EFRAG
European Financial Reporting Advisory Group

Dr. Alexander Schaub
Director General
European Commission
Directorate General for the Internal Market

1049 Brussels

DRAFT FOR COMMENTS BY 24 May 2004

XY June 2004

Dear Dr. Schaub,

Re: Adoption of amended IAS 36 *Impairment of Assets* and amended IAS 38 *Intangible Assets*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the amended IAS 36 *Impairment of Assets* (IAS 36) and the amended IAS 38 *Intangible Assets* (IAS 38).

The amendments to IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* have been issued by IASB together with IFRS 3 *Business Combinations*, which is part of the first phase of a project which has the objective to improve the quality of the accounting for business combinations, for goodwill and intangible assets.

The reason for IASB to issue amendments to IAS 36 and IAS 38 was to reflect particularly those changes related to its decisions in the Business Combinations project but not to reconsider all the existing requirements of IAS 36 and IAS 38. Therefore, the changes made in IAS 36 are mainly concerned with the impairment test for goodwill; the changes made in IAS 38 are concerned with clarifying the notion of "identifiability" with regards to intangible assets and the accounting for in-process research and development projects acquired in a business combination.

The introductions to the revised standards (IAS 36 IN5 to IN18 and IAS 38 IN5 to IN13) summarise the main changes from the previous versions of IAS 36 and IAS 38, on which we provided a positive endorsement advice as part of our 19 June 2002 "en bloc" endorsement letter.

Although the complexity of the impairment test for goodwill in IAS 36 has been reduced, as proposed by EFRAG, by eliminating the second of the two steps proposed in the Exposure Draft of amendments to IAS 36, it is recognised that the implementation of the test in practice is very difficult compared to the well known application of the amortisation approach. The main criticism with regard to the impairment test for goodwill is that it does not distinguish between acquired and pre-existing internally generated goodwill of the acquirer nor between acquired goodwill and goodwill internally generated after the business combination. Thus losses in acquired goodwill can be masked by gains in pre-existing or internally generated goodwill. We acknowledge that there is no alternative to avoid the potential subsequent replacement of acquired goodwill by internally generated goodwill but we urge the Board to continue research work on this.

We welcome the strengthening of the requirements regarding the projection of future cash flows as well as the extended disclosure requirements regarding the underlying assumptions, which will increase the robustness of the impairment test for goodwill compared to the proposal in the Exposure Draft.

In IAS 38 we welcome the change from the Exposure Draft regarding the measurement of intangible assets acquired in a business combination. The Board replaced its presumption that sufficient information should always exist to measure reliably the fair value of such an asset by a rebuttable presumption that it is “normally” possible to measure it with sufficient reliability to qualify for recognition separately from goodwill. This change, which resulted from comments received during the field tests, acknowledges that it is very difficult in some cases to measure the fair values of individual intangible assets. We are pleased to note the effectiveness of the field tests in this and other areas and we encourage the Board to continue to use this medium of consultation in appropriate cases.

Despite the change to the measurement presumption, the Board retained its proposed approach to recognition of intangible assets acquired in a business combination. It is still required, for example, to recognise in-process research and development projects separately from goodwill if they meet the identifiability criterion and can be measured reliably. Moreover, also in a separate acquisition of an intangible asset, IAS 38 considers the probability criterion to be satisfied and it would not be necessary to pass the recognition test established in the Framework.
IASB acknowledges in paragraph 18 of the Basis for Conclusions that there is an inconsistency between the recognition criteria in the Framework (based on probability of occurrence and reliability of measurement of expected future cash flows) and the approach to measuring fair values in, for example, a business combination. We believe that this inconsistency should be addressed at an early date in the context of a review of the general recognition principles in the Framework.

IAS 36 and IAS 38 should be applied on acquisition to goodwill and intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004 and, to all other assets, for annual periods beginning on or after 31 March 2004. Earlier application is encouraged.

EFRAG has evaluated the amended IAS 36 and IAS 38 and the related Basis for Conclusions. Our evaluation is based on input from standard setters and market participants in accordance with EFRAG's due process.

We consider the improvements in the amended IAS 36 and IAS 38 to outweigh the concerns raised in this letter and therefore, on balance, EFRAG is supportive of the amended IAS 36 and IAS 38 and concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards that:

i. they are not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
ii. they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

<u>Dissenting opinion regarding the adoption of the amendments to IAS 38 *Intangible Assets*:</u>

Dissent of Mr. Dominique Thouvenin:
Paragraph 25 of IAS 38 (Revised March 2004) *Intangible Assets* states that the probability criteria in paragraph 21 (a) are always considered to be satisfied for separately acquired intangible assets. The reason given for this (BC27) is that the price paid by an entity to acquire separately an intangible asset normally reflects expectations about the probability that the future benefits associated with the intangible asset will flow to the entity.
Paragraph 33 states the probability recognition criteria in paragraph 21 (a) are always considered to be satisfied for intangible assets acquired in business combinations.
The reason given for this (BC17 and BC18) is that fair value is the required measurement for acquisition of an intangible asset as part of a business combination, and fair value incorporates probability assessment.
Dominique Thouvenin believes that the Framework requires a prior recognition test based on probability, even when measurement reflects the effect of probability. This inconsistency between the recognition criteria in the Framework and IAS 38 revised is acknowledged in paragraph BC18. For Dominique Thouvenin, this inconsistency should be resolved as part of an in depth review of the Framework, before changing the recognition criteria for intangible assets acquired separately or in a business combination. He therefore concluded that IAS 38 revised does not meet the criteria of relevance and comparability required of financial information and, as this is a major issue, he does not believe that it is in the European interest to adopt IAS 38 revised.

However, the majority of EFRAG members believe that it is in the European interest to adopt IAS 36 and IAS 38 in its amended version and, accordingly, we recommend their adoption.

We should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman