Comments on the EFRAG draft comment letter BusCom II

EFRAG questions

Preferably the introduction should include comments of a more general nature referring to the due process requiring more time to discuss fundamental issues.

Question 1

We agree with the EFRAG comments with the exception of:

1.1. EFRAG's disappointment that no full convergence is achieved

We do not believe that the benefits of the proposed amendments would have been considerably higher if full convergence would have been achieved (last paragraph – point (4) of your letter). Considering (i) the fact that we are trying to converge over ruled accounting standards (US GAAP) with mostly principles based standards (IFRS) and (ii) the cross-cutting issues with other standards it seems to us an unrealistic slogan to expect full convergence at this stage.

1.2. Changes to concepts in the Framework

While we have some conceptual sympathy with EFRAG's major concern as regards the interaction with the Framework we do not support your firm position because:

- We believe it is flawed to state that the Framework needs to be kept up-to-date at all times because it is part of the IAS 8 hierarchy. To start with, the Framework has not the same authority as an IFRS which is why it was not endorsed by Europe and vice-versa. Consequently, stating that you see a departure from the Framework as a "breach of law" seems to be quite stretched. Indeed, under EFRAG's reasoning, *most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards* and *accepted industry practices* would also come in the standard-setting equation; which would make it impossible to develop IFRS further.

- More fundamentally, we believe it should be clear that the Framework contains the fundamental concepts on which the IASB bases most of its accounting standards decisions. However, the qualitative Framework characteristics are sometimes conflicting and standard-setting has practicability (cost-benefit) constraints.

- Reality is that several endorsed IFRS requirements are, often for very good reasons, already in conflict with concepts in the Framework.

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Question 2

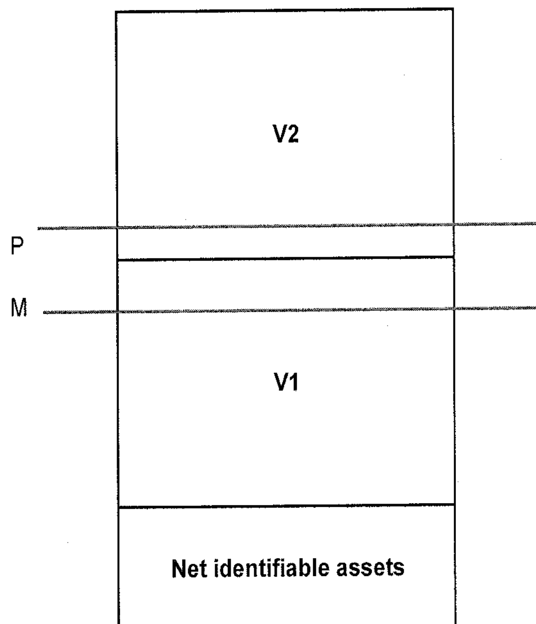
We support EFRAG's position but have the following comments on your arguments:

2.1 Considerable costs of a full goodwill approach

In a business combination it is common practice to fair value an acquiree as a whole based on the income or market approach. Therefore, we do not support EFRAG's *considerable cost* argument.

In practice, the consideration for a business combination will be based on two values: i) the estimated value of the target company on a stand-alone basis (i.e. based on the current business plan – referred to hereafter as V1) and ii) the expected future value taking into account the effects of the combination (i.e. based on the new business plan – referred to hereafter as V2). Since there will be general consensus about V1, the purchase price (in the chart below P) will normally be between V1 and V2 and actually depend on V2 (which will be different from acquirer to acquirer) as well as on the appetite of the parties involved to combine. For the rare cases that the acquiree is a public company, we have indicated the market value in the chart below as M.

Illustrative chart of values involved when acquiring a company



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2.2 Better financial reporting under a full goodwill approach?

The IASB explains in BC 134-138 that since goodwill is an asset (economic resources) controlled by the acquirer it should be recognised in full instead of the portion purchased. We believe that this reasoning is rather narrow because it presumes that the acquirer controls the future (economic benefits), which we find odd.

The question whether goodwill is an asset or not was extensively debated during the development of IFRS 3. At that time the IASB concluded that it is more representationally faithful to recognise goodwill as an asset than to recognise it as an expense (BC 135). Today, the majority of the IASB seems to ignore the particular nature of the goodwill asset and instead refers to a *present inconsistency* in accounting for acquisitions in which less than all of the equity interest is acquired (BC 135). We continue to believe that goodwill is at best a residual asset and therefore agree with EFRAG and the five dissenting Board members that the current proposal to recognise future economic benefits attributable to the non-controlling interest in addition as an asset (goodwill) is not an improvement of IFRS.

Furthermore, conceptually, we are concerned about the IASB's approach in applying fair value. For the purpose of the draft IFRS fair value is defined as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties". The application guidance (A8) explains that the objective of measuring the fair value of the acquiree is to estimate the price at which 100 per cent of the acquiree could be exchanged in a current transaction between knowledgeable, unrelated willing parties. In paragraph 20 it is further explained that the consideration paid by the acquirer on the acquisition date is presumed to be the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree.

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We have the following conceptual problem:

- Is a control premium different from future synergies/profits (goodwill)? We believe the answer in "no". However, under the proposed approach future synergies/profits should only be recognised (as part of goodwill) to the extent they have been paid for. Or, to say it differently, the question arises which fair value is most relevant. This issue becomes apparent in Example 3 where the fair value of TC is determined for 60% on the acquisition price paid (taking into account the future synergies/profits) while 40% is based on the quoted market price of the share price of the acquiree which does not take into account the new business plan following the combination. We believe that this approach is weak from a conceptual point of view because different pieces of values are added up (see also illustrative chart under 2.1 above). The conceptual conflict will become even more apparent in the vast majority of business combinations where the acquiree is not a public company. Indeed, if we take the same case as Example 3 with the only difference that the acquiree is not listed, the 40% would be based on the new (or old !?) business plan but the goodwill would not be recognised for the non-controlling interest because it has not been paid for (effect of paragraph 61 as illustrated in the illustrative example hereafter). However, the total fair value, that will be different depending on the acquirer and its business case, would need to be disclosed (see further comments under question 15 below).
  In short, it seems that the current proposals lead to the adoption of a partial (to the extent paid) entity specific value method, an approach that was rejected by the IASB last year when it adopted IFRS 4 *Insurance Contracts*. We support the IASB's view that entity specific values do not belong in general purpose financial statements and therefore believe that the proposed full goodwill approach is not an improvement of IFRS.

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We have reworked Example 4 illustrating our understanding of how the interaction between paragraphs 49 and 61 works as well as its flows as explained above:

Example 4 - scenario's

	IASB	case 1	case 2
Fair value TC	195	200	217,5
Less net assets acquired	-150	-150	-150
Goodwill :	45	50	67,5
Impact of § 61 (see below)	0	0	-14
Goodwill to be allocated	45	50	53,5
Price paid for AC share (application § 61)	160	160	160
FV of AC's 80% interest in TC	160	160	174
Goodwill reduction based on § 61	0	0	-14
Less 80% of net assets	-120	-120	-120
Goodwill allocated to AC	40	40	54
Difference: goodwill allocated to non-controlling inter.	5	10	-0,5

Question 3

Yes we agree with the reasons for issuing the ED as expressed by the board and believe that the overall objectives of the ED will be achieved, except for the full goodwill approach.

We do not share EFRAG's view that the extended use of fair value for transactions involving non-listed companies could have a detrimental effect on the quality of the financial information provided. Neither do we agree that a piece by piece introduction of fair value results in lack of relevance. Finally, we do not believe that too subjective estimates are being introduced.

Question 4

We agree with EFRAG that there seems to be an inconsistency with the proposed new definition of a business combination and that the (draft) IFRS 3 requirements are not suitable for true mergers. It should be clarified that the latter is the result of the adoption of IFRS 3, not of the proposed amendments to IFRS 3.

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Question 5

While we agree that the distinction between a business and a group of assets may be a fine one we disagree with EFRAG's statement that not extending the scope of IFRS 3 to acquisitions of all asset groups is a conceptual inconsistency. The only inconsistency we see is that EFRAG seems to propose a further introduction of fair value accounting while under question 2 EFRAG sounds to be against an increased use of fair value.

Question 6

We fully support a prospective adoption as proposed by the IASB and regret that EFRAG seems to ignore the practicability and credibility aspects of a retrospective transition. We do not understand the statement that "new standards can be applied with hindsight to the benefit of the entity" and strongly belief that only high quality financial reporting is beneficial to the entity.

Question 7

We believe that the economic entity view proposals are consistent with the December 2003 improvement of IAS 27 *Consolidated and Separate Financial Statements* (minority interest is no longer a cost but an attribution of the result) which was fully supported by EFRAG in its March 2004 endorsement advice and endorsed by the Commission in December 2004.
Economic entity approach is the preferred approach for consolidations as it focuses on control concepts. This makes the recognition of any profit or loss on transactions with shareholders consistent with other IFRS principles of revenue recognition: revenues and related profits can only be accounted for when there is a loss of control over the subject of the transaction.

Question 8

We agree with EFRAG (paragraph 19) that the proposed approach has merits and share the concern that there might be practical issues in determining when an entity has an unconditional obligation.

a) with regard to the Framework, we refer to our comments under 1.2 above.
b) To our understanding there is no level of uncertainty that would preclude recognition of an unconditional obligation ?.
c) Yes: under the proposed amendments to IAS 37 most non-financial liabilities would be measured at the amount the entity expects it would rationally pay to settle the exposure. We believe that such an approach is superior to the current IAS 37 requirements.

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IASB Questions proposed amendments to IFRS 3

Question 1

We support EFRAG's comment as regards true mergers (see also our comments on the EFRAG question 4 above) and wonder whether any proactive work has been already been undertaken by Europe.

As explained in detail in our comments to EFRAG question 2 above, we strongly disagree with the majority of the IASB proposing a full goodwill recognition approach. EFRAG's wording "not yet convinced" seems to be rather different from the message given in its introductory arguments to the EFRAG question 2 above.

Question 2

We agree with the EFRAG comments.

Question 3

As explained in detail in our comments to EFRAG question 2 above, we strongly disagree with the majority of the IASB proposing a full goodwill recognition approach.

With regard to the economic entity approach we want to highlight that these proposals are consistent with the December 2003 improvement of IAS 27 *Consolidated and Separate Financial Statements* (minority interest is no longer a cost but an attribution of the result) which was fully supported by EFRAG in its March 2004 endorsement advice and endorsed by the Commission in December 2004.

Question 4

Yes we believe the guidance is sufficient – see also our comments 2.1 and 2.2 above to the EFRAG question 2. We do not support EFRAG's comments as regards Example 3 in A15 and believe that refused bids should not be considered relevant.

Question 5

We support the EFRAG comments.

Question 6

We support the EFRAG comments except for the point on the use of contingent considerations.

Comments on the EFRAG draft comment letter BusCom II

Question 7

We agree with the EFRAG position: the proposals introduce a fundamental inconsistency with other assets acquired that are subsequently not measured at fair value.

If we agree that acquisition related costs are not assets we should be consistent and amend all other standards that currently require capitalisation of acquisition related costs; being IAS 2 *Inventories*, IAS 11 *Construction Contracts*, IAS 16 *Property, Plant and Equipment*, IAS 17 *Leases*, IAS 23 *Borrowing Costs*, IAS 38 *Intangible Assets*, IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 40 *Investment Property* and IAS 41 *Agriculture*. Such a change seems to be too fundamental and should not be introduced in a project that only deals with business combinations.

Question 8

We are happy with the draft EFRAG response.

Question 9

We agree.

Question 10

We agree with EFRAG that a direct recognition in equity seems to be more appropriate. This issue should probably be dealt with in the *Reporting Performance* project.

Question 11

We do not agree with the EFRAG draft comments.

The way the IASB has now ruled the 'negative goodwill' (by first reducing the goodwill) is an improvement as it brings down the fair value effects within purchase accounting to a realistic amount: the amount of net assets including goodwill can not exceed the amount paid.

Comments on the EFRAG draft comment letter BusCom II

Question 12

No, we agree with the IASB that it should be presumed that management has sound economic reasons supporting the price paid. Therefore, the determination of overpayment at acquisition date is not relevant. We do not agree with EFRAG's example suggesting that paying a premium to eliminate competition should be considered as an overpayment. In such a case the price paid would be justified by a combination of future synergies and increased income, which are part of goodwill.
In general, we believe that the fair value of an acquiree is different from acquirer to acquirer because of the synergy potential. As explained in detail under 2.2 above we believe it would not be an improvement of IFRS to replace the current purchased goodwill approach by the proposed full goodwill approach.

From BC 178 we understand that the IASB defines overpayment as the difference between the price paid and the fair value of the interest in the acquiree. From example 3 and paragraph 61 it is further understood that the fair value of the interest in the acquiree should include expected synergies from the business combination to the extent paid for. We strongly believe that the premium an entity is willing to pay (over the fair value of the acquiree on a stand-alone basis) will not be higher than its share in the value of the expected synergies from the business combination for the simple reason that it would make very little business sense to do the transaction at a higher price. However, if such an overpayment would occur, it will be revealed in the mandatory annual impairment testing (see paragraph 96 of IAS 36) instead of waiting till evidence of overpayment arises, as currently proposed by the Board in BC 178.

Question 13

We agree.

Question 14

We found the proposed guidance appropriate except for the following:

- Since paragraph A92 is difficult to understand, we recommend the IASB to include a worked example.
- We noted that paragraph A103 does not clearly state that the fair values of the awards need to be determined at the acquisition date and that any excess needs to be expensed over the vesting period. The latter only becomes clear after reading paragraphs A108-109.

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Question 15

We believe that EFRAG should be more specific when it states that the requirements are too extensive and may not meet the cost benefit criterion. In particular we found the paragraph 76 (d) disclosure requirement completely impracticable for any company that grew primarily trough acquisitions and redundant since it overlaps with the IAS 1 paragraph 86 requirement to disclose separately the nature and amount of all items of income and expense that are material.

Paragraph 72 (e) would require disclosure of the acquisition-date fair value of the acquiree and the basis for measuring that value. As explained in our comments to question 12 above, the fair value of an acquiree is different from acquirer to acquirer because of the synergy potential. The problem arises to whom the synergies belong: e.g. new sales of products of the acquirer trough the distribution network of the acquiree. In general, it would probably be better to require disclosure of the expected future synergies for the entity, which is already common practice today, instead of requiring fair value disclosures of acquirees for which it is not clear to what extent future synergies should be taken into account.

Paragraph 72 (f) refers to equity or "member interests" of the acquirer. To our knowledge "member interests" is not defined in IFRS ?

While we agree that fair valuing of intangibles will most of the time only be possible by making use of valuation techniques we do not understand EFRAG's comment that it is not convinced that the use of valuation techniques would result in reliable information. We believe that this statement is besides the point since the only relevant question is whether it is better financial information to have all acquired intangible assets subsumed in goodwill or to recognise them separately. So, the question relates to allocation, not to recognition. In this respect, it should be noted that 14 months ago EFRAG supported the endorsement of IFRS 3. Today, the only proposed change to the intangibles recognition criteria relates to intangible assets with an indefinite life.

Question 17

We agree.

Question 18

We agree but see our comments under 1.1 on the EFRAG question 1.

Question 19

We agree.

Comments on the EFRAG draft comment letter BusCom II

Other comments

EFRAG

Determining the acquisition date

We do not support EFRAG's abuse comment and believe that potential fraud should not be a driver in standard setting. We believe that paragraph 18 is sufficiently clear in a principles based context.

Proposed amendments to IFRS 3

Paragraph 34 prescribes that the acquirer shall not recognise a separate valuation allowance (e.g. for uncollectible receivables) as of the acquisition date for a assets (e.g. receivables) required to be recognised at fair value in accordance with the draft IFRS. The Board reasoned that uncertainty about collections is included in the fair value measure. While we fully agree with this reasoning, we strongly believe that the proposal is impracticable because it would lead to differences between the accounting data (accounts receivable subledger) and the underlying source documents (sales invoices). We therefore urge the IASB to delete this unnecessary rule from the final standard and leave it up to practice how to organize its accounting ledgers.

Cross-cutting issue with IAS 22

Companies that adopted IFRS before 2005 may have recognised provisions in accordance with paragraph 31 of IAS 22 *Business Combinations*. Currently, IFRS 3 does not contain any transitional provisions for such liabilities that do not meet the IAS 37 recognition criteria. While it can be understood from the current paragraph 78 of IFRS 3 that the accounting is grandfathered it would probably be more consistent to include the same transitional provisions as those for *previously recognised contingent liabilities* (new paragraph 87). Such transitional provisions would avoid confusion in practice as to how the IAS 22 provisions should be dealt with and avoid that they would lead to income recognition when no longer justified.

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IASB Questions proposed amendments to IAS 27

Question 1

We refer to our comments to the EFRAG question 7 above.

Question 2

We support the EFRAG concern and believe that this question should be addressed in the *Reporting Performance* project.

Question 3

We agree with the EFRAG Draft response.

Question 4

We agree with the IASB proposal and refer to our comments to the EFRAG question 7 above.

Question 5

We do not understand EFRAG's concern about "using hindsight in a way that could significantly benefit the entity" and strongly belief that only high quality financial reporting is beneficial to the entity. We support a prospective adoption as proposed by the IASB and regret that EFRAG seems to ignore the practicability and credibility aspects of a retrospective transition.

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IASB Questions proposed amendments to IAS 37

Question 1

We share EFRAG's concern expressed in the second paragraph of point (a).

Question 2

We agree with the IASB proposals as supported by EFRAG. We also share the EFRAG concern with regard to practical implications.

Question 3

We agree.

Question 4

We agree with the proposed EFRAG comments.

Question 5

We agree with the EFRAG comments, except for the arguments that relate to the Framework which we find far too academic (see also our comments to the EFRAG question 1.2. above).

Question 6

On balance, we support the proposed measurement amendments to IAS 37 but we agree with EFRAG that the proposals should be postponed until the conceptual questions have been thoroughly studied.

Question 7

We agree.

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Question 8

We do not agree with the comment of EFRAG. See BC 67 for further clarifications. The issue is related to what will be the price that a third party would ask to take over the onerous contract. From that perspective, the point of the IASB is defendable and fits into the concept of non avoidable costs. If afterwards the company does not enter into a sublease, additional costs will have to be accounted for in the subsequent periods which is acceptable as these additional costs are linked to a decision of management not to enter into a sublease.

The same issue exists when looking to impairments: the basis is the higher of net sales price or value in use. So if the sales value is higher than the nbv of a building no impairment is recorded and in the subsequent periods additional costs (depreciations) will be accounted for which is linked to the decision not to sell but to continue to use.

Question 9

We agree.

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IASB Questions proposed amendments to IAS 19

Question 1

We believe it should be clarified or illustrated what a "short period" means. More fundamentally, it is our understanding that the proposed amendments create divergence with SFAS 88 Employer's Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits and SFAS 112 *Employers' Accounting For Post Employment Benefits* (as well as Belgian GAAP) under which voluntary post employment benefits are recognised at the time of acceptance by the employee. This approach was recently confirmed in EITF 05-5 *Accounting for the Altersteilzeit Early Retirement Programs*. Due to the importance of this issue for Europe we believe that EFRAG should convince the IASB to reconsider its proposed amendments thereby achieving further convergence with US and Belgian GAAP.

In addition the fact that the IASB aligned IFRS to US GAAP is not per se the right move. As social plans in Europe are much more developed than in the US, a tailored made IFRS statement related to plans such as early retirement, additional holidays is needed.

Question 2

We agree.

Question 3

We agree.