

**ABI RESPONSE TO
INTERNATIONAL ACCOUNTING STANDARDS BOARD

EXPOSURE DRAFT 3: BUSINESS COMBINATIONS
AMENDMENTS TO IAS 36 (IMPAIRMENT OF ASSETS)
AND IAS 38 (INTANGIBLE ASSETS)**

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ABI RESPONSE TO ED3: BUSINESS COMBINATIONS AND AMENDMENTS TO IAS 36 (IMPAIRMENT OF ASSETS) AND IAS 38 (INTANGIBLE ASSETS)

1 EXECUTIVE SUMMARY

1.1 Issues Raised by the IASB

- 1.1.1 Exposure Draft 3 requires all business combinations within its scope to be accounted for by applying the purchase method. This requires an acquirer to be identified for every business combination, this being the combining entity that obtains control of the other combining entities or operations.
- 1.1.2 The acquirer must measure the cost of a business combination as the aggregate of the fair value at the date of exchange of assets given, liabilities incurred, and equity instruments issued in exchange for control of the acquiree plus any related costs.
- 1.1.3 The acquirer must recognise separately at the acquisition date the acquiree's identifiable assets and liabilities (ie those meeting the IASB definition of "asset" and "liability"), intangible assets as defined in IAS 38, and contingent liabilities if their fair value can be measured reliably.
- 1.1.4 Goodwill resulting from a business combination must be recognised by the acquirer as an asset initially measured as the excess of the cost of the business combination over the acquirer's interest in the net fair value of the acquiree's assets and liabilities that are recognised.
- 1.1.5 Amortisation of goodwill in a business combination is no longer permitted. Instead goodwill must be tested for impairment annually or, where appropriate, more frequently in accordance with IAS36 (Impairment of Assets).
- 1.1.6 If the fair value of the net assets acquired exceeds the cost of the business combination, the acquirer must reassess both elements. Any excess remaining after that reassessment must be recognised by the acquirer immediately in profit or loss.
- 1.1.7 Sufficient disclosure must be provided to enable users to evaluate the nature and financial affect of business combinations, and to evaluate changes in the carrying amount of goodwill during the reporting period.

1.2 Key ABI Response Points

- 1.2.1 We do not support the requirement for all business combinations to be accounted for by applying the purchase method. While in the vast majority of cases this will be the most appropriate method, there may be some circumstances where there is a true merger of equals. In this case it will be difficult to identify an acquirer. Compliance with ED3, may therefore necessitate the introduction of a degree of artificiality.

- 1.2.2 There is an inconsistency between the requirement of ED3 to recognise the fair value of contingent liabilities in a business combination and the requirements of ED 37.
- 1.2.3 While we are generally in favour of a consistent approach, we believe that in many cases the requirement for goodwill to be subject to an annual, or more frequent, impairment test may be unwarranted and will require a considerable amount of additional work with insufficient benefit. Where goodwill clearly has a limited life, amortisation will be more appropriate but subject to an impairment test where conditions are known to have changed adversely.

2 **DETAILED RESPONSE POINTS**

2.1 **IASB Questions and ABI Responses**

Q1 **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?

We agree with the proposed scope exclusions. We are also content with the definitions of business combinations involving activities under common control.

Q2 **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?

While acquisition accounting should be the norm, there have been a number of recent cases in practice involving a true merger of equals where merger accounting has been more appropriate. We believe that the option to adopt merger accounting in appropriate circumstances should remain open. If IASB is concerned about possible abuse, it should define more closely the circumstances under which this accounting basis can be used. In the absence of a merger accounting option, the requirement for acquisition accounting where there is a merger of equals may introduce a degree of artificiality, for example in the need to identify an acquirer, and convey a misleading impression to accounts users of the true nature of the transaction.

In the long run the “fresh start” approach may offer the best solution, although we are aware that some accounts preparers have concerns over the potentially onerous requirement to fair value both parties involved in a merger. We note the Board's commitment to explore in future whether this method might be applied to some business combinations.

Q3 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?

We support the proposals for modifying the circumstances where a business combination could be regarded as a reverse acquisition. We are also in agreement with the proposed additional guidance on accounting for reverse acquisitions.

Q4 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?

We agree with this where acquisition accounting is appropriate, but not where there is a true merger of equals that justifies the adoption of merger accounting.

Q5 Provisions of 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?

We disagree with this proposal. We prefer the current approach in IAS22 as we believe the criteria set out in paragraph 31 of that standard are sufficient justifications for recognising restructuring provisions that were not liabilities of the acquiree.

Q6 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?

ED3 requires the recognition of contingent liabilities in the circumstances of a business combination whereas in other circumstances IAS37 requires only note disclosure. This inconsistency should be addressed. While the reasoning behind this is understood, it raises two potential issues. Firstly, is it correct to recognise a liability that, because an obligation to part with future benefits does not necessarily exist at the balance sheet date, may not satisfy the IASB definition of a liability? Secondly, it may be difficult to fair value such a liability objectively, particularly in the subsequent periods following an acquisition. In practice this will depend on the acquirer's view of how likely it is that the contingent liability will crystallise. We believe the position should be harmonised on the basis of IAS 37.

Q7 Measuring the Identifiable Assets 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?

We agree with this proposal.

Q8 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?

We agree that acquired goodwill should be recognised as an asset and, where its useful life is indefinite or very long-term, be subject to an annual, or where justified more frequent, impairment test. Where goodwill clearly has a limited life however we believe there should be no requirement for an annual impairment test with its attendant practical problems. In these circumstances amortisation would be more appropriate with an impairment test only where justified by circumstances.

Q9 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?

We do not think it would be appropriate to recognise any excess of the fair value of the net assets acquired over the cost of the combination, after reassessment, immediately in the profit and loss account. We think that any transfer to profit and loss account should be deferred for a period of 12 months to allow time for any subsequent adjustments to be made, in particular where the position is initially determined on the basis of estimated figures. This practice would be consistent with that referred to in question 10 below.

Q10 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?

We agree with what is being proposed and consider that a 12 month period would normally be sufficient for completing the accounting of a business combination.

2.2 IAS36 Questions

Q1 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?

We agree that testing should be no more frequent than annually. It would seem logical for the annual impairment test for goodwill acquired in a business combination to be performed at each accounting year end, unless there has been a significant event in the meantime. This would be consistent with the required treatment for intangible assets.

Q2 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?

We agree with this proposal.

Q3 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?**

We agree with what is being proposed.

Q4 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?

- (b) 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?

We agree with what is being proposed.

Q5 **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?

We agree with what is being proposed.

Q6 **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?

We agree that this is appropriate.

Q7 **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 when one or more of the criteria on paragraph 137 are satisfied? If not, why not?

As major portfolio investors, insurers believe the proposed disclosures would be helpful. There will be some concern however over any requirement to disclose information that may be commercially sensitive.

2.3 **IAS38 Questions**

Q1 **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?

We agree that the criteria are appropriate.

Q2 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.

While it will often be the case that sufficient information is available to measure reliably the fair value of material intangible assets, there may be circumstances where this is not the position. In these circumstances it will not be possible with any reliability to show them at fair value separately from goodwill. Examples of this are the acquisition of brands or distribution channels.

Q3 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?

We agree with what is being proposed.

Q4 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)?

We agree that this appropriate.

Q5 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?

We agree with this proposal.