope exemption. Control continues to rest with the shareholders of the former holding company such that no acquisition has occurred, and no acquirer can be identified. This issue should be addressed in the IFRS.

ED 3 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?

25. We agree with the elimination of the pooling of interests method on pragmatic grounds. In our view, instances of true mergers do exist but are very rare. Accordingly, we consider that the risk of acquisition accounting being applied where no acquirer exists is outweighed by the benefits of introducing a more certain and consistent approach around the world to accounting for business combinations.

26. We are not certain at present that 'fresh start accounting' would provide a meaningful alternative to the pooling of interests method. Paragraphs BC31 and BC33 of ED 3 identify the absence of fair values as a serious failing of the pooling of interests method. However, this is more a criticism of historical cost accounting generally. Further, we assume that fresh start accounting would fail to provide users of the financial statements with comparable performance data on a combined basis. We look forward to assessing the merit of the Board's proposals on this issue.

ED 3 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?

27. We agree with the description of circumstances in which reverse acquisition treatment is appropriate, and welcome the additional guidance.

28. We note that it is possible to construct a fact pattern in which, although control passes to the legal subsidiary, the existence of common shareholders means that majority shareholders in the legal parent retain the largest shareholding in the combined group. This is relevant to the guidance on identifying an acquirer. We would be willing to supply an example of this fact pattern to the Board.

ED 3 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?

29. We agree with the proposals in the context of two entities combining. As indicated in the answer to Question 1 above, we consider that the addition of a shell holding company to a single existing holding company should fall under the common control scope exclusion, and that the ED is unclear on this point. Where a new company is formed to effect a business combination of more than two entities, it may be very difficult in practice to identify an acquirer since no single entity attains overall control. The IFRS should provide clear guidance for such situations.

30. In addition, paragraph 22 does not explain how the new entity should account for the company deemed to be the acquirer. We assume that if A effectively acquires B through entity C, C should treat B as an acquisition but would account for A as a common control transaction. The IFRS should provide clear guidance on this issue.

ED 3 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?

31. We agree that provisions should be allowed only where they are recognised in accordance with IAS 37. However, we consider that where provisions are included on this basis, there should be disclosure of subsequent movements on individual classes of provision. This is necessary to identify instances where there are offsetting movements in old provisions that are no longer required and new provisions arising post-combination.

ED 3 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?

32. We agree in principle that fair values can be determined for both contingent assets and contingent liabilities and that identified contingencies will influence the price paid for an acquired entity. In our view, all contingent assets and liabilities should be recognised in financial statements at fair value. However, we strongly believe that the changes to the accounting treatment of contingent assets and liabilities should be introduced simultaneously, and that the accounting should not depend on whether recognition takes place as a result of a business combination. Accordingly, we do not agree with the proposal in ED 3 to fair value contingent liabilities outside of the wider scope of the Concepts project.

33. Paragraph BC84 confirms that contingent liabilities identified in a business combination and measured at fair value will continue to be measured at fair value after the business combination. Other contingent liabilities will be measured in accordance with IAS 37 and will therefore be subject to an additional "probable existence" criterion. Paragraph BC82 explains that the recognition criteria applying to liabilities and contingent liabilities will occur in the future as part of the Concepts project, but not as part of this project.

34. We believe it is confusing to have contingent liabilities recognised and measured on two different bases. Consequently, the Board should continue to recognise contingent liabilities in a business combination in accordance with IAS 37 until that standard is amended as part of the Concepts project. We would have similar concerns if, as part of Phase II and in advance of the Concepts project, contingent assets were dealt with on a basis that is inconsistent with the requirements of IAS 37.

35. We are also concerned that there will be instances where the fair value of a contingent asset or liability will be unreliable. For example, on the acquisition of a tobacco company there may not be any other party willing to take on the risk of legal defence against health claims.

ED 3 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?

36. We agree that minority interests should be measured initially by the acquirer at the fair values of the acquiree's identifiable assets and liabilities (but not contingent liabilities, as explained above). We are concerned at this stage at suggestions that, as part of Phase II, minority interests may be grossed-up for notional goodwill. We await publication of the Board's arguments for that approach before commenting in detail.

ED 3 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?

37. We agree that goodwill acquired in a business combination should be recognised as an asset. However, we strongly disagree that all goodwill should be subject to an "impairment only" regime. This approach is appropriate only where two conditions exist: firstly, goodwill can be shown not to have a finite life; and secondly, an impairment test can be shown to be both reliable and justified in terms of cost/benefit.

38. We note the Board's comments in paragraph BC107 that the primary challenge it faced in deliberating the subsequent accounting for goodwill was achieving

an acceptable level of reliability in the form of representational faithfulness, while at the same time striking some balance with what is practicable. In our view, an "impairment only" approach does not achieve this balance, for the following reasons:

- goodwill and identified intangibles, which are similar in nature, will be subject to different accounting treatment. This diminishes comparability and reliability, and, moreover, creates a serious risk of accounting arbitrage;
- there will be instances where the life of goodwill is known with a high degree of probability not to be indefinite, for example goodwill arising on the acquisition of new technology businesses;
- impairment tests are complex and subject to a high degree of subjectivity and uncertainty such that they are no less arbitrary than amortisation over a finite life. In practice, the continued identification of acquired goodwill is highly problematic, particularly following the restructuring and combination of existing businesses; and
- the cost of impairment tests may not be justified, particularly in the case of many unquoted entities where the tests are likely to convey little useful information to users of their financial statements. It is more important for companies to disclose at the time of an acquisition the key assumptions made regarding the acquiree's competitive position, the integration process and related synergies and other benefits and the sustainable future cash flows, and to subsequently report progress against these assumptions. Significant changes to the position will result in an adjustment to the carrying value of goodwill in the financial statements.

39. We also note that impairment-only effectively permits capitalisation of internally-generated goodwill. This is prohibited by the Framework and, moreover, results in a lack of comparability between the financial statements of acquisitive companies and those growing without recourse to acquisition. We urge the Board to undertake at an early date a comprehensive review of the approach to accounting for intangibles generally. Until this issue is resolved satisfactorily this conceptual weakness further undermines the case for imposing annual impairment on all reporting entities without an assessment of the costs and benefits involved.

40. We believe that "impairment only" should apply where the life of goodwill is difficult to assess, and, moreover, the annual impairment tests are both feasible and cost effective. In practice, the focus of analysts is larger listed companies, and we recognise that in this context accounting information generated by appropriate annual impairment testing has more predictive value - albeit, generally of a confirmatory nature - than goodwill amortisation charges. However, any benefit of annual impairment testing to users of the financial statements of most smaller companies - both quoted and unquoted - would be heavily outweighed by the cost and effort involved. We therefore strongly recommend that the Board permits amortisation over a finite life on clearly-defined cost/benefit grounds.

41. We recognise that it is not uncommon for goodwill to represent either an overpayment for the acquired business or expected synergies that prove, in the event, to be unrealised. Accordingly, where a policy of amortisation is adopted, we recommend that the reporting entity is required to test the value of goodwill for impairment at the end of the first full financial year following an acquisition. Entities would continue to assess at each balance sheet date whether there is any indication that goodwill is impaired.

ED 3 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?

42. We agree that negative goodwill creates a gain, closely resembling the gain arising on the revaluation of an asset. In principle we support retention of the current guidance in IAS 22:61 that - where an element of the gain is shown to be related to future losses - recognition in the income statement should be deferred. However, we recognise that this may provide opportunities for profit smoothing, and therefore on balance we accept the accounting treatment proposed in the exposure draft.

ED 3 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?

43. We agree with the basic proposals, but see little merit in limiting the hindsight period to a strict 12 month period following acquisition, rather than to the end of the first reporting period (interim or final) that ends more than one year after the acquisition. We recommend that the Board adopts a less rigid approach.

44. We note that paragraph 64 carries forward the IAS 22 requirement for a specific element of goodwill to be expensed when income tax carry-forwards, which were not recognised as deferred tax assets at the time of acquisition, are subsequently realised. We do not agree with this exception to the general approach to adjustments to initial accounting, and note that it is to be reconsidered as part of Phase II (BC 132). We also find this application of strict matching to be inconsistent with the general approach to impairment of goodwill, which avoids a write-down where the ***current*** implied value of goodwill is no lower than carrying value.

IAS 36 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?

45. We agree that annual testing is appropriate, but do not consider that testing for impairment other than at the balance sheet date is consistent with the principle set out in IAS 36 that assets are not carried at more than their recoverable amount.

IAS 36 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?

46. We agree with the proposal.

IAS 36 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?

47. We agree with the proposals, except that we consider that there is too little guidance in the ED (including in Appendix B) on the choice of discount rate, which remains the single most subjective - and hence unreliable - factor in an impairment test. In this respect, while proposed paragraph 25A(d) and (e) point to relevant factors, the amendments offer no additional practical help on how to translate the factors into reliable or consistent discount rates. Whilst prescriptive or lengthy guidance should be avoided, we believe that preparers would benefit from the provision of additional, basic guidance on, for example, the circumstances in which use of the WACC is appropriate.

IAS 36 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?

48. We agree with the proposals.

IAS 36 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?

49. We consider 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 than 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. Further, a requirement for a one-step test is consistent with the approach to testing other intangibles for impairment, reducing the scope for accounting arbitrage.

50. 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:

- where the impairment of goodwill based on its implied value (step 2), say 20, is less than the impairment identified in the screening test (step 1), say 100, then the second step serves only to allocate the impairment between goodwill (20) and other assets (80) and, due to the inclusion of internally generated goodwill within implied goodwill, results in other assets being written down to less than their individual recoverable amount;
- where the impairment of goodwill based on its implied value (step 2), say 120, is greater than the impairment identified in the screening test (step 1), say 100, then the write-down of goodwill to implied value results in the cash generating unit being carried at 20 less than its recoverable amount.

51. We note that the Board acknowledges in the Basis of Conclusions (C47) that a one-step test would be less costly, simpler and consistent with IAS 36. We agree. 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.

52. We note that the proposals draw on certain aspects of US GAAP, but the result is an unsatisfactory hybrid between fair values and value-in-use. In the case of US GAAP, other assets will have been individually tested under either SFAS 144 or 142 for impairment prior to testing goodwill. The equivalent step 1 screening mechanism, based on the fair value of a business unit, serves only to check whether step 2 needs to be undertaken and does not quantify the impairment write-down. By comparison, the Board's proposal requires step 1 to reflect the full rigour of calculating value-in-use, and quantifies the total impairment based on value-in-use, making the step 2 process unnecessary and potentially causing a misstatement of other assets.

53. We are concerned that the Board appears to have drawn insufficiently on the experience in the USA of applying their equivalent standards. We address this aspect further in our answer to IAS 38 Question 2.

54. If our suggestion that a one-step impairment test is preferable is accepted, the Board might also consider the merit of including a requirement to value pre-existing goodwill when an acquired business is combined with an existing business, as is the case in the current UK standard on impairment (FRS 11, paragraphs 50-53).

IAS 36 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?

55. We agree with the proposal on pragmatic grounds.

IAS 36 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?

56. We recognise that the level of disclosure proposed in ED 3 and the amendments to IAS 36 and 38 is high. However, on balance we consider that the cost of providing the prescribed information is likely to be outweighed by the benefit to analysts and other users of the financial statements. Nonetheless, the volume of detail required is likely to obscure points of substance; we recommend that the Board encourages appropriate aggregation of information wherever this improves comprehensibility, not only on the grounds of materiality.

<u>IAS 38 Questions</u>

IAS 38 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?

57. We agree with the criteria.

IAS 38 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.

58. We do not support the proposal to fair value IPR&D where this leads to divergence in subsequent accounting treatment between IPR&D acquired in a business combination (which is initially at fair value) and other IPR&D, which is recognised in accordance with IAS 38. The Board indicates in the Basis of Conclusions (B45) that IAS 38 may be revised, but not as part of this project. Consequently, we consider that IPR&D acquired in a business combination should continue to be recognised in accordance with IAS 38 (and therefore mostly subsumed within goodwill) until such time as IAS 38 is revised.

59. In principle, we believe that the identification of intangibles acquired in a business combination enables users to better understand the economics of the transaction, and provides a basis for management to subsequently explain their stewardship of those assets. This components approach also facilitates a more reasoned estimation of the useful life of each identified intangible asset, and is thus more reliable than an approach under which all non-separable intangible assets are simply subsumed within goodwill. However, we do not accept the contention that it is always possible to measure the fair value of intangibles reliably. The proposed amendments to IAS 38 are not consistent on this point: paragraph 30 states that sufficient information should always exist to measure reliably the fair value of identifiable intangibles, whereas paragraph 38 (in the context of exchanges of assets) acknowledges - correctly, in our view - that in some circumstances reliable fair values cannot be determined.

60. There are also a number of issues on which the Board appear to have taken insufficient account of experience of applying the equivalent standards in the USA. These issues are addressed in detail in the following paragraphs, and cover:

- the adequacy of implementation guidance;
- materiality;

- the difficulty of identifying certain assets and the risk of double-counting; and
- the initial assessment of fair value.

Adequacy of implementation guidance

61. Significant difficulties have arisen in the application of SFAS 141 and 142 as little guidance was issued by the FASB at the time that the standards were issued. These difficulties are evidenced by the many questions which have been put to the FASB since the issue of the standards, requesting clarification of certain issues and guidance on how certain provisions in the standards should be implemented. Numerous pronouncements have subsequently been issued by the FASB as a result of these questions. We do not advocate the publication of extensive guidance seeking to address issues which should be resolved through the exercise of judgement. However, it may be appropriate for the Board to consider issuing at an early stage at least some basic guidance on some of the key provisions of the proposed new standards.

62. In addition to the guidance issued by the FASB subsequent to the issue of the US standards referred to above, further guidance on the valuation aspects has been issued by the AICPA. In January 2002, the AICPA issued a Practice Aid document covering the valuation of IPR&D in the pharmaceutical and high-tech industries. This document covers valuation principles, valuation theory and valuation methodology. It has subsequently been adopted in the US as "best practice" for all valuations related to purchase price allocation. Some of the more useful points might be included in the implementation guidance issued by the Board.

Materiality

63. 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 concept of materiality is not addressed by the US standards, and accordingly some companies have devoted considerable resources to identifying and valuing immaterial intangible assets that appear on the SFAS 141 list.

64. The Board should make it very clear that the list of intangibles is suggestive only and is in no way mandatory or comprehensive. The focus of the reporting entity should be the recognition and valuation of intangibles - generally few in number - that are material and were taken account of when the acquisition price was determined. The initial accounting should be adjusted during the hindsight period for any material intangibles first identified after an acquisition is complete.

Difficulty of identifying certain assets and the risk of double-counting

65. In practice, it has been very difficult to identify separately assets such as trade dress, order or production backlog, customer relationships (both contractual and non-contractual) and databases. 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 – the shape of the *Coca Cola* bottle is legally protected, but how does it generate value without the associated trademark?

66. Moreover, the inability to separate one intangible from another related intangible can lead to duplication of values. In order to value an intangible asset, it is necessary to identify the cash flows associated with that asset. 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.

67. This is particularly true in the area of customer-related intangibles. A customer list may be bought or sold, provided that there are no restrictions attaching to it. Such transactions occur fairly frequently in the market place and are easily valued by reference to the future income that the owner expects to generate from those customers. However, the business might also have contracts and other relationships with those customers and an order backlog from those customers. In these circumstances the same cash flows may inadvertently be counted twice - or more often. Customers only generate one income stream, yet it may be recorded for valuation purposes under each of the asset types. 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.

The initial assessment of fair value

68. We consider that the draft guidance in IAS 38 (paragraphs 29-35) on ascribing fair values to intangibles could be subject to differing interpretation where a company purchases as part of a business combination an intangible asset which it does not intend to use. For example, it would be possible to determine a fair value for a trade name attaching to a chain of retail stores offered for sale. If a potential bidder decided to re-brand the stores under its own name if its bid was successful, the brand would have no value-in-use and we assume that this would lead to an immediate impairment charge under IAS 36. On a fair value basis, the brand would similarly lose value as it is not maintained. The Board should clarify the approach required under IAS 38 in such circumstances, including the relevance of any entity-specific factors that might affect the nature and valuation of the intangibles recognised by the acquirer.

69. We also assume that impairment would be unavoidable where the acquiring business already has relationships with customers of the acquiree. The acquired asset would be ascribed a full value, yet the value-in-use to the acquirer is only

the value of the incremental revenues it expects to achieve by putting the two businesses together. The differences between fair value and value-in-use, whether positive or negative, emerge when assets are tested for impairment. This further highlights the difficulty of mixing fair value and value-in-use bases within the impairment tests.

IAS 38 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?

70. We agree with this proposal.

IAS 38 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)?

71. We agree with this proposal.

IAS 38 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?

72. We agree with this proposal.

OTHER DETAILED POINTS

Transitional rules

73. Under the Board's proposals for first-time application, a company prevented by national GAAP from separately recognising certain identifiable intangibles is required to continue to include such intangibles within goodwill and accordingly to subject them to the impairment testing routine. In some cases, such intangible assets may have a clearly-finite life. We consider that such companies should be permitted to reclassify such goodwill as an identified intangible asset. We welcome reports of discussions at the March meeting of the Board which appear to lend support to this position.

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