EFRAG

European Financial Reporting Advisory Group

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International Accounting Standards Board
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Email: CommentLetters@iasb.org

Dear Alan,

Re: ED of Proposed Amendments to IFRS 3 *Business Combinations* and Proposed Amendments to IAS 27 *Consolidated and Separate Financial Statements*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations* and Proposed Amendments to IAS 27 *Consolidated and Separate Financial Statement* ("the EDs").

This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRSs on the issues.

At the outset we would like to make clear that we support the objective of achieving convergence between IFRS and US GAAP in the accounting for business combinations and non-controlling interests. We do not believe however that in this particular case convergence requires entirely new bases of accounting to be developed for both IFRS and US GAAP. It could be achieved far more simply and practically by convergence with the better of the two existing standards; citing the objective of convergence in support of the current proposals is inappropriate.

Furthermore, having evaluated the proposals as a whole in the light of the comments received on the draft comment letter we issued in early August, we do not support the proposals in the EDs. That is because we believe that the proposed approach does not produce more useful information than the current IFRS 3; indeed in many respects we believe that it will have the opposite effect. In addition it will create major practical implementation issues. We also believe that it is inappropriate to introduce such radical and untested concepts through revision to specific *standards* at a time when the conceptual framework is under active review.

Our recommendation to the IASB and FASB is therefore that they should concentrate for the time being on simply doing what they set out to do, i.e. converging the existing standards to the better accounting solution, which we believe to be IFRS 3 (subject perhaps to some minor improvements to achieve convergence and to address certain practical aspects linked with the application of the acquisition method). This would therefore be an accumulated cost

approach – in effect an approach based on fair valuing the consideration transferred for the acquired stake - and be based on the modified parent entity view.
Further conceptual changes might then be considered during the framework review allowing time for proper debate and consideration, including comprehensive field testing and field visits of any new proposals as part of the consultation process.

Our main concerns are outlined in more detail in the following section, after which we provide our responses to the questions raised in the EDs (see Appendices 1 and 2). In addition we have a number of concerns regarding the structure and process of the project; those concerns are explained in Appendix 3.

Main Concerns with the Proposed Amendments to IFRS 3 and IAS 27

Our reasons for not supporting the EDs are that we disagree with:

1. using convergence to justify introduction of radical new and untested concepts,
2. the reasons for issuing the proposals and the assumed benefits,
3. the increased use of Fair Value without a conceptual debate,
4. the accounting for business combinations at fair value,
5. the application of an economic entity view,
6. the proposed full goodwill method,
7. the proposed treatment of acquisitions in steps,
8. the extended scope without providing a solution for true mergers, and
9. the way new concepts are introduced.

1. Using Convergence to Justify Introduction of Radical New and Untested Concepts

We very much support the alignment of IFRS and US GAAP standards on this subject. In particular cases convergence may mean significant changes to standards if necessary and should not only mean converging around existing models. However, in the absence of other compelling reasons for change (and we do not believe there is any user pressure to change the fundamentals of IFRS 3/SFAS 141) then convergence alone should largely mean moving to the better standard.
We accept that some minor changes to the “converged” standard might be necessary or appropriate, but the important word here is “minor”. Therefore, if convergence is the primary motivation then we believe that many of the changes do not need to be made to achieve convergence. In that context we would like to remind the Board that, when it initially described the scope of this phase of the project, it described it as being to provide appropriate and convergent guidance on how to apply the purchase method (now acquisition method), i.e. the basic approach in IFRS 3 and SFAS 141 (see proposed amendments to IFRS 3 IN5).

2. The Reasons for Issuing the Proposals and Assumed Benefits

We believe that the EDs introduce fundamental changes to existing accounting without sufficient proof that the existing IFRS 3 concept has major deficiencies that require repair.
When proposing to make fundamental changes to existing accounting, it is essential that the reasons for making the changes are explained and are persuasive. However, in our opinion - and in the opinion of most of those who responded to our draft comment letter - the reasons for the changes proposed in the EDs are neither well explained nor obvious. Furthermore, those arguments given in favour of the changes ignore what we consider to be very important shortcomings and limitations of the proposals. Many of those limitations and shortcomings are only set out in the dissenting views section, much of which we support.

For example, the Board argues that the two main reasons for issuing the EDs are that (i) by extending the scope of IFRS 3 and by applying a single method of accounting to all business combinations the *comparability* and *transparency* of the financial statements is increased and (ii) by requiring the fair value measurement of the acquiree as a whole and of the assets and liabilities acquired, the *relevance* and *reliability* of the financial information provided is improved (IFRS 3 IN6-7). Whilst we support the objective of increasing and improving the relevance, reliability, comparability and transparency of financial information, we can not see that the proposal will achieve this.

3. The Increased Use of Fair Value Without Conceptual Debate

It is not clear to us from the EDs what benefits are gained by requiring the acquirer to recognise the acquiree as a whole at fair value. As already mentioned, the EDs talk of improved relevance and reliability and there is some material on this in the Basis for Conclusions (BC16-17), but those arguments do not seem to be well articulated; certainly we found them very unconvincing. It is also not clear to us from the EDs why the benefits that these proposals are claimed to have are thought to exceed the considerable costs of applying the proposals

One of the things that concerns us most about the EDs (and in fact the direction of IASB's work in general) is that more and more use is being made of fair value measures before fundamental measurement principles have been debated and agreed. The impression one gains from listening to IASB's debates is that the Board thinks it self-evident that market-based current value (i.e. fair value) is a more appropriate measurement basis than any other basis in almost every circumstance, yet many of its constituents are clearly not convinced. In the context of the current proposals we certainly are not.

In looking at any measurement basis, there are almost invariably trade-offs to be made. Historical cost tends in general to be more easily ascertained and hence reliable; however, it may become less relevant over time if the objective is to arrive at an estimate of current earnings potential. Current value is generally more relevant in this latter case, but may be so subjective that any relevance is undermined to such an extent it is of little or no worth to users – it is widely accepted for example that internally generated goodwill (and hence presumably the fair value of a business) cannot be reliably measured.

Our recommendation to the IASB is therefore to discuss, and consult fully on, the proposed changes first as part of the fair value measurement project.

4. The Accounting for Business Combinations at Fair Value

In addition we do not agree with the implicit assertion that the fair value of a business can be reliably assessed simply because of the existence of a transaction involving what may be a comparatively small, albeit controlling, stake. Indeed the Board themselves clearly have little or no faith in this conclusion as they do not accept that such measurement can give rise to a loss nor to a profit except to the extent that goodwill is first eliminated. Even if there were circumstances in which this was the case, we do not believe that measuring the value of the whole business (and hence goodwill) is worth the inevitable additional time and cost as any value ascribed at that point in time will be highly subjective and rapidly gain all the attributes of historical cost since it will not be updated.

It can be expected that the most difficult cases will be acquisitions of less than 100% where it is required to determine fair value of a hypothetical transaction starting from an agreed purchase price linked to the stake acquired. We believe that the task of determining the fair value of a business as a whole is very judgmental and in many cases based on subjective measurement input. In this context the EDs do not provide robust guidance on how to measure goodwill of non-controlling interests. We are concerned that the reliability and verifiability of information presented will be unsatisfactory.

Furthermore we see conflicts between the proposed fair value hierarchy – as developed by the FASB – and the existing fair value measurement principles under IAS 39. On conceptual grounds we believe that there is no objective market fair value for a subsidiary from a buyer's perspective. Every single buyer assesses the value of a company it intends to acquire in the context of what the benefits would be to its individual group as it stands. There may be more or less synergies depending on buyer and hence insufficient objectivity of the so-called acquisition date fair value. We refer to the examples 3 and 4 in the EDs, which demonstrate the practical limitations of the proposed approach.

In addition, since the purpose of consolidated financial statements has not yet been properly considered in the conceptual framework project, we believe that the Board has not correctly identified the primary users of such statements (see section 5 below). Accepting our view that the primary users are the parent company shareholders, this leads us to the conclusion that, the main informational benefit is in assessing whether their money has been well spent i.e. assessing returns against an accumulated historical cost (including the related transaction costs). These connotations of stewardship would not be so easily lost if the Board were to retain them more explicitly in the framework.

We therefore disagree that the proposed fair value measurement approach would result in relevant and reliable information; we believe an accumulated cost model is the correct approach to adopt. This would also ensure a consistent treatment of business combinations and acquisition of assets or asset groups until a more fundamental debate has taken place and thus would in addition reduce our concern regarding the fine distinction line between the two as defined by the definition of business. We also believe it better reflects the economic substance of a transaction.

5. The Application of an Economic Entity View

We agree that non-controlling interests do not meet the definition of a liability. Consequently we believe they should be classified within equity, but a specific sort of equity. In that context we refer to the different presentations of equity in the IASB and FASB proposals.

However, we do not accept that, because non-controlling interests are classified within equity, it follows that an economic entity view has to be applied. In our view the economic entity view issue is of much broader dimension and we disagree with the proposal mainly for the reason that it moves away from the fundamental objective of financial statements, which is primarily providing information to the shareholders of the parent entity.

In general, claims (either equity or liabilities) are entity specific. Consolidated accounts are only prepared because it is accepted that the equity holders and creditors of an entity can gain better information about the cash flows available to support their claims by looking at the underlying financial position, earnings and cash flows of the investments which their entity controls. In our view therefore these are the primary users and we prefer the modified parent entity approach because we believe that users' needs are better addressed thereby. The information requirements of minority equity interests are in our view similarly addressed by the consolidated accounts of the entity in which they hold their interest. We doubt that a move to an economic entity view gives rise to better information to parent company investors since there will inevitably be a lack of transparency and accountability for subsequent transactions. Indeed some results seem somehow surprising from the perspective of the parent company shareholders. For example, under the Boards proposals, the subsequent acquisition for cash of a partial share in a successful and growing business will result in a reduction in the equity attributable to such shareholders to the extent that the net assets (including in this context goodwill) are not revalued after the initial acquisition.

The proposals build on a change, implemented via the Improvements Project, to the presentation of the minority interests (now the non-controlling interests) that required non-controlling interests to be classified as part of the ownership interest in the consolidated group and, as such, treated as a separate component of equity. However, we regard this decision – as the dissenting Board member on this issue (see IAS 27 DO1-3) – as not pre-empting the conceptual debate to take place. We have heard it argued that the information that we believe users can obtain from consolidated financial statements prepared using a parent entity approach can actually also be obtained from the parent's separate statements.

In our view this argument ignores the fact that not necessarily all subsidiaries in a group are held by the parent entity.

6. The Proposed Full Goodwill Method

As we have noted above we do not agree with either use of fair values to measure the acquired businesses or the economic entity view. It therefore follows that we do not see the benefits of the proposed full goodwill method. At present it is the cost of the acquisition that is allocated on the basis of fair values of acquired assets and liabilities. We don't see an inconsistency between a cost basis and allocation based on fair values and therefore no necessity to move to a hypothetical full fair value measurement of the acquiree, in particular for cases of partial acquisitions.

In the Basis for Conclusions the Board notes that the full goodwill method is relevant because it is consistent with the concepts underlying the preparation of consolidated financial statements. However:

1. they do not explain what significant benefit is to be derived by the parent company shareholders to justify the considerable time and money necessary to determine a subjective amount of goodwill attributable to another part of equity based on a purely hypothetical transaction. Although mention is made of the predictive value of including full goodwill with other assets it is not explained how this will be significantly better than the current position. In each case there is no ongoing segregation of the net assets of particular subsidiaries and hence no better means of establishing the proportion of earnings that will flow to the non-controlling interests and as previously explained the goodwill will rapidly become assume the characteristics (and hence relevance) of historical value. Furthermore, the full goodwill would not be measured at fair value, as the Board acknowledges, and therefore, the amount shown in the balance sheet would not have the predictive value claimed by the Board,
2. we disagree with the IASB contention that goodwill is an asset like any other asset and is controlled by the parent company. The nature of goodwill is in our view sufficiently different to justify a different accounting treatment. Under IFRS 3 goodwill is no more than a residual – as explained by the Board itself in the proposed amendments to IFRS 3 paragraph 50 – and cannot be controlled as such.

We have heard at least one Board member argue that the proposal has the effect of improving the goodwill impairment test by removing the cushion that would otherwise exist when only partial goodwill is recognised. We do not agree, for two reasons: the comment seems to imply that, when partial goodwill is recognised, the impairment test is carried out by comparing the fair value of full goodwill against the partial goodwill recognised in the balance sheet; secondly, in our view if 'cushions' exist, they are the result of internally generated goodwill (which over time cannot be distinguished from acquired goodwill).

7. The Proposed Treatment of Acquisitions in Steps

The EDs propose that the fair value of the consideration transferred by the acquirer would include the fair value of the acquirer's non-controlling equity investment in the acquiree at acquisition date that the acquirer owned immediately before the acquisition date. For step acquisitions this means that the acquirer would remeasure its non-controlling equity investment in the acquiree at fair value as of the acquisition date and recognise any gain or loss in profit or loss.

Although we agree that the nature of the investment changes at the moment the acquirer gains control, we do not think conceptually that this event would have an impact on profit or loss for the period. We also believe that for the investment held previously to the acquisition no transaction has taken place and hence no effect on the result of the period should be shown. The proposed approach seems to be based on hypothetical assumptions and transactions and that concerns us because we think only real transactions should be reflected in financial statements.

8. The Extended Scope Without Alternative Approach for True Mergers

We agree with the scope in general but we are concerned that the acquisition method should not be forced on real merger situations, which we believe exist and probably more frequently in combinations of mutual entities and combinations by contract alone than others. Therefore, we would remind the Board of its commitment to carry out further research on an alternative accounting method, e.g. fresh-start accounting.

We also recommend the Board to spend additional resources on the question of how to account for entities under common control, since this is an area which occurs frequently and gives rise to a number of potential issues.

9. The Way how New Concepts are Introduced

We are extremely concerned about the fact that the Board is moving to new concepts without first debating them fully in the context of the Framework and the general objective of financial statements so that all the implications can be properly considered. We believe that the Framework constitutes a reference point for accounting change - a link between existing and new standards - and should therefore provide a justification for everything the IASB develops in the name of good accounting. While we can accept minor changes resulting in deviations from the current Framework - supposed the related benefits are big enough - we do not support any major concepts changes, which are in conflict with the Framework. Introducing major changes in the way the EDs are proposing damages the authority of the Framework and creates the risk that changes that may be appropriate in particular circumstances will at some future date be extended to other circumstances without proper debate.

Until a global debate on measurement has taken place and conclusions have been reached, we think it is premature to make any significant change to the measurement requirements of existing standards. In this context we note that the IASB has issued on 16 November a Canadian-prepared Discussion Paper with the title “Measurement Bases for Financial Accounting – Measurement on Initial Recognition” and has also decided to carry out a project on Fair Value Measurement similar to the current FASB project. It seems odd to us that the fair value proposals in the EDs have been issued before there has been a chance to have the extensive debate on measurement that these projects seem likely to start.

Summary of EFRAG recommendations

Based on the above mentioned concerns we have a number of recommendations which we hope you will consider to be constructive.

The originally stated objective of this phase of the Business Combinations project was to achieve a satisfactory degree of convergence and provide additional guidance on certain areas where diverging views exist in practice. We recommend that the IASB focuses exclusively on this objective and does not get distracted but other possibilities.

We recommend that the Board seeks to achieve this objective by:

1. deciding not to pursue (at least for the time being) any of the changes proposed in the EDs that would involve changes to existing concepts. In other words, for the time being:
    a. the current accumulated cost approach of IFRS 3 should be retained,
    b. there should be no change to the initial recognition measurement requirements,
    c. the reliability criterion applicable to the recognition of identifiable assets and liabilities, including intangible assets, should be retained
    d. the parent entity approach should be retained.

The possibility of adopting a full goodwill approach, fair valuing the acquiree, deleting the reliability criterion, and adopting the economic entity approach should instead be referred to the ongoing Framework project, where they can be debated fully and in their proper context, and where they can be subject to a due process (including discussion papers) that reflects the significance of the changes proposed;

2. identify with the FASB what changes are needed to SFAS 141 in order to bring it into line with the existing IFRS 3 to achieve convergence, then issue a revised set of proposals for amending IFRS 3;
3. issue in a revised IAS 27 accounting requirements and guidance for changes in interest after control is obtained on the basis of AV1-AV3; no recognition of gains or losses unless a real transaction occurs in the context of re-measuring investments held before acquisition, and
4. carry out further research and field testing of new concepts.

We expand on these points and provide additional comments in the Appendices to this letter, which set out our responses to the questions raised in the EDs.

If you have any question concerning our comments please contact either Reinhard Biebel or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

ED OF PROPOSED AMENDMENTS TO IFRS 3 BUSINESS COMBINATIONS

Question 1—Objective, definition and scope

Question 1—Are the objective and the definition of a business combination appropriate for accounting for all business combinations? If not, for which business combinations are they not appropriate, why would you make an exception, and what alternative do you suggest?

EFRAG Response:

As mentioned in our introduction we do not support the objective of the proposals in the EDs. That is because we believe that the proposed approach does not produce more relevant, reliable and therefore useful information than the current IFRS3; indeed in many respects we believe that it will have the opposite effect. In addition it will create major practical implementation issues. We also believe that it is inappropriate to introduce such radical and untested concepts through revision to specific standards at a time when the conceptual framework is under active review.

We have several difficulties with the proposed objective and the definition of a business combination:

- **As we explained when we commented on the ED 3 Business Combinations and the ED of proposed amendments to the scope of IFRS 3 we believe that in practice there are true mergers - particularly in the area of combinations involving two or more mutual entities or combinations achieved by contract alone - and we believe that, in those cases, the application of the acquisition method, involving the identification of the acquirer in all cases, will not reflect economic reality.**

  For that reason, we believe it is important that an alternative accounting method for such combinations – such as fresh start accounting, to which the Board is committed (although it is not yet part of the active projects) - is investigated as soon as possible and added to the Boards' agendas.
- **Further we note that the change to the definition of a business combination has introduced some uncertainty as to whether true mergers are now deemed to be business combinations. We think the intention of the scope paragraph is that all business combinations (including true mergers) shall be subject to the acquisition method. This seems to be confirmed by BC32 of the Amendments to IFRS 3, which states that all business combinations included in the scope of IFRS 3 are within the scope of the draft revised IFRS 3. However, we see an inconsistency between this and the proposed new definition of a business combination ("acquirer obtains control"). In our view, in a true merger there is no acquirer. Although a true merger would meet the current definition of a business combination under IFRS 3 ("bringing together"), it would appear not to meet the proposed new definition. That means they will not technically be within the scope of the revised IFRS 3. Therefore we agree with the view of the dissenting members as stated in AV14 and disagree with the revision of the definition as proposed.**
- **The definition of a business combination has been widened with the introduction of the control criterion. We generally agree that taking control is the key feature of an acquisition. It should however be clear that current projects on consolidation and control may have an impact on this aspect of the standard and to make two lots of changes to the definition would be highly undesirable.**

- **As explained more fully below, we disagree that, when applying the acquisition method, the acquirer should measure and recognise the acquiree, as a whole, at its fair value at the acquisition date.**
- **Similarly, we disagree that under the acquisition method the acquirer should measure and recognise the non-controlling interests' share of goodwill.**

Question 2—Definition of a business

Question 2—Are the definition of a business and the additional guidance appropriate and sufficient for determining whether the assets acquired and the liabilities assumed constitute a business? If not, how would you propose to modify or clarify the definition or additional guidance?

EFRAG Response:

We acknowledge that the proposed definition of a business is important because all assets acquired or liabilities assumed would be accounted for differently with substantial consequences (e.g. acquisition-related cost, income taxes, goodwill). We understand that the proposed definition has been changed for convergence reasons and is broader than the current definition because it is based on the notion of "…integrated set of activities and assets that is *capable* of being conducted…." The set of activities does not need to be conducted and managed for the purpose of etc; being capable of that is sufficient. We believe that the proposed broadening of the definition scopes acquisition of certain asset groups into the standard for business combinations. We are concerned that the dividing line is not a difference in substance with the result that in situations that are alike, different accounting can result.
We do not support broadening the scope of the standard; instead we recommend the Board reconsiders whether it would be preferable to leave the term "capable of being" out of the definition.

We question why "providing dividends" has been distinguished from "providing a return to investors" (Amendments to IFRS 3 paragraph 3(d)). Additional explanations in the Basis for Conclusions would be helpful to ensure that the subtlety that the IASB is trying to achieve here is reflected in the standard's implementation.

Questions 3-7—Measuring the fair value of the acquiree

Question 3—In a business combination in which the acquirer holds less than 100 per cent of the equity interests of the acquiree at the acquisition date, is it appropriate to recognise 100 per cent of the acquisition-date fair value of the acquiree, including 100 per cent of the values of identifiable assets acquired, liabilities assumed and goodwill, which would include the goodwill attributable to the non-controlling interest? If not, what alternative do you propose and why?

<u>EFRAG Response:</u>

We believe that the proposed approach is not appropriate for the reasons set out by the dissenting Board members (in Proposed Amendments to IFRS 3 AV2 – AV7) and in our covering letter. In our view, the revised standard should continue to be based on the parent-only, accumulated cost approach with goodwill as the residual between total cost of the acquisition and the acquisition date fair value of assets acquired and liabilities assumed as laid down in the current IFRS 3.

We recognise that the Board argues that the generally accepted principle underlying consolidation is that the whole of the assets and liabilities acquired in an acquisition should be consolidated and that, by proposing that 'full goodwill' should be recognised, the Board is merely applying that generally accepted principle to an asset (purchased goodwill) that it believes is just another asset of the acquiree. We also recognise that the Board could argue that applying the generally accepted principle that the assets and liabilities acquired in a business combination should be recognised by the acquirer at fair value means that it is necessary to estimate the fair value of full goodwill; and measuring goodwill as the difference between the fair value of the acquiree as a whole and the aggregate of the fair value of the other assets and liabilities acquired is an attempt to estimate the fair value of full goodwill. However, in our view goodwill is not like any other asset. Users of financial statements do not generally think it has the same level of information content as the asset numbers, and accounting treatments that produce very useful information when applied to other assets do not necessarily generate as much benefit when applied to goodwill. For that reason we believe it is particularly important in this case to consider the costs and benefits of what is being proposed, and we are not convinced that the Board has identified benefits arising from the proposals that outweigh the cost involved. The benefits mentioned by the Board are the alignment of initial and subsequent fair value measurement and getting closer to a fair value attribute of goodwill in order to present the value of a total business instead of a share acquired, but we doubt that users will see those as significant benefits or as benefits that outweigh the increased 'softness' of the goodwill and equity numbers caused by the proposals.

Another concern we have is that the fair value measurement approach as proposed is not based on objective market fair value as is normally the use but rather carries elements of entity-/buyer-specific elements, because the fair value of an acquiree can vary from acquirer to acquirer based on the amount of synergies the acquiree believes to be able to extract in the future.
The proposed concept is not fully consistent as example 3 and 4 demonstrate because the fair value of the acquiree as a whole is deemed to consist of at least two elements, the consideration paid by the acquiree for the stake acquired (60%) and the quoted market price of the acquiree for the stake not acquired (40%). We do not think this is a conceptually clean approach even before considering the limitations to the approach regarding over- or underpayments. In other words we disagree with the full fair value in an acquisition of less than 100% of the shares because the acquisition of the minority part is based on a hypothetical transaction and does not reflect the real transaction.

Question 4—Do paragraphs A8-A26 in conjunction with Appendix E provide sufficient guidance for measuring the fair value of an acquiree? If not, what additional guidance is needed?

EFRAG Response:

We disagree with this approach as a whole and we believe that the EDs do not provide - and suspect that it is probably impracticable to provide - sufficient guidance on how to gross up fair value of the interest acquired to the fair value of the acquiree as a whole.
We also believe that, in practice, measuring the fair value of an acquiree is not always easily derived from quoted market prices; instead in many cases the calculation is dependent on a number of entity inputs and is therefore entity-specific. This will have a direct impact on the reliability of the calculation.
We refer to Example 3 in A15, which demonstrates some of the difficulties. The example gives the impression that what the other bidders were prepared to pay for the interest in the acquiree is of no relevance in determining the fair value of the acquiree as a whole. We would have thought that information about other potential bidders may well be relevant. Therefore, either we have misunderstood what the IASB is trying to achieve, or the example has overlooked some important factors; either way, the exercise acquirers are being asked to do is not as straightforward as it may at first seem.

We also refer the Board to the definition of fair value (Amendments to IFRS 3 paragraph 3 (i)) and the footnote on page 25, which states that "the definition of fair value is based on the definition in the FASB's Proposed Statement Fair Value Measurements. The FASB plans to issue a final Statement on fair value measurements in the fourth quarter of 2005. The definition of fair value may change in that final Statement." So, not only do the proposals require entities to apply a measurement basis that can involve significant subjectivity and judgement, at least in cases of less developed and liquid markets, but the proposal is also to adopt a fair value concept that is not finalised and may be subject to further change in the near future. We understand that the intention is to amend the proposal to reflect any amendments made by FASB in finalising its own thinking on the fair value concept. We are very troubled by this because, in our view, the IASB should not be seeking comments on a concept that is subject to further change unless it is also proposing to consult on those changes; otherwise there would be a lack of due process. We therefore recommend the Board conducts an appropriate analysis of the approach taken by FASB before accepting it without consultation and would like to see that being part of the project on "Fair Value Measurement", which is an active project on the IASB agenda. As a possible outcome we presume that Appendix E may be revised and it would be premature at this moment to convert it into a standard.

Question 5—Is the acquisition-date fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree the best evidence of the fair value of that interest? If not, which forms of consideration should be measured on a date other than the acquisition date, when should they be measured, and why?

<u>EFRAG Response:</u>

We generally agree that the consideration transferred in exchange for the acquirer's interest in the acquiree at the acquisition date is the best evidence of the fair value of that interest. However, we believe it is not the best estimate for the fair value of the acquiree as a whole. Therefore, we prefer the total cost approach, where the total cost of the business combination are allocated to the acquired assets and liabilities on the basis of fair value. We support the current IFRS 3 concepts on this matter. In the case of a step acquisition goodwill is accordingly computed for each individual transaction and is not modified as an outcome of subsequent acquisitions, which means that goodwill for non-controlling interests is not recognised. When control is obtained, identifiable assets and liabilities are recognised in the financial statements and as explained above they are measured by allocating the cost of the combination on the basis of their fair values on that date. The portion held by the acquirer before control is obtained is not part of the control transaction (in contrast to the assumptions in the EDs) and therefore any change in value is treated as a revaluation and does not give rise to profit.

With regard to contingent considerations we believe that they should only be recognised if the outflow of benefits is probable (see also our response to Question 6).

Question 6—Is the accounting for contingent consideration after the acquisition date appropriate? If not, what alternative do you propose and why?

<u>EFRAG Response:</u>

No. We disagree with the proposed treatment of contingent considerations and therefore also with the subsequent treatment after the acquisition date. We understand the IASB concern that there is a mixture of different elements of contingent considerations, one element linked to the purchase price determination resulting in adjustments of goodwill and another element which is linked to future events being reflected in the profit and loss statement. In practice we would expect that changes are more likely to be related to post-combination events and we would like to see a distinction between the two. Instead of changing the approach now we recommend that the Boards carry out further research with the aim of coming up with a principle-based and practicable approach to distinguish acquisition related changes of acquisition price from changes related to new (i.e. post combination) events.

Question 7—Do you agree that the costs that the acquirer incurs in connection with a business combination are not assets and should be excluded from the measurement of the consideration transferred for the acquiree? If not, why?

<u>EFRAG Response:</u>

We do not agree with the logic because (a) we agree with the two dissenters (Basis for Conclusions AV18) that the proposed principle is inconsistent with the treatment of direct acquisition related cost in other existing standards where the direct costs form part of the carrying amount of the asset acquired in order to calculate a basis on which to assess the return on investment and (b) we disagree that such costs are not part of the consideration transferred.
We recognise that the fair value concept as developed by the FASB in its Fair Value Measurement project proposes that acquisition-related costs should not be considered to be part of fair value, and that all the IASB is doing is adopting the same approach. However, we believe that serves only to highlight the need for the IASB to start its own comprehensive debate on measurement before introducing changes that have not been widely debated to date outside the US.

In line with our recommendation to keep the accumulated cost approach for the measurement of business combinations we believe, incidentally, that the Board is wrong to argue that the costs the acquirer incurs in connection with a business combination should be excluded from the measurement of the consideration transferred because "those costs…are not assets." Costs are never assets, but cost may be an appropriate way of measuring something that is an asset.

Questions 8 and 9—Measuring and recognising the assets acquired and the liabilities assumed

Question 8—Do you believe that these proposed changes to the accounting for business combinations are appropriate? If not, which changes do you believe are inappropriate, why, and what alternatives do you propose?

<u>EFRAG Response:</u>

We agree with the general principle to fair value assets acquired and liabilities assumed at acquisition date and therefore we agree with the fair value measurement of receivables as part of the allocation of total cost of the acquisition.
However, in line with our position on IAS 37, although we can support a fair value measurement basis, we disagree that contingent assets and liabilities should be recognised and measured because we believe that the probability criterion as well as reliability plays an important role in the recognition process of assets and liabilities as well as in the measurement process. Thus we agree with the dissenting Board members (Basis for Conclusions AV19).

In addition, as regards the recognition criteria for assets acquired and liabilities assumed, we note that, in contrast to paragraph 37 (a) to (c) of the current version of IFRS 3, the draft revised IFRS 3 in paragraphs 28 to 31 does not mention the 'reliability of measurement recognition criterion' anymore. In BC98 of draft revised IFRS 3 the Board explains that it decided to delete the notion because an equivalent statement is already part of the recognition criteria in the Framework (paragraph 86 – 88). Based on our understanding that the Framework can not override a standard and to prevent uncertainty we recommend the Board reinstate the 'reliability of measurement

recognition criterion' in the revised IFRS 3 or - as a minimum – include a direct reference to the Framework paragraph. Without clarification, we believe this opens the door for recognising assets and liabilities in the balance sheet at amounts that are not reliable, which is in conflict with the qualitative characteristics of the Framework. There is some evidence that the range of intangible assets which currently require recognition and measurement is creating implementation difficulties. Therefore we would prefer for the effects of this current range to be more properly evaluated before the boundaries are extended even further by removing the reliability criteria. We therefore urge the Board to reinstate this important requirement in the standard.

Incidentally it would seem more logical if the heading of this section (and related sections in other parts of the standard) was "Recognising and measuring the assets acquired…" instead of "Measuring and recognising the assets acquired…".

Question 9—Do you believe that these exceptions to the fair value measurement principle are appropriate? Are there any exceptions you would eliminate or add? If so, which ones and why?

<u>EFRAG Response:</u>

We agree that the exceptions are appropriate and enable the accounting principles established for certain assets and liabilities in specific standards to be applied subsequent to the business combination.

Questions 10-12—Additional guidance for applying the acquisition method to particular types of business combinations

Question 10—Is it appropriate for the acquirer to recognise in profit or loss any gain or loss on previously acquired non-controlling equity investments on the date it obtains control of the acquiree? If not, what alternative do you propose and why?

<u>EFRAG Response:</u>

We do not support the proposed approach. Although we agree that previously acquired non-controlling equity investments – including any goodwill element - should be the basis for the allocation of the cost price. The full consolidation and the allocation of the cost price to the individual assets and liabilities now controlled is performed on the date the acquirer obtains control regardless of how it has been accounted for until then, because the nature of the investment changes. We disagree that there is anything to be charged to profit or loss. Indeed, we have major difficulties with showing any change in the profit and loss account since we do not see any transaction with a third party regarding these investments and therefore do not support any impact on the profit for the year and if there is an impact (from revaluation) then it should rather be reflected in equity.

This view is also in line with our preference for an accumulated cost approach where the question of re-measuring goodwill normally does not arise.

Question 11—Do you agree with the proposed accounting for business combinations in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest? If not, what alternative do you propose and why?

EFRAG Response:

We note that the Board itself admits (in BC177) that this limitation of gain recognition is inconsistent with the general fair value attribute and could lead to transactions being misrepresented. The Board argues that this is necessary because otherwise it "could lead to other difficulties in practice". We have two comments on this:

- **We have argued, in this letter and previously, that the Board is being premature in changing the measurement basis of various assets and liabilities to fair value before undertaking a thorough and comprehensive analysis of, and debate about, all aspects of measurement. Until that analysis and debate has taken place, we believe that accounting is being moved in a radical new direction that is not yet fully understood. We see the day one profit issue—whether it arises in a business combination, after initial recognition of a financial instrument, on the application of general revenue recognition principles, or in accounting for insurance contracts—as a good illustration of this. It shows that, despite the Board's insistence that fair value is an appropriate measurement basis in most circumstances; the Board remains uncomfortable with some of the apparent implications of a fair value measurement system.**
- **We argue in this letter that the Board is, in proposing that the fair value of the acquiree should be recognised by the acquirer, pursuing concepts over practicality. The Board has shown however by its proposals on this issue that it is prepared to amend its proposals to reflect practicability. On that basis we think the Board needs to explain why it is appropriate to apply a pragmatic approach here but not when developing some of the other proposals in the EDs.**

Question 12—Do you believe that there are circumstances in which the amount of an overpayment could be measured reliably at the acquisition date? If so, in what circumstances?

EFRAG Response:

We do believe there are cases where an overpayment exists and we believe that over- and underpayments should in principle be treated symmetrically. Where an overpayment exists it is often triggered by entity- or buyer-specific circumstances reflected in expectations about future synergies. The consideration transferred – the purchase price – is a better indicator of the fair value of the interest acquired and does

reflect future profits; if those future profits are not recognised at acquisition date in goodwill, future profits for the period can be overstated. We therefore believe that cost results in a more faithful representation than fair value.
The Board has taken a different approach—that the fair value of an acquiree can be measured reliably—and in those circumstances we are not sure why the Board thinks it will not be possible to measure overpayments since it assumes it is always possible to determine the fair value of the acquiree as a whole.

Question 13—Measurement period

Question 13—Do you agree that comparative information for prior periods presented in financial statements should be adjusted for the effects of measurement period adjustments? If not, what alternative do you propose and why?

<u>EFRAG Response:</u>

We agree that comparative information should be adjusted for effects of measurement period adjustments and welcome the proposal, which we regard as a real improvement to the existing IFRS 3.

Question 14—Assessing what is part of the exchange for the acquiree

Question 14—Do you believe that the guidance provided is sufficient for making the assessment of whether any portion of the transaction price or any assets acquired and liabilities assumed or incurred are not part of the exchange for the acquiree? If not, what other guidance is needed?

<u>EFRAG Response:</u>

We support the fundamental principle in the standard, which appears quite clear to us. However, the guidance provided is quite detailed and lengthy and it gives the impression that it is drafted mainly to prevent abuse. We think the reality is that preparers will need to use judgement to make the assessment referred to in the question. It is our conviction that a clear principle better achieves the objective than detailed guidance. Therefore we suggest the guidance should either be deleted or amended to make it more principles based.

Question 15—Disclosures

Question 15—Do you agree with the disclosure objectives and the minimum disclosure requirements? If not, how would you propose amending the objectives or what disclosure requirements would you propose adding or deleting, and why?

EFRAG Response:

We generally agree with the disclosure objectives but we believe that the minimum requirements are too extensive and may not meet the cost benefit criterion.
We regard particularly the following requirements as too extensive:

- **Paragraph 72 does not appear to be a realistic requirement for acquisitions after the balance sheet date but before the issuance of financial statements – although there is a practicality exemption in paragraph 73 (b).**
- **Paragraph 72 (e) appears to ask for information which is very subjective; we prefer the current disclosure requirements**
- **Paragraph 74 (b) is based on hypothetical accounting, which we do not support**
- **Paragraph 76 (b) is a very important information and should remain highlighted**
- **Paragraph 76 (d) is so detailed as to be impracticable for past acquisitions; furthermore it is not part of the FASB standard and should be removed**

On the other hand paragraph 78 (b) of the FASB Exposure Draft, which requires disclosure of goodwill by reportable segments should we believe be added to the IASB EDs.

Questions 16-18—The IASB's and the FASB's convergence decisions

Question 16—Do you believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill? If not, why? Do you have any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics:
(a) the intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability; and
(b) cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole?

EFRAG Response:

No, we do not believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill. In addition to the assembled workforce example we can think of customer lists or regulatory licences, where there are restrictions on sale or where regulation of markets reduces the ability of sale.
In addition, we believe that active markets in many cases do not exist; indeed, in paragraph 78 of IAS 38 the Board admits that it is unusual that active markets exist for intangible assets. In such circumstances it is extremely difficult to determine the fair value without making use of valuation techniques. We are concerned – for several

reasons already explained - that valuation techniques, if applied to a significant proportion of the balance sheet, will increase the amount of measurement subjectivity. We see the need for a period of assessment of intangible valuations under the current standard before it is contemplated to extend it even further.

Question 17—Do you agree that any changes in an acquirer's deferred tax benefits that become recognisable because of the business combination are not part of the fair value of the acquiree and should be accounted for separately from the business combination? If not, why?

EFRAG Response:

We agree that any changes in an acquirer's deferred tax benefits that become recognisable because of the business combination should be accounted for separately from the business combination.
However, where part of the goodwill effectively relates to those deferred tax assets then subsequent separate recognition thereof should naturally result in an impairment of the goodwill and we believe it would be helpful if the Board would indicate that.

Question 18—Do you believe it is appropriate for the IASB and the FASB to retain those disclosure differences? If not, which of the differences should be eliminated, if any, and how should this be achieved?

EFRAG Response:

We understand that convergence is the ultimate objective of this exercise and appreciate the Board's efforts. Although we would expect that convergence leads to the elimination of all diverging requirements, we can understand why certain differences in disclosure requirements remain and regard it is appropriate to retain them for the time being subject to those recommendations made in our response to Question 15.

Question 19—Style of the Exposure Draft

Question 19—Do you find the bold type-plain type style of the Exposure Draft helpful? If not, why? Are there any paragraphs you believe should be in bold type, but are in plain type, or vice versa?

<u>EFRAG Response:</u>

We agree with the bold type – plain type distinction and find it helpful. We have not (yet) identified any paragraphs which should be changed from one typeface to another.

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ED OF PROPOSED AMENDMENTS TO IAS 27 *Consolidated and Separate Financial Statements*

Question 1

Draft paragraph 30A proposes that changes in the parent's ownership interest in a subsidiary after control is obtained that do not result in a loss of control should be accounted for as transactions with equity holders in their capacity as equity holders. As a result, no gain or loss on such changes would be recognised in profit or loss (see paragraph BC4 of the Basis for Conclusions).
Do you agree? If not, why not and what alternative would you propose?

EFRAG Response:

We disagree with the proposed treatment. According to the proposal in the case of increasing values an increase in ownership after control is obtained would reduce equity. We agree with the view expressed by the dissenting Board members (ED of proposed amendments to IAS 27 AV1 – AV3); the consequences of changes in controlling interests in subsidiaries after control is established – increases and decreases - should be reported in the income statement since the primary objective of financial reporting is to provide information to the shareholders of the parent entity. Our view is based on our preference for the modified parent entity approach, which involves reporting performance from the perspective of a controlling interest.
We do however agree that non-controlling investments do not meet the definition of a liability and should be classified as a separate item of equity. We are aware that in the current IFRS standards some elements of the economic entity view have already been incorporated but we believe that a fundamental choice between the both approaches would require a more thorough discussion in relation to the conceptual framework.

Question 2

Do you agree that the remaining non-controlling equity investment should be remeasured to fair value in these circumstances? If not, why not and what alternative would you propose?

Do you agree with the proposal to include any gain or loss resulting from such remeasurement in the calculation of the gain or loss arising on loss of control? If not, why not, and what alternative would you propose?

EFRAG Response:

We have great difficulties accepting the proposal if the investment remains a jointly controlled entity (IAS 31) or an associate (IAS 28). For example, assume that an entity that owns 100% of an entity sells 60% off and, as a consequence, loses control of it. The entity still owns the 40% for which no transaction has taken place. According to the proposal a change of measurement basis would be required although the 40% have not been subject to any transaction. We believe this is not correct.

The broader question of where measurement changes should be recognised should be subject to the discussions in the "Performance Reporting" project.
We disagree with the proposal that gains or losses resulting from remeasuring the remaining non-controlling equity investment to fair value shall be included in the calculation of the gain or loss arising on loss of control.

Question 3

Do you agree that it is appropriate to presume that multiple arrangements that result in a loss of control should be accounted for as a single arrangement when the indicators in paragraph 30F are present? Are the proposed factors suitable indicators? If not, what alternative indicators would you propose?

EFRAG Response:

Yes, we agree that the factors proposed in paragraph 30F are suitable indicators for whether a multiple arrangement that results in a loss of control should be accounted for as a single arrangement, with respect to the consolidation issue.

Question 4

Do you agree with the proposed loss allocation? Do you agree that any guarantees or other support arrangements from the controlling and non-controlling interests should be accounted for separately? If not, why not, and what alternative treatment would you propose?

EFRAG Response:

We disagree. As we prefer the modified parent entity view, we prefer the current IAS 27 loss allocation.

Question 5

Do you agree that proposed paragraphs 30A, 30C and 30D should apply on a prospective basis in the cases set out in paragraph 43B? Do you believe that retrospective application is inappropriate for any other proposals addressed by the Exposure Draft? If so, what other proposals do you believe should be applied prospectively and why?

EFRAG Response:

We agree with the proposal, although we generally believe in the principle of retrospective application because it ensures comparability and enhances understandability. There may be circumstances in which retrospective application is

not possible (because the information needed is not available) or is undesirable (because it would be necessary to apply hindsight in a way that could significantly benefit the entity). In those cases prospective application should be required on an exceptional basis.

Structure and Process of the Project

(These comments cover also our process concerns regarding the proposed amendments to IAS 37 and IAS 19)

Our concerns discussed in this Appendix are as follows:

1. Conceptual changes
2. The number of phases of the project
3. Changes made to changes
4. Use of discussion papers
5. Further research and field visits
6. Length of comment period
7. Effective date and time for implementation

1. EFRAG notes that a number of proposals made are not consistent with the existing Conceptual Framework (e.g. moving the probability criterion from recognition to measurement). This concerns us because we believe that, if changes are to be made to existing basic concepts, they should first be discussed in the context of the Framework itself. The IASB itself seemed to have accepted this previously - we refer to paragraph BC112 of the current IFRS 3, where the Board agreed that the role of the probability criterion in the Framework should be considered more generally as part of a concepts project - and it is not clear what has changed since to justify a change in approach.

   We can accept minor changes to Frameworks as long as it serves user needs, but we believe that, if major changes are to be made to existing concepts, an exposure draft proposing the relevant changes to the Framework should be issued before or at the same time that the conceptual changes are reflected in Exposure Drafts of IFRSs. This is important because we think it essential that the Framework is kept up-to-date at all times. That is because it is part of the hierarchy in IAS 8. In jurisdictions where the Framework is not part of a hierarchy and is intended solely as a tool for the standard setter (as is the case in the UK), it is acceptable to view the Framework as a 'living' thing that is written down occasionally, but when preparers are required in certain circumstances to take the Framework into account that approach is inappropriate.

2. The EDs are the output of Phase II of an apparently multi-phased long-term project on Business Combinations. However, although there are references in the EDs to some of the work that is to be carried out in later stages (for example, fresh start accounting (Amendments to IFRS 3, BC32), joint ventures and combination of businesses under common control (Amendments to IFRS 3, BC42) and general treatment of acquisition of asset groups (Amendments to IFRS 3, BC41)), the exact scope of these future phases and the time schedule for completion is not explained. We urge the Board to explain more fully its plans and– if possible - provide a project timetable. This would enable those trying to evaluate the proposals to put them in their proper context. It would also help to dispel the current impression that accounting for business combinations is an area subject to constant change.

3. As we have said before, it is essential in these multi-phase projects that the Board ensures that decisions made in an early phase of the project are not revised in a later phase, thereby changing a standard that is already established in practice in the interim.

Yet Phase II proposes to change a number of the decisions implemented via Phase I of the project, including some of the key definitions (business and business combination) and the approach to the recognition of contingent assets and liabilities.
It can be expected that the outcome of other ongoing projects such as measurement or control may also have considerable impact on consolidation accounting and probably on accounting for business combinations.

4. We are a firm believer in the need for a single set of high quality accounting requirements that apply throughout the world and we recognise that, if real progress is to be made towards that objective, certain fundamental issues need to be addressed. Achieving convergence of consolidation methodology is one of those issues. However, the EDs introduce a number of significant changes (e.g. fair value measurement at initial recognition) that have important implications which in the case of proposed changes to the recognition criteria of IAS 37 go beyond accounting for business combinations. EFRAG believes those changes need in depth consideration so that their practical relevance and implications can be analysed. If this analysis is to be done well, it should not be rushed. Bearing that in mind we regret that the Boards have decided to move directly to the issuance of EDs instead of issuing a discussion paper first. A discussion paper would have given constituents the opportunity of an in depth consideration of the proposed concepts at an early stage and without being put under the time pressure that an ED with a short comment period imposes. It would probably also have had the positive side-effect of giving constituents more time to get familiar with the proposals, thus resulting in less resistance and scepticism towards new concepts.

5. Following that a logical next step in our view would have been to carry out field visits. Such visits proved to be a very beneficial exercise during the development of phase 1 of Business Combinations.

6. We are concerned about the shortness of the comment period (see our separate letter submitted to you during August 2005).

7. We are also concerned about the short implementation time if the effective date remains as proposed in the EDs. Assumed, the EDs will in an amended version be published as IFRSs, we believe that a sufficient period for implementation should be granted and therefore the originally envisaged effective date has to be postponed.

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