CL 105

DOVEBID®-BACHE
Valuation Services

March 25, 2003

Ms. Annette Kimmitt
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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Ms. Kimmitt:

Response to Invitation to Comment on ED 3 *Business Combinations* and Exposure Draft of Proposed Amendments to IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*

We appreciate the opportunity to provide comments, which we set out below, on the International Accounting Standards Board (IASB) exposure drafts related to its Business Combinations project. Before beginning our comments, it is probably useful to provide a brief background on DoveBid Valuation Services. This should clarify our perspective as well as confirm our qualifications.

DoveBid Valuation Services values businesses, as well as tangible and intangible assets for transaction pricing, financial and tax reporting, and secured lending purposes. We have extensive experience with valuations prepared for U.S. generally accepted accounting principles (U.S. GAAP), such as purchase price allocations and goodwill impairment reviews. While we deal with accounting issues as an integral part of many of our engagements, we are not an accounting firm. We focus our comments, therefore, on valuation-related issues, as well as providing our opinions on enhancing the usefulness of financial statements to users.

EXPOSURE DRAFT ED 3 *BUSINESS COMBINATIONS*

Question 2 — Method of accounting for business combinations

We welcome the abolition of the pooling-of-interests method in accounting for business combinations. The existence of two methods to account for business combinations inhibits comparability, and creates an incentive to structure transactions to secure a particular accounting result.

There is anecdotal evidence, from press reports as well as from preparers, that the ability to secure pooling-of-interests treatment affected how transactions were evaluated and priced. An example is the frequent comment, both in the press as well as in testimony before the Financial Accounting Standards Board (FASB), that Lucent delayed its

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acquisition of Ascend in order to secure pooling-of-interests treatment. Finance theory suggests that different accounting treatments should have no impact on value or on the evaluation of an acquisition because they do not change cash flow. In practice, considerable effort has been devoted to securing pooling-of-interests treatment.

The pooling-of-interests method, and the fact that it does not cause acquired assets to be measured at fair value, has meant that financial statements do not properly reflect the value of assets under management's stewardship. This limits the ability of investors to evaluate management's performance.

We recognize that the usefulness of the purchase method has been negatively affected in the past by the requirement to amortize purchased goodwill over what was essentially an arbitrary period. With goodwill to be no longer amortized, we believe that the purchase method is enhanced.

The use of the purchase method provides fair value information to users, which is more relevant than the carry forward of historical cost information provided by the pooling-of-interests treatment.

Despite the difficulty in identifying the acquirer in certain circumstances, we believe that the purchase method provides better information than pooling-of-interests in all circumstances.

Question 7 — Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

We believe that assets, liabilities, and contingent liabilities should be recorded at fair value rather than the benchmark approach allowed under IAS 22. The ability to choose one of two methods under IAS 22 impairs the comparability of financial statements. The recording of assets as a combination of fair value and historic cost, based on the percentage owned by an acquirer versus a minority interest, does not provide useful information to users of financial statements.

Question 8- Goodwill

We believe that goodwill qualifies as an asset, and that it should be recognized at acquisition and tested for impairment annually. In our experience, goodwill amortizations do not provide meaningful information to investors and are often adjusted for (effectively ignored) in evaluating a stock for investment. Continuing amortization of such items would decrease the attention paid by investors to net income, and increase relia nce on less regulated pro-forma results. An impairment, even when already reflected in a company's stock price, provides information to users of financial statements.

We recognize that some of the recent impairment charges recorded by companies reflect not only disappointing operating performance, but also the fact that some of these acquisitions were paid for in stock, whose value may have been inflated because of investors' "irrational exuberance." As management is able to influence but not control stock values, some impairment charges may reflect prior unrealistic expectations of shareholders rather than solely poor stewardship of assets by management.

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 our experience, negative goodwill often results from mistakes in measuring the identifiable assets. We believe that actual bargain purchases are rare in active markets. We, therefore, welcome the IASB's position that the first step when negative goodwill is identified, should be to reassess the identification of assets and liabilities. That said, where a bargain purchase is found to exist, immediate recognition of the gain in the same period as the transaction that generated the gain, is appropriate.

EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 36 IMPAIRMENT OF ASSETS

Question 1 Frequency of impairment tests

We believe that the requirements in respect of the frequency of testing of goodwill and intangible assets with an indefinite life are appropriate.

Question 3— Measuring value in use

Financial theory would indicate that discounted cash flow (DCF) techniques should be used to evaluate proposed transactions. However, approaches with this rigor are not universally applied. As a result, we believe that one of the unspoken benefits of the proposed standards is that it may increase the thoroughness of management in pricing and evaluating deals. Because such information will need to be considered for accounting purposes, it may ensure that such information is considered by management in evaluating a transaction.

(a)

We believe that flexibility should be allowed in reflecting uncertainties in either cash flows or the discount rate. However, in our experience, the expected cash flow approach described in Appendix B, which uses a cash flow that has been adjusted for uncertainty, is very rarely applied in practice.

(b)

We believe that, as a matter of best valuation practice, past actual cash flows and management's past ability to forecast accurately should be considered in evaluating the reasonableness of cash flow forecasts. However, there may be circumstances when this is not practical, for example, entry into new markets and new management. We regard this as a valuation implementation issue that does not need to be explicit in a standard. We believe that it is very important that any forecasts used to value intangible assets should be consistent with what was used to evaluate and price a transaction (subject to possible adjustment for fair value considerations).

(c)

We believe that it is important that the IASB, either directly or through agreement with another body such as the International Valuation Standards Committee (IVSC) should provide implementation guidance on valuing intangible assets. This will facilitate the consistent valuation of assets as well as providing a framework which auditors can use to review value conclusions. We believe that an appendix to the IAS is not the best mechanism for distributing such guidance.

Consistent with FASB Concept Statement 7, Appendix B of the proposed amendment to IAS 36 recommends use of the expected cash flow approach. We have rarely, if ever, seen this approach applied in practice, a view consistently expressed in discussions we have had with members of the Big 4. In particular, appraisers often find it difficult to get a single cash flow estimate from a client, never mind a fully comprehensive probability weighted cash flow. While clients often use a discounted cash flow to price deals, they do not use expected cash flows. The use of such an approach would, therefore, not be consistent with how deals were priced by registrants' management or boards.

The proposed standard requires the use of pre-tax cash flows (ED on IAS 36, para. 43). In our experience, companies and appraisers invariably use after-tax cash flows in valuing businesses and assets. Use of pre-tax cash flows would be inconsistent with the objective of using the same approach to price a transaction, as well as on which to base the accounting.

Question 5 —Determining whether goodwill is impaired

We believe that the approach to testing for and measuring impairment is appropriate. Based on our actual experience implementing similar U.S. regulations, it can be successfully applied in practical situations, at reasonable cost.

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

We are concerned that publishing detailed assumptions may expose preparers to legal sanction, when, as inevitably happens, performance does not meet the forecast. However, we acknowledge that disclosure is important to evaluate the reasonableness of approach used, assuming that assessing the reasonableness of such forecasts has not been delegated to auditors.

Para 144 (e) (iv) provides that for each key assumption, management must disclose the amount by which the key assumption must change in order for the aggregate recoverable amount to equal the aggregate fair value. We understand that this provision seeks to allow users of financial statements to understand how sensitive the impairment analysis is to individual variables, and to allow users to consider the reasonableness of the main assumptions. However, we believe that this could prove unworkable in terms of the level of information that would need to be provided, and that disclosure of the key assumptions required under Para 134 (e) (i) would be sufficient.

The requirement to disclose the change in weighted average growth rate under Para 134 (e)(v) does not appear to reflect the effect of discounting. Thus, the weighted average growth rate for annual growth rates over a six-year period of 100 percent, 100 percent, 50 percent, 50 percent, 25 percent and 25 percent in years 1-6, respectively, is 55 percent. Equally, the weighted average growth rate for annual growth rates over a six-year period of 25 percent, 25 percent, 50 percent, 50 percent, 100 percent and 100 percent in years 1-6, respectively, is also 55 percent but the effect on value is very different.

The proposed disclosure of such large amounts of information means that, in effect, the rules are approaching a requirement to publish the actual forecasts, which we believe is inappropriate. We believe that greater attention should be focused on ensuring that forecasts and approaches are reasonable, which can be achieved in part by increased training for preparers, auditors and regulatory bodies, as well as by providing detailed implementation guidance.

EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 38 INTANGIBLE ASSETS

Question 1 - Identifiability

We believe that the separability and contractual/other legal rights criteria are appropriate. Having developed significant experience with applying the similar provisions under U.S. GAAP, we find this rule to be relatively easy to apply in practice.

We believe that it would be useful for the standard to include a list of qualifying intangible assets similar to the list in SFAS 141. This would assist auditors in reviewing purchase price allocations prepared by preparers. It would also reduce uncertainty over what are qualifying assets, and possible arguments by preparers that certain items are not qualifying intangible assets.

Question 2 — Criteria for recognizing intangible assets acquired in a business combination separately from goodwill

We believe that, in most circumstances, sufficient information will exist in a business combination to reliably measure intangible assets. The Board might consider providing disclosures that highlight to the users of financial statements that the values attributed to intangible assets tend to be more volatile than the values attributable to tangible or current assets (though those latter assets are also subject to, often substantial, write-down in the event of decline of performance, reorganization or bankruptcy)

Question 3 Indefinite useful life/
Question 5 — Non-amortization of intangible assets with indefinite useful lives

We believe certain intangible assets should not be amortized. For example, trademarks, when adequately supported, often increase rather than decrease in value. The use of an arbitrary approach to amortize such an asset would be unattractive for the same reasons that amortizing goodwill is unattractive, e.g., it leads to arbitrary charges, which are ignored by users, and reduces the reliance placed on traditional net income measures in favor of pro-forma reporting. However, given the incentives that exist to classify an intangible asset as indefinite lived, in terms of eliminating ongoing amortization, it is important to emphasize that the fact that a life may be difficult to estimate does not mean that an intangible asset has an indefinite life.

Question 4 Useful life of intangible assets arising from contractual or other legal right

We believe that there are arguments for and against including renewal periods in valuing an asset. In particular, in pricing a transaction, a company is likely to have considered the issue of renewal for material assets. In pricing a transaction, management has assumed that an asset would be renewable, but because evidence for renewal does not exist in a form acceptable to a company's auditor, such renewal is not included in valuing the asset, and the value attributed to the asset for accounting purposes will not match the value attributed by management. This is contrary to our view that the approach used to account for a transaction should, as much as possible, be consistent with the approach used to value a business and its assets for transaction pricing.

OTHER

Determining the Cost of a Business Combination

ED 3 proposes that the published price at the date of exchange be used to value quoted equity instruments issued in a business combination. This differs from current U.S. guidance which states that the value to be used be based on the market price for a reasonable period before and after the date that the terms are agreed to and announced.

Where the stock price is volatile, as is the case for many stocks currently, or where there is a significant time between the date of announcement and the closing date, the stock price will differ between these two approaches and these differences may be material. Having worked on several projects where a U.S. registrant has been required to record a transaction at an announcement date price that substantially exceeded the price at the closing date, when the fair value of the acquired assets is much lower, we believe that the approach in ED 3 is appropriate.

It is possible to argue that the price at announcement best reflects the "market's view" as to the value of the business to be acquired and that subsequent price movements may reflect other factors at the acquiree. However, it is generally the case that the fair value of the acquiree would also be affected by many of these same factors (i.e. many of the changes in a stock's price are based on market or industry factors rather than company-specific factors). Also, given that the acquiree's shareholders do not sell or transfer their shares until the exchange date, it is likely that they base their final acceptance decision on the value at, or immediately prior to, the date of exchange.

Recognition of Contingent Consideration

The proposed standard appears to advocate the recognition of contingent consideration that is dependent on performance criteria more liberally than is done under U.S. GAAP. This would seem to be consistent with the valuation of intangible assets, as explained before.

The valuation of intangible assets is generally based on a forecast of expected future cash flows. These cash flows will usually indicate whether the performance criteria for the contingent consideration will be met. Therefore, if one assumes that the forecasts are sufficiently reliable to value the contingent consideration, they are presumably equally reliable to base a calculation of contingent consideration.

Inclusion of Profit Margin on Future Activities

Para B 15(d) of Exposure Draft (ED) 3 indicates that inventory is to be valued after deduction of a reasonable profit allowance. I note that in valuing intangible assets under the standard adjusted discounted cash flow method, no profit margin is deducted. This is an apparent inconsistency.

Implementation Guidance

While there have been requirements to identify intangible assets in IASB for some time, the additional guidance given in the proposed new standards, as well as the expected increase in the number of companies that produce IASB-compliant financial statements, will lead to a significant increase in the requirement to value intangible assets.

We anticipate that there may be difficulties in practice in securing sufficient qualified appraisers of intangible assets. In the U.S., such requirements have long existed and been enforced. As a result, businesses have developed with the requisite valuation expertise. This may not apply in all areas which adopt IFRSs.

We believe that additional guidance should be provided, but do not believe that such valuation guidance should form part of the proposed standards. We note that the American Institute of Certified Public Accountants has released a practice aid on valuing intangible assets, especially in-process research and development (IPR&D), to establish consensus and implementation guidance in this area. We believe that IASB should consider a similar step.

We also note that the success of the standard will depend on how it is enforced in practice. We believe that the increase in U.S. compliance with the need to break out intangible assets separately has been the result of pressure from the Securities and Exchange Commission, as regulator. We are concerned that inconsistent application of these rules, particularly given the subjectivity implicit in valuing intangible assets, will lead to comparability problems across jurisdictions.

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Please feel free to contact the undersigned to address any of the issues raised in this response.

Yours faithfully

James Calvert

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