**ED 3 Business Combinations**

***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 definitions and additional guidance helpful in identifying transactions within the scope exclusion? If not, what additional guidance would you suggest, and why?*

**Response**

(a) We believe these business combinations should be addressed, but understand that they will be considered in Phase II of the business combinations project. One area that is currently unclear under the Exposure Draft, is the accounting for goodwill arising on investment in a joint venture which is accounted for using the equity method. This issue is not addressed in IAS 31, Financial Reporting of Interests in Joint Ventures, and is excluded from the scope of the Exposure Draft. However, the transitional provisions of the Exposure Draft do include guidance on how to deal with equity accounted investments. It is not clear whether these apply to joint ventures that are accounted for using the equity method (the alternative treatment allowed under IAS 31). We request the IASB to clarify this matter, either in the Standard resulting from this Exposure Draft or in Phase II of the business combinations project.

We note that, as a consequential amendment arising from the Exposure Drafts in this phase of the business combinations project, it is proposed that the definition of joint control in IAS 28, Accounting for Investments in Associates, and in IAS 31, Financial Reporting of Interests in Joint Ventures, will be changed to require unanimous consent for financial and operating decisions. We consider the requirement for unanimity to be unduly restrictive, as joint control is consistent with the making of decisions based on majority voting for some financial and operating decisions, although major strategic decisions in a joint venture would require unanimous consent.

(b) Yes, it is helpful to have additional guidance.

***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?*

**Response**

While we accept that almost all business combinations take the form of the acquisition of one party by another party, we believe that in certain (rare) instances a business combination genuinely takes the form of a merging of two entities. We believe this to have been the case in a number of large combinations in the UK in the last five years. We acknowledge that eligibility for the pooling of interests method has been open to wide interpretation, and that the considerable difference between acquisition accounting and pooling of interests accounting means that, at the extreme, a borderline decision can have a major impact on the financial statements of the combined entity. Comparability between entities also suffers where similar combinations are treated differently for accounting purposes. However, the requirement that an acquirer must be identified in all combinations brings its own problems of interpretation. Where the decision is not clear-cut, there is scope for selection of an acquirer on the basis of the impact that restating the net assets of one or other of the parties to fair value will have on the initial financial statements of the combined entity.

As we believe that some business combinations are genuine mergers, and that eliminating the pooling of interests accounting method will create problems of identification of an "acquirer" in certain situations, we would prefer that the criteria for application of the pooling of interests method be refined to restrict it to very few situations, rather than ruled out altogether. We believe that the present UK rules on merger accounting would form a pragmatic starting point for this.

The criteria should continue to include requirements for similar respective market valuations of the entities prior to announcement of the combination, and arrangements to ensure that the shareholders of each entity maintain substantially the same voting rights relative to each other. A greater emphasis than currently exists on plans for the management of the combined entity would help reduce the possibility of transaction structures being designed simply to achieve pooling of interests accounting.

***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?*

**Response**

(a) Yes, we agree that this is an appropriate description. As proposed, the power to govern the financial and operating policies of another entity so as to obtain benefits from its activities should be the overriding factor in determining which party is the acquiring entity.

(b) The additional guidance appears to be appropriate.

***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?*

**Response**

The new entity is merely a shell formed for the purpose of effecting a business combination. It is appropriate to look at the economic substance of the combination, using the evidence available, to determine which entity, if any, is, in reality, the acquirer.

However, as noted in our response to Question 3 above, we believe that in certain, rare, circumstances, genuine mergers of equals do occur and a pooling of interests accounting treatment should continue to be available for these situations.

***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?*

**Response**

Treating restructuring provisions differently depending on whether they arise in connection with a business combination or not reduces the internal consistency of the financial statements. We therefore concur with the proposal that the accounting for a business combination should recognise only those provisions which already qualify for recognition in the accounts of the acquired entity under IAS 37 on the acquisition date. Accordingly, any provision for terminating or reducing the activities of the acquiree should be recognised in the accounts of the combined entity and in accordance with the normal requirements of IAS 37.

***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?*

**Response**

Yes, we believe this to be appropriate. However, we are concerned about the inconsistency of treatment when compared with contingent liabilities arising in the acquiring entity prior to the combination and in the combined entity after the combination, none of which will be recognised on the balance sheet. We believe that this inconsistent treatment of items within the same category of liability will impair the quality of the balance sheet, and could well be confusing for users of the financial statements.

***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?*

**Response**

We agree that this is an appropriate method for measuring the minority proportion's interest in the acquiree's identifiable assets and liabilities.

***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?*

**Response**

We agree that goodwill should be recognised as an asset in accounting for a business combination.

We agree that, in many cases, goodwill may be deemed to have an indefinite useful life and that non-amortisation is an appropriate treatment on these grounds. It is also the accounting treatment recently adopted in the USA, and therefore has the benefit of enhancing worldwide convergence.

However, we have concerns that undertaking such tests every year will be an onerous burden for entities which have entered into several acquisitions – or, indeed, one large acquisition which affects many different cash-generating units.

We also believe that, in some cases, acquired goodwill does have a limited useful life. This might be the case, for instance, in acquisitions of entities operating in high technology industries. The goodwill may principally represent an assembled workforce skilled in technologies which, due to the fast-moving nature of the industry, could be expected to become obsolete within five or ten years. After the acquisition, the acquired know-how may be transferred to the combined entity and contribute to development of future technologies, but this process represents the replacement of externally-acquired goodwill with internally-generated goodwill, which should not be recognised on the balance sheet.

For all the above reasons, we believe it would be preferable to retain amortisation of goodwill as an allowed alternative to the benchmark treatment of non-amortisation. A requirement to test amortised goodwill for impairment whenever there is an indication that it may be impaired would ensure that the goodwill is not over-valued, whichever accounting treatment is selected.

This would also provide greater consistency with the accounting treatment of intangible assets, which may be deemed to have finite or indefinite useful economic lives depending on the circumstances of each asset, and therefore be amortised or not accordingly. As it is often difficult to distinguish acquired intangible assets from goodwill, this comparability would remove any incentive to opt for one asset or the other purely on the grounds of allowed accounting treatment.

***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?*

**Response**

We believe that such an excess will usually reflect either an expectation of future losses or a genuine bargain purchase. In the former case, it may be more appropriate to recognise the excess on the balance sheet and release it to the income statement over an appropriate period, reflecting the period over which future losses are expected. In the case of a bargain purchase, the entity has effectively created a gain at the acquisition date by exchanging the consideration paid for net assets of a higher value. In these circumstances it is more appropriate to recognise the excess immediately in the income statement.

In view of these alternative scenarios, a requirement to consider the reasons behind creation of the excess in determining the appropriate accounting treatment could have been a justifiable approach. However, the proposed method has the benefit of simplicity and of comparability of treatment across all relevant business combinations. On balance, we therefore feel that the proposed requirement for immediate recognition in profit or loss is an acceptable approach.

***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?*

**Response**

(a) We would suggest that the maximum time for finalising the accounting should be the period ending with the second year-end after acquisition, rather than twelve months from acquisition. To facilitate further convergence with US GAAP, the option to declare the initial accounting complete prior to this point would be a useful addition to the Standard for entities which reconcile their financial statements to US GAAP.

(b) Yes, any adjustments after completion of the initial accounting should be made only to correct an error.

## Amendments to IAS 36 Impairment of assets

### *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?*

### Response

We agree that, for material amounts of goodwill or material intangible assets, it is appropriate to undertake an impairment test annually, and whenever there is an indication that the goodwill or asset may be impaired. However, we do not understand why there should be less flexibility concerning when indefinite-lived intangible assets are tested in that annual period (at the year-end) than when goodwill is tested (at any point in the year provided there is consistency year-on-year). Where the same cash-generating units contain both intangible assets and goodwill, it would be easier from a practical point of view to carry out tests on both at the same time, and using the same date would provide greater clarity for users of the financial statements. To enhance the relevance of the information in the year-end financial statements, we suggest that the tests should be carried out in the last quarter of the annual reporting cycle. We also have concerns over the materiality threshold for impairment testing. Paragraph 8 states that any goodwill or intangible asset with an indefinite useful life should be tested annually. As impairment tests entail a significant amount of time and effort, we believe that annual tests should be carried out annually only for material items. There should be provision for immaterial items to be tested less frequently, with the proviso that they must always be tested whenever there is an indication that they may be impaired.

### *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?*

### Response

Yes, we believe that this is the appropriate way to test intangible assets with indefinite useful lives for impairment.

### *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?*

**Response**

(a) We agree with the guidance provided, and with allowing a choice of adjusting cash flows or the discount rate to reflect risk.

(b) The projections should take into account past actual cash flows. However, a judgement on management's past ability to forecast cash flows accurately will be highly subjective. We believe that management should be relied upon to make forecasts on a best-estimate basis.

(c) The guidance in proposed Appendix B appears to be appropriate.

***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?*

**Response**

We consider that it is appropriate to allocate goodwill to cash-generating units at a level that is consistent with the lowest level at which management monitors the return on the investment in that goodwill. We also agree with the proposed approach to goodwill on disposal of an operation within a cash-generating unit or on reorganisation of the entity's reporting structure.

***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?*

**Response**

(a) Yes, this is an appropriate method of measuring the recoverable amount of a cash-generating unit.

(b) The first step of the impairment test is a full valuation of recoverable amount. We do not believe it is appropriate to use it as a screening mechanism to decide whether a second step is required. As we comment in (c) below, we believe that the first step is sufficient, and simple assumptions as to the allocation of the impairment loss identified in this step will preclude the need for a second step at all.

As the Board acknowledges, the test proposed allows internally-generated goodwill to shelter acquired goodwill. Both contribute to the recoverable amount of the cash-generating unit, but only acquired goodwill is recognised in the carrying amount to which recoverable amount is compared. While we appreciate the difficulty in isolating internal goodwill, we do believe that it is possible at least to take account of goodwill generated internally prior to the acquisition date, by assessing its fair value at the time of the acquisition and adding a notional amount to the carrying amount of the cash-generating unit for the purpose of subsequent impairment testing of the acquired goodwill. This is the approach taken by the UK's FRS 11. Unfortunately it is not consistent with the approach used in US GAAP. We would ask the IASB to work with the FASB towards convergence on a more robust test.

In some circumstances, a cash-generating unit may pass the first step, but an impairment charge against goodwill would be indicated if the full test was nevertheless carried out. The ED does not refer to this possibility, but we believe that an entity should be permitted to recognise an impairment loss against external goodwill if it has strong evidence that one has taken place, regardless of whether the first step suggests an impairment has occurred.

(c) This is an appropriate method of measuring impairment losses for goodwill. However, the calculation of implied goodwill may involve a significant amount of time and expense in its requirement to carry out formal valuations of all the identifiable assets and liabilities in the cash-generating unit. As the measurement of the impairment loss is, of necessity, rather approximate and likely to understate any impairment of external goodwill (see (b) above), we believe that an assumption that any loss relates firstly to external goodwill would be a helpful simplification and would not seriously undermine the integrity of the recognition of the loss. It is, in any case, likely that acquired goodwill would be the first item to lose value if a cash-generating unit was impaired. Under this approach, the loss would be allocated to acquired goodwill and any excess would then be ascribed to the identifiable assets and liabilities on a pro rata basis. This method removes the need for a second stage to the impairment test which possibly only adds spurious accuracy of allocation to a rather unsatisfactory measurement.

***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?*

**Response**

We agree that reversals of impairment losses recognised for goodwill should be prohibited. The difficulty in determining whether an apparent reversal actually arises from additional internally-generated goodwill is too great to justify recognition of reversals.

***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?*

**Response**

(a) We believe that the disclosures are excessive. As the disclosures must be made every year for every segment containing goodwill or an intangible asset with an indefinite useful life, their volume could serve to deter a user of the financial statements from reading them with attention. In particular, we feel that:

- the requirement in (d) to disclose the amount by which the aggregate of the recoverable amounts of cash-generating units exceeds the aggregate of their carrying values could disclose sensitive information about the entity's internal valuation of its business operations. Although the sensitivity of the disclosure would be mitigated by the use of aggregate figures for some entities, an entity which tests for impairment only one cash-generating unit, which is also a primary reporting segment and therefore has its carrying amount disclosed elsewhere, would be required to reveal its valuation of an identifiable business unit.

- the requirements in (e)(iv) and (f)(ii) to disclose the sensitivity of the cash-generating unit's valuation to changes in each key assumption also entail disclosure of potentially commercially sensitive information, for example, management's view of the outcome of litigation with third parties or of disputes with tax authorities.

- the requirement in (e)(v) to disclose the change in the weighted average growth rate used to extrapolate beyond the period covered by the budgets or forecasts that would cause the aggregate recoverable amount of the cash-generating units to equal their carrying amount involves complicated calculations, particularly as the rate must be weighted by reference to the amount of goodwill and identifiable intangible assets with indefinite lives in each cash-generating unit. The meaning of this disclosure may be rather obscure.

(b) In general, we agree that separate disclosure is appropriate if the criteria are satisfied.

As a general point for both (a) and (b) above, we believe that the Standard should make clear that the detailed disclosures are required only for material amounts of goodwill.

**<u>Amendments to IAS 38 Intangible assets</u>**

***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?*

**Response**

We agree that these criteria are appropriate for determining whether an asset meets the identifiability criterion in the definition of an intangible asset.

***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.*

**Response**

We do not believe it is appropriate to consider the probability recognition criterion as always satisfied when an intangible asset is acquired in a business combination. There is a fundamental difference between recognising an asset only once it is probable that future economic benefits will be received, as required by paragraph 89 of the Framework, and recognising an asset because it is possible to attribute a fair value to it which reflects market expectations about the probability that future economic benefits will flow to the acquirer. The latter approach will result in some assets being recognised which have a high probability of becoming impaired shortly after recognition, Although this probability may mean that the value recognised is relatively low, recognition of any asset in these circumstances exposes the income statement to future volatility. While supporting the general objective of more rigorous recognition of intangible assets in a business combination, and a consequent reduction in the amount of goodwill recognised, we do not believe that this principle should be extended to the point where intangible assets are recognised which have a high risk of impairment in the short term associated with them.

One example is that of acquired in-process R&D. We agree that it is possible to ascribe fair value to late-stage R&D projects, and clearly the acquiring entity's assessment of this value is reflected in the price it is willing to pay for an acquisition target. However, for R&D projects, the spectrum of certainty of successful completion, and therefore the probability of economic benefits flowing to the acquirer, is very wide. We believe that recognition on the balance sheet of acquired late-stage R&D projects is justified, and, indeed, that these may be recognised where expenditure on an internal project would not be, on the grounds that the value of an acquired project has been demonstrated by the acquirer's willingness to pay for it. However, recognition of early-stage R&D projects as intangible assets exposes the financial statements to volatility which is unwarranted by any gain in quality of information on the effects of the business combination.

The price paid for a collection of such projects reflects the fact that some will be expected to fail and some to succeed. We do not believe that recognising such an asset provides useful information to users of the financial statements, as it reduces the reliability of asset measurement on the balance sheet and potentially distorts earnings for several years. The recognition of frequent impairments may also suggest to users of the financial statements that the acquiring entity over-paid for the assets, whereas, in the nature of in-process R&D, it is likely that some projects will fail and some will, over time, exceed the value placed on them at the acquisition date. As it is not possible to revalue such assets to an amount above cost, only the "bad news" would be reflected in the financial statements, while "good news" would not be recognised until the assets start to generate economic benefits. Due to the long-term nature of R&D projects in the pharmaceutical industry, this leaves the financial statements exposed to an asymmetrical treatment of the assets over a period of many years.

The ED recognises that the fair value of an assembled workforce is not capable of reliable measurement, and we agree with this conclusion. We believe that early-stage in-process R&D should also be excluded from the requirement to recognise all intangible assets acquired in a business combination, for the reasons outlined above.

In summary, we agree with the principle laid out in the ED of consistent treatment for all acquired intangible assets, whether acquired individually or as part of a business combination. We also welcome the move to recognise that acquired assets may be capitalised at an earlier stage of development than internally-generated assets. This reflects the fact that the consideration paid for externally acquired assets provides some evidence of reliability of measurement and of probability of economic benefits which internally-generated assets have yet to demonstrate. However, we believe that the criteria for recognition of acquired intangible assets should be stricter than those proposed in the ED, and that the Framework's principle that an asset is recognised only when it is probable that future economic benefits will flow to the acquirer should be upheld.

### *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?*

### Response

Yes, it is appropriate to recognise that some assets are expected to generate economic benefits for an indefinite period of time. We welcome this proposed amendment to 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)?*

**Response**

While we agree that the existence of evidence to support renewal is an appropriate basis for inclusion of a renewal period in a useful life, we would prefer to amend the discussion of this point to reflect the following:

- an important factor in determining whether the useful life should include the renewal period(s) is the existence of another party to the contractual or legal arrangement whose agreement to renewal may or may not be given. Where there is doubt over the expected actions of another party at a future date it would be inappropriate to extend the useful life beyond the term of the current arrangement.

- the likelihood of renewal should be assessed on the balance of probabilities. If the economic substance of the arrangement is that it will be renewed, then the useful life selected should reflect the renewal period(s).

- The significance of the level of costs involved in renewal is not relevant to whether a renewal period should be recognised in the useful life attributed to the intangible asset, except insofar as it affects the probability that the entity will renew the arrangement. If costs are significant, these will create an additional asset at the date of renewal which should be amortised over the length of the renewal period.

***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?*

**Response**

We agree that non-amortisation is appropriate for intangible assets with indefinite useful lives. By definition, it is not possible to set a period on the useful lives of these assets and so any amortisation policy would be arbitrary. We believe that the proposed requirement for annual impairment tests provides an adequate safeguard against failure to recognise on a timely basis any unanticipated consumption of the economic benefits inherent in the assets.

Technical Committee of the 100 Group of Finance Directors