

**ICAEW REP 12/05**

**FRED 36: BUSINESS COMBINATIONS (IFRS 3) &  
AMENDMENTS TO FRS 2 ACCOUNTING FOR SUBSIDIARY  
UNDERTAKINGS (PARTS OF IAS 27 CONSOLIDATED AND  
SEPARATE FINANCIAL STATEMENTS)**

*Memorandum of comment submitted in October 2005 by the Institute of Chartered Accountants in England and Wales, in response to Accounting Standards Board FRED 36 Business Combinations (IFRS 3) & Amendments to FRS 2 Accounting for Subsidiary Undertakings (Parts of IAS 27 Consolidated and Separate Financial Statements), published on 28 July 2005*

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## **INTRODUCTION**

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on FRED 36 *Business Combinations (IFRS 3) & Amendments to FRS 2 Accounting for Subsidiary Undertakings (Parts of IAS 27 Consolidated and Separate Financial Statements)*, published by the Accounting Standards Board on 28 July 2005.

## **WHO WE ARE**

2. The Institute of Chartered Accountants in England and Wales (the 'Institute') is the largest accountancy body in Europe, with more than 125,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

## **MAJOR ISSUES**

4. Our responses to the exposure drafts *Proposed Amendments to IFRS 3 Business Combinations* and *Proposed Amendments to IAS 27 Consolidated and Separate Financial Statements*, published by the International Accounting Standards Board on 30 June 2005, are attached. These set out our overall views on the proposals. In general, we are very much in agreement with the concerns highlighted by the ASB. Our responses to the specific questions raised by the ASB are set out in paragraphs 6 to 13 below.
5. In July 2005 we submitted a memorandum of comment to the ASB regarding the policy statement exposure draft, 'Accounting Standard-Setting in a Changing Environment: The Role of the Accounting Standards Board'. In it we suggested that for the time being at least there is a continuing role for a UK GAAP separate from IFRS GAAP. All our comments below should be read in the context that the ASB will continue for the time being to pursue and maintain a separate UK GAAP.

## **RESPONSES TO SPECIFIC QUESTIONS**

*ASB 1 Should the IASB proposals succeed to a Standard the ASB would prefer to defer implementation until the full impact of the proposal can be evaluated through practical implementation. The following options for implementation into UK accounting standards have been identified, which would you prefer? Please explain your preference.*

- i. *implement the Business Combinations ‘package’ in full simultaneously with the IASB (ie 1 January 2007);*
  - ii. *not to implement immediately but reconsider implementation of the Business Combinations ‘package’ after a period of time has lapsed and the IFRS have been in effect. This would allow consideration of the practical implications to be more fully researched;*
  - iii. *issue Phase I (FRED 37 Intangible Assets and FRED 38 Impairment of Assets) to be effective 1 January 2007 but defer Phase II (FRED 36 Business Combinations and FRED 39 Amendments to FRS 12 and FRS 17) until after the IFRS are effective and consideration of the practical implications are more fully researched; and*
  - iv. *issue Phase I (as in (iii) above) plus FRED 39. It might be noted that the Preface to FRED 39 sets out some concerns the Board has in relation to the proposed amendments to FRS 12.*
6. We prefer option (ii) - to defer implementation until the relevant IFRSs have been in effect for a period of time. As well as the advantage noted in (ii) itself, this will allow the ASB to retain all its options while it deliberates on the future of UK GAAP.
7. We reject options (i) and (iv) for the reasons set out in the attached response to the IASB. In particular, we believe that the proposals in FRED 39 are inferior to current IFRS and UK GAAP.
8. With regard to option (iii), it is unclear whether the ASB would propose to adopt the IASB’s ‘Phase I’ - ie, including not only FRED 37 and FRED 38 but also existing IFRS 3 - or its *own* Phase I which would exclude any version of IFRS 3. We presume the latter is intended under this option; we would reject the introduction into UK GAAP at this stage of either version of IFRS 3 and, as noted in our attached response to the IASB, we have reservations about the proposed amendments to IFRS 3. Our specific comments on FRED 37 and FRED 38 in a UK context are as follows.
- (a) We can see some features FRED 37 (IAS 38) *Intangible Assets* that are superior to current UK GAAP, but we are concerned that a requirement for unlisted companies to identify and value a long list of intangibles would incur an expense that would be disproportionate to any benefit. Therefore, if the ASB were minded to implement IAS 38 at this time, we would like to see an emphasis on a cost-benefit filter based on reliable measurement or on a defined list of intangibles. For example, initial experience of applying similar requirements in the US suggests there is overlap between the various items listed within customer-related intangibles.
  - (b) FRED 38 (IAS 36) *Impairment of Assets* is in many respects comparable with FRS 11, although certain aspects, such as segmental allocation of goodwill, are more onerous. In our view, however,

especially if the UK were to retain the ability to amortise goodwill, it would be beneficial for those entities amortising to continue to be required to monitor subsequent cash flows for a number of years, as in FRS 11.

On balance, therefore, as set out above, we favour option (ii).

*ASB 2 Do you support the proposal, as set out in paragraphs 54 and 55, that the UK IFRS based-standard should include an option, to allow goodwill having a limited useful life to be amortised over its useful life?*

9. Yes, because of the cost-benefit considerations set out in paragraphs 24 and 56 of the ASB commentary. As set out above, we believe that where an impairment test is triggered for an entity amortising goodwill, UK entities should be required to replace the amortised amount with actual data as currently required by FRS 11.

*ASB 3 The draft FRS excludes from its scope the accounting for business combinations under common control. The Board is considering whether to include additional guidance in the UK IFRS-based standard that would retained some of the provisions of FRS 6. FRS 6 permitted group reconstructions to be accounted for by applying merger accounting. Do you consider the Board should retain those provisions of FRS 6 that permit the use of merger accounting for group reconstructions? Do you consider that any guidance is needed? If so please provide details for the type of the guidance you consider necessary.*

10. Yes, if the Board moves to adopt IFRS 3 in the UK (which we do not believe it should do), we consider that the Board should retain those provisions of FRS 6 that permit the use of merger accounting for group reconstructions, and that guidance is needed. That guidance would in any event be helpful.
11. In our response to ‘Accounting Standard-Setting in a Changing Environment’, we suggested that in UK GAAP the ASB might consider a prohibition on merger accounting, perhaps excluding ‘not for profit’ entities and cases involving common control. If the ASB were to press ahead with implementing IFRS 3, then guidance would be needed in the UK standard on group reconstructions and other common control transactions. Many IFRS preparers will look to UK GAAP for guidance on common control. Removing the relevant material in FRS 6 without replacement would remove this essential source of guidance.
12. We suggest also that the guidance in FRS 6 could be expanded to deal with, for example, instances where book values rather than fair values are justified on the transfer of businesses within a group, and the circumstances in which an accounting difference due to under or over-payment should be treated as an adjustment to reserves rather than goodwill. If the ASB decides to retain FRS 6, or to issue such guidance in any case, it should consult in due course on these and other improvements.

***ASB 4** The draft IFRS sets out in paragraph 43 that an acquirer shall measure and recognise, separately from goodwill, an acquired non-current asset (or disposal group) that is classified as held for sale as of the acquisition date in accordance with paragraphs 7-11 of IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. IFRS 5 is not an adopted UK IFRS-based standard. Previously FRS 7 required business operations to be sold within one year of the acquisition date to be treated as a single asset and the fair value to be based on the net proceeds of sale. The draft UK IFRS-based standard proposes to retain those paragraphs of FRS 7 that were previously applicable. Do you agree with this proposal?*

13. Yes. We applaud the ASB for not having introduced IFRS 5 to UK GAAP and believe that the relevant provisions of FRS 7 are unquestionably preferable.

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**ICAEW REP 09/05**

**PROPOSED AMENDMENTS TO IFRS 3 BUSINESS COMBINATIONS**

*Memorandum of comment submitted in October 2005 by the Institute of Chartered Accountants in England and Wales, in response to International Accounting Standards Board exposure draft Proposed Amendments to IFRS 3 Business Combinations, published on 30 June 2005*

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## **INTRODUCTION**

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the exposure draft *Proposed Amendments to IFRS 3 Business Combinations*, published by the International Accounting Standards Board on 30 June 2005.

## **WHO WE ARE**

2. The Institute of Chartered Accountants in England and Wales (the 'Institute') is the largest accountancy body in Europe, with more than 125,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

## **MAJOR ISSUES**

### **Overall response**

4. While we accept there are aspects of accounting for business combinations which require action by the Board to improve IFRS 3, and in this respect we agree with certain of the proposals in this exposure draft, we do not agree with many of the major conclusions reached and accordingly we generally do not support the exposure draft. Moreover, we do not agree that IASB has followed an acceptable development process for proposed changes of such significance. In proposing to move from a modified form of the parent company model to an entity model, and to increase use of fair values, the IASB and FASB have devised a 'third way' approach that is not justified as necessary for convergence, nor has it been explained and debated as a better alternative to the present arrangements. Our concerns are set out below.

### **Process**

5. We are concerned that IASB has proposed such radical changes to existing practice without a full and proper debate of the conceptual issues. The correct process would have been for the IASB to have examined the underlying conceptual issues in the context of developing the Framework, and to have issued discussion papers dealing separately with the topics of consolidation models, and measurement bases. There is also a concern that in moving directly to exposure drafts with the intention of issuing revised standards, IASB is placing too heavy a burden on businesses which have recently undergone significant change in reporting requirements and who would

benefit from a period without further upheaval. We do not see it as an acceptable sequence of change in which the Framework is retrofitted to accord with new standards. We suggest that this approach does not support the requirement that preparers will use the Framework in interpreting and applying current standards.

6. We are also concerned that the IASB provides no evidence of problems identified by users resulting from existing GAAP that need to be addressed. There is no indication of the effect of the proposed changes in terms of their size and incidence, nor any attempt to assess what proportions of different types of combinations will be affected. We would, however, support improvement to IFRS 3 in due course (see paragraph 14) by a requirement to fair value contingent assets consistently with contingent liabilities, to reconsider the treatment of contingent consideration, and to introduce application guidance on many of the subjects identified in the exposure draft.

### **Accounting model**

7. We do not support moving from a parent company model (albeit already in a modified form) to an entity model for consolidated financial statements. In this respect, we concur with the five dissenting Board members and the views expressed in AV 2-7. While the entity model may have certain merits, these have not been expounded by the ASB, contrasted with the benefits of the current model, nor subjected to rigorous conceptual debate. In our view, the current parent model has not been shown to be fatally flawed, and we are not aware of calls to change a method which works reasonably well in practice.
8. Consolidated financial statements are provided primarily for the shareholders of the parent entity, to whom they are addressed. These parent entity shareholders look to the consolidated accounts for information which enables them to make decisions, including whether a transaction results in a gain or loss to them. By contrast, we do not believe that minority shareholders in a subsidiary entity look to the parent's consolidated accounts in order to make decisions, or indeed at all. Accordingly, we disagree with the treatment of transactions with minorities as movements in equity. We do not consider that the changes made to IAS 27 as part of the improvements project were understood to represent a change of consolidation principle, but rather were a matter of presentation. We consider it is too simplistic to straight-jacket non-controlling interests into a three-way asset/liability/equity model. We encourage the Board to re-deliberate this issue and develop an approach which provides parent shareholders with information on gains and losses which arise from transactions with minorities.
9. For these reasons, reporting on the basis proposed by the Board will have the effect of disguising the financial position of the majority - the equity shareholders in the parent to whom the financial statements are primarily addressed - without providing any counterbalancing improvement in the information available to, or required by, any other stakeholders.

## **Fair value**

10. In general, we understand the IASB's desire to move financial reporting towards more relevant measures if this can be done without sacrificing reliability. However, we believe that the conclusion that greater use of fair values is therefore needed should be fully articulated and properly debated, rather than introduced piecemeal. Moreover, we cannot discern any benefit in adopting the approach set out in the exposure draft, although there is a significant cost. Indeed, our business members express grave concerns over the Board's general move towards point-in-time fair values without a proper articulation of how such values may be reliably generated, or the need of users for this rather than other forms of value information.
11. We see significant practical costs and difficulties attaching to the requirement to fair value the whole of the acquiree when less than 100 per cent has been acquired. Such an exercise will be largely hypothetical, and therefore judgemental and subjective. The IASB has laid no foundation for the assertion that using fair values in this way will improve the relevance or reliability of financial information. In our view, the information currently provided under IFRS 3, based on the accumulation and allocation of cost, is useful information in practice.
12. We note that the exposure draft aims to achieve greater consistency between the treatment of goodwill and the treatment of other assets acquired in a business combination. However, the proposals are somewhat ineffective in pursuit of these aims in that goodwill remains a residual, and the distinction remains between the treatment of acquisitions of businesses and acquisition of assets that are not businesses. Moreover, while improving the reliability and consistency of the goodwill measure is in principle a laudable aim, we suggest that in practice it is largely a wasted effort, as research consistently shows that users do not find the goodwill number useful, and disregard it.

## **Transaction costs**

13. In our view, acquisition-related costs are part of the consideration the acquirer is prepared to pay for the acquiree, and should therefore be taken into account in measuring the consideration transferred for the acquiree. In this respect, we concur with the dissenting views in AV 18. We also note that the capitalisation of acquisition costs is embedded in a number of other standards (see paragraph 25 below), and change to IFRS 3 would introduce inconsistencies. It is relevant to a user to understand that value in use of an acquired entity exceeds its cost and, for this reason, the Board might reconsider IAS 36 and in particular the need to check for overpayment.

## **Our preferred approach**

14. In our view, IASB should:
  - Make no changes to present standards for three years (for the reasons given in paragraph 5 above); thereafter

- Retain the main principles of IFRS 3, in particular that the acquisition method should be required for all business combinations;
- Extend the scope of business combinations to include mutual entities, however, we are not convinced that sufficient research has been conducted to conclude that an acquirer may always be identified in combinations by way of contract;
- Retain the modified parent entity approach, but add guidance on step acquisitions and partial disposals;
- Amend IFRS 3 to require contingent assets to be fair valued in an acquisition, and add application guidance as proposed on such issues as determining whether a payment is consideration or employee remuneration;
- Retain the IFRS 3 approach to acquisition costs, but amend IAS 36 to allow value in use to be assessed to check for over-payment;
- Reconsider the treatment of contingent consideration (we have not concluded on this issue, but discuss the issues in paragraph 24 below); and
- Amend the list of identified intangibles to reflect the experience gathered in the United States from applying SFAS 141 and 142, for example, to limit the list of customer-related intangibles.

## **SPECIFIC QUESTIONS**

### **Question 1—Objective, definition and scope**

*The proposed objective of the Exposure Draft is:*

*...that all business combinations be accounted for by applying the acquisition method. A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses (the acquiree). In accordance with the acquisition method, the acquirer measures and recognises the acquiree, as a whole, and the assets acquired and liabilities assumed at their fair values as of the acquisition date. [paragraph 1]*

*The objective provides the basic elements of the acquisition method of accounting for a business combination (formerly called the purchase method) by describing:*

- (a) *what is to be measured and recognised. An acquiring entity would measure and recognise the acquired business at its fair value, regardless of the percentage of the equity interests of the acquiree it holds at the acquisition date. That objective also provides the foundation for determining whether specific assets acquired or*

*liabilities assumed are part of an acquiree and would be accounted for as part of the business combination.*

- (b) when to measure and recognise the acquiree. Recognition and measurement of a business combination would be as of the acquisition date, which is the date the acquirer obtains control of the acquiree.*
- (c) the measurement attribute as fair value, rather than as cost accumulation and allocation. The acquiree and the assets acquired and liabilities assumed would be measured at fair value as of the acquisition date, with limited exceptions. Consequently, the consideration transferred in exchange for the acquiree, including contingent consideration, would also be measured at fair value as of the acquisition date.*

*The objective and definition of a business combination would apply to all business combinations in the scope of the proposed IFRS, including business combinations:*

- (a) involving only mutual entities*
- (b) achieved by contract alone*
- (c) achieved in stages (commonly called step acquisitions)*
- (d) in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date.*

*(See paragraphs 52-58 and paragraphs BC42-BC46 of the Basis for Conclusions.)*

**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?*

- 15. We are not convinced that the objective and the definition are appropriate for all business combinations.
- 16. The objective states that ‘in accordance with the acquisition method, the acquirer measures and recognises the acquiree, as a whole’. We agree that this is one way of implementing the acquisition method, but as set out in paragraphs 7 to 9 above we do not believe that the IASB has laid a conceptual foundation for moving from the present parent company model to an entity model.
- 17. The definition of a business combination as a ‘transaction or other event in which an acquirer obtains control of one or more businesses’ is superior to the previous definition in that the earlier definition was largely circular. However, our reading of the proposed definition is that it excludes true mergers. If the

IASB's intention was to establish that no bringing together of entities could be classed and treated as a merger, then the drafting fails to achieve this aim, because of the circularity of paragraphs 4 and 10.

18. In our view, it is entirely possible to have a business combination in which there is no acquirer. This can occur in the case of combinations achieved by contract alone, specifically in relation to dual-listed arrangements under which the activities of two entities are managed through contractual arrangements as a single economic entity, while the two retain their separate legal identities. We agree that the acquisition method should always be used if there is an acquisition. However, further discussion and subsequent guidance is required on how to identify the acquirer.

### **Question 2—Definition of a business**

*The Exposure Draft proposes to define a business as follows:*

*A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:*

- (1) a return to investors, or*
- (2) dividends, lower costs, or other economic benefits directly and proportionately to owners, members, or participants.*  
*[paragraph 3(d)] Paragraphs A2-A7 of Appendix A provide additional guidance for applying this definition. The proposed IFRS would amend the definition of a business in IFRS 3. (See paragraphs BC34-BC41.)*

**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?*

19. We are broadly content with the widening of the scope of the definition to include assets that are 'capable' of being conducted for the given purposes, and the guidance in A2 to A7. However, it is not clear how this guidance applies to the acquisition of entities which own a single asset such as an investment property but are also exposed to tax liabilities. In the absence of consistent guidance for asset purchases and business combinations, there is the risk of anomalies. If the acquisition of a single asset entity is accounted for as an asset purchase, the re-measurement of (say) an investment property to fair value generates a day 2 profit but ignores the inherent tax liability which existed on acquisition. In practice, accounting on the basis that this is a business combination provides an easier reconciliation to ongoing accounting under IAS 40 and IAS 12, although it is not clear that the acquisition would meet the definition of a business combination.

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

*The Exposure Draft proposes that in a business combination that is an exchange of equal values, the acquirer should measure and recognise 100 per cent of the fair value of the acquiree as of the acquisition date. This applies even in business combinations in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at that date. In those business combinations, the acquirer would measure and recognise the non-controlling interest as the sum of the non-controlling interest's proportional interest in the acquisition-date values of the identifiable assets acquired and liabilities assumed plus the goodwill attributable to the non-controlling interest. (See paragraphs 19, 58 and BC52-BC54.)*

**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?*

20. We do not agree with the proposed approach. The arguments against the full goodwill method are well-expressed in paragraphs AV2 - AV7. The revised IFRS 3 should continue to be based on the parent model and cost-based approach currently adopted in the standard. As set out in paragraphs 10 to 12 above, we believe that the resulting goodwill number would be less reliable than the one obtained under the current approach. While we understand the motives of the IASB, there is no point in attempting to apply a supposedly greater degree of conceptual rigour to valuing goodwill if it actually results in a less reliable number. The lack of confidence shown by users in the goodwill number will become even more acute.

*The Exposure Draft proposes that a business combination is usually an arm's length transaction in which knowledgeable, unrelated willing parties are presumed to exchange equal values. In such transactions, the fair value of the consideration transferred by the acquirer on the acquisition date is the best evidence of the fair value of the acquirer's interest in the acquiree, in the absence of evidence to the contrary. Accordingly, in most business combinations, the fair value of the consideration transferred by the acquirer would be used as the basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree. However, in some business combinations, either no consideration is transferred on the acquisition date or the evidence indicates that the consideration transferred is not the best basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree. In those business combinations, the acquirer would measure the acquisition-date fair value of its interest in the acquiree and the acquisition-date fair value of the acquiree using other valuation techniques. (See paragraphs 19, 20 and A8-A26, Appendix E and paragraphs BC52-BC89.)*

**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?

21. As we do not agree with the proposal to fair value the whole of the acquiree, we have not given detailed consideration to this question. However, we submit that the guidance overall is rather too simplistic in dismissing factors that may well be relevant in making the valuation. There is a tension here between the desire to provide as ‘hard’ a number as possible by limiting the input factors, and the desire to ensure that all the relevant factors are taken into account, with some resultant softness. This serves to emphasise our point that arriving at a reliable estimate of the fair value will be difficult and contentious, given the range of factors and the subjectivity involved.
22. We note that the definition of fair value is based on the FASB’s proposed definition, which is subject to exposure and comment and consequently to change.

*The Exposure Draft proposes a presumption that the best evidence of the fair value of the acquirer’s interest in the acquiree would be the fair values of all items of consideration transferred by the acquirer in exchange for that interest measured as of the acquisition date, including:*

- (a) *contingent consideration;*
- (b) *equity interests issued by the acquirer; and*
- (c) *any non-controlling equity investment in the acquiree that the acquirer owned immediately before the acquisition date.*

*(See paragraphs 20-25 and BC55-BC58.)*

**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?

23. Yes. However, we do not agree that the fair value of the acquiree should be the basis for the acquisition accounting.

*The Exposure Draft proposes that after initial recognition, contingent consideration classified as:*

- (a) *equity would not be remeasured.*
- (b) *liabilities would be remeasured with changes in fair value recognised in profit or loss unless those liabilities are in the scope of IAS 39 Financial Instruments: Recognition and Measurement or [draft] IAS*

*37 Non-financial Liabilities. Those liabilities would be accounted for after the acquisition date in accordance with those IFRSs.*

*(See paragraphs 26 and BC64-BC89.)*

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

24. We can see both sides of this issue. On the one hand, we believe that the widespread existence of contingent consideration can be seen as de facto evidence that the fair value of the acquired interest could not be established reliably at the acquisition date and that adjustments therefore relate properly to the value at that date. This would lead us to retain an unlimited measurement period for contingent consideration. On the other hand, we can see that contingent consideration can be affected by events subsequent to acquisition, and an unlimited measurement period may encourage structuring transactions to exploit the treatment as an addition to goodwill. Accordingly, a requirement to expense all adjustments may be justified as a pragmatic approach to potential for abuse.

*The Exposure Draft proposes that the costs that the acquirer incurs in connection with a business combination (also called acquisition-related costs) should be excluded from the measurement of the consideration transferred for the acquiree because those costs are not part of the fair value of the acquiree and are not assets. Such costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; the cost of issuing debt and equity instruments; and general administrative costs, including the costs of maintaining an internal acquisitions department. The acquirer would account for those costs separately from the business combination accounting. (See paragraphs 27 and BC84-BC89.)*

**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?*

25. No. Acquisition-related costs are part of the consideration the acquirer is prepared to pay for the acquiree. As these costs are incurred in the expectation of future value, they are assets. We therefore agree with the views expressed in AV18.
26. We consider the Board's proposed approach introduces an inconsistency with equity accounting (IAS 28), other cost-based measurements (IAS 2, 16 and 38), and other fair value-based standards (IAS 39 and 40). It is however relevant to a user to understand that value in use of an acquired entity exceeds its total cost, and we would encourage the Board to reconsider the requirements of IAS 36 in checking for overpayment.

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

*The Exposure Draft proposes that an acquirer measure and recognise as of the acquisition date the fair value of the assets acquired and liabilities assumed as part of the business combination, with limited exceptions. (See paragraphs 28-41 and BC111-BC116.) That requirement would result in the following significant changes to accounting for business combinations:*

- (a) *Receivables (including loans) acquired in a business combination would be measured at fair value. Therefore, the acquirer would not recognise a separate valuation allowance for uncollectible amounts as of the acquisition date.*
- (b) *An identifiable asset or liability (contingency) would be measured and recognised at fair value at the acquisition date even if the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. After initial recognition, such an asset would be accounted for in accordance with IAS 38 Intangible Assets or IAS 39 Financial Instruments: Recognition and Measurement, as appropriate, and such a liability would be accounted for in accordance with [draft] IAS 37 or other IFRSs as appropriate.*

**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?*

27. We agree with the proposals. In certain respects, these do not appear to change IFRS 3 and we assume are included as changes to US GAAP. In respect of contingent assets, we consider the requirement to fair value on acquisition corrects an anomaly which was introduced in IFRS 3. However, in our response to IAS 37, we do not consider that the ongoing accounting under IAS 37 requires change.

*The Exposure Draft proposes limited exceptions to the fair value measurement principle. Therefore, some assets acquired and liabilities assumed (for example, those related to deferred taxes, assets held for sale, or employee benefits) would continue to be measured and recognised in accordance with other IFRSs rather than at fair value. (See paragraphs 42-51 and BC117-BC150.)*

**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?*

28. We agree that the proposed exceptions are appropriate. However, we do not consider that either IAS 12 or IFRS 5 are high quality standards, and we

would encourage the Board to review them once experience of their application is available.

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

*The Exposure Draft proposes that, for the purposes of applying the acquisition method, 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. Accordingly, in a business combination achieved in stages (step acquisition) 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. If, before the business combination, the acquirer recognised changes in the value of its non-controlling equity investment directly in equity (for example, the investment was designated as available for sale), the amount that was recognised directly in equity would be reclassified and included in the calculation of any gain or loss as of the acquisition date. (See paragraphs 55, 56 and BC151-BC153.)*

**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?*

29. Although we do not oppose the remeasurement of previously acquired non-controlling interests, we strongly oppose the recognition of resulting gains and losses in the income statement. Such gains and losses are subsumed into a continuing controlling interest which is not held for sale. Accordingly, a comparison may be made with available for sale items, and recognition in equity until realisation would be appropriate.

*The Exposure Draft proposes that in a business combination in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest (referred to as a bargain purchase) any excess of the fair value of the acquirer's interest in the acquiree over the fair value of the consideration transferred for that interest would reduce goodwill until the goodwill related to that business combination is reduced to zero, and any remaining excess would be recognised in profit or loss on the acquisition date.*

*(See paragraphs 59-61 and paragraphs BC164-BC177.) However, the proposed IFRS would not permit the acquirer to recognise a loss at the acquisition date if the acquirer is able to determine that a portion of the consideration transferred represents an overpayment for the acquiree. The boards acknowledge that an acquirer might overpay to acquire a business, but they concluded that it is not possible to measure such an overpayment reliably at the acquisition date. (See paragraph BC178.)*

**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?

30. We agree that this is a practical solution. However, we question its conceptual basis in the context of the proposals, as it seems to be more consistent with an allocation of cost model that treats goodwill as a residual (which we believe is a preferable model).

**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?

31. Overpayments may occur in practice, and we consider they should be considered within the scope of IAS 36. In this content, we do not see any reason why value in use could not be computed at the acquisition date.

### **Question 13—Measurement period**

*The Exposure Draft proposes that an acquirer should recognise adjustments made during the measurement period to the provisional values of the assets acquired and liabilities assumed as if the accounting for the business combination had been completed at the acquisition date. Thus, comparative information for prior periods presented in financial statements would be adjusted, including any change in depreciation, amortisation or other profit or loss effect recognised as a result of completing the initial accounting. (See paragraphs 62-68 and BC161-BC163.)*

**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?

32. No. Such adjustments are in substance changes of estimates, and should not be dealt with as prior year adjustments. In the special case of a business combination, we would not oppose a catch-up adjustment in the period of re-estimation.

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

*The Exposure Draft proposes that an acquirer assess whether any portion of the transaction price (payments or other arrangements) and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred by the acquirer and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree would be included in the business combination accounting. (See paragraphs 69, 70, A87-A109 and BC154-BC160.)*

**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?

33. We welcome the additional guidance which deals with practical issues and, despite its length, will improve consistency and reduce scope for abuse.

**Question 15—Disclosures**

*The Exposure Draft proposes broad disclosure objectives that are intended to ensure that users of financial statements are provided with adequate information to enable them to evaluate the nature and financial effects of business combinations. Those objectives are supplemented by specific minimum disclosure requirements. In most instances, the objectives would be met by the minimum disclosure requirements that follow each of the broad objectives.*

*However, in some circumstances, an acquirer might be required to disclose additional information necessary to meet the disclosure objectives.*

*(See paragraphs 71-81 and BC200-BC203.)*

**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?

34. We agree with the disclosure objectives, but note that the actual disclosures may be lengthy. We recommend field-testing with preparers and users to determine the usefulness of specific disclosures with the related cost-benefit implications.

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

*The Exposure Draft is the result of the boards’ projects to improve the accounting for business combinations. The first phase of those projects led to the issue of IFRS 3 and FASB Statement No. 141. In 2002, the FASB and the IASB agreed to reconsider jointly their guidance for applying the purchase method of accounting, which the Exposure Draft calls the acquisition method, for business combinations. An objective of the joint effort is to develop a common and comprehensive standard for the accounting for business combinations that could be used for both domestic and cross-border financial reporting. Although the boards reached the same conclusions on the fundamental issues addressed in the Exposure Draft, they reached different conclusions on a few limited matters.*

*Therefore, the IASB’s version and the FASB’s version of the Exposure Draft provide different guidance on those limited matters. A comparison, by paragraph, of the different guidance provided by each board accompanies the*

*draft IFRS. Most of the differences arise because each board decided to provide business combinations guidance that is consistent with its other standards. Even though those differences are candidates for future convergence projects, the boards do not plan to eliminate those differences before final standards on business combinations are issued.*

*The joint Exposure Draft proposes to resolve a difference between IFRS 3 and SFAS 141 relating to the criteria for recognising an intangible asset separately from goodwill. Both boards concluded that an intangible asset must be identifiable (arising from contractual-legal rights or separable) to be recognised separately from goodwill. In its deliberations that led to SFAS 141, the FASB concluded that, when acquired in a business combination, all intangible assets (except for an assembled workforce) that are identifiable can be measured with sufficient reliability to warrant recognition separately from goodwill. In addition to the identifiability criterion, IFRS 3 and IAS 38 required that an intangible asset acquired in a business combination be reliably measurable to be recognised separately from goodwill. Paragraphs 35-41 of IAS 38 provide guidance for determining whether an intangible asset acquired in a business combination is reliably measurable. IAS 38 presumes that the fair value of an intangible asset with a finite useful life can be measured reliably. Therefore, a difference between IFRS 3 and SFAS 141 would arise only if the intangible asset has an indefinite life.*

*The IASB decided to converge with the FASB in the Exposure Draft by:*

- (a) eliminating the requirement that an intangible asset be reliably measurable to be recognised separately from goodwill; and*
- (b) precluding the recognition of an assembled workforce acquired in a business combination as an intangible asset separately from goodwill.*

*(See paragraphs 40 and BC100-BC102.)*

**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?*

35. We are not convinced that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill. In the absence of an active market, as is the case for most intangibles, many valuations will be difficult to substantiate and therefore inherently unreliable.

IAS 38 acknowledges that where there is no history or evidence of exchange transactions for the same or similar assets, so that estimating fair values would be dependent on immeasurable variables, it may not be possible to fair value an identifiable intangible. There are also problems as to the extent to which certain items - for example, non-contractual customer relationships - can be separated from goodwill, and there is overlap in the various types of customer-based intangibles. Given the different treatments under the proposed standard, there will always be an incentive for preparers to make choices based on the results. We suggest that the best approach to this issue might be to examine the results of implementing SFAS 141 and 142 in the US, to see if this points to the possibility of improvements that could be incorporated in the joint proposals.

*For the joint Exposure Draft, the boards considered the provisions of IAS 12 Income Taxes and FASB Statement No. 109 Accounting for Income Taxes, relating to an acquirer's deferred tax benefits that become recognisable because of a business combination. IAS 12 requires the acquirer to recognise separately from the business combination accounting any changes in its deferred tax assets that become recognisable because of the business combination. Such changes are recognised in post-combination profit or loss, or equity. On the other hand, SFAS 109 requires any recognition of an acquirer's deferred tax benefits (through the reduction of the acquirer's valuation allowance) that results from a business combination to be accounted for as part of the business combination, generally as a reduction of goodwill. The FASB decided to amend SFAS 109 to require the recognition of any changes in the acquirer's deferred tax benefits (through a change in the acquirer's previously recognised valuation allowance) as a transaction separately from the business combination. As amended, SFAS 109 would require such changes in deferred tax benefits to be recognised either in income from continuing operations in the period of the combination or directly to contributed capital, depending on the circumstances. Both boards decided to require disclosure of the amount of such acquisition-date changes in the acquirer's deferred tax benefits in the notes to the financial statements.*

*(See paragraphs D4 and BC119-BC129.)*

**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?*

36. We agree.

*The boards reconsidered disclosure requirements in IFRS 3 and SFAS 141 for the purposes of convergence. For some of the disclosures, the boards decided to converge. However, divergence continues to exist for some disclosures as described in the accompanying note Differences between the Exposure Drafts published by the IASB and the FASB. The boards concluded that some of this divergence stems from differences that are broader than the Business Combinations project.*

*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?*

37. In principle, we consider that differences should only be retained when they reflect differences in other standards.

**Question 19—Style of the Exposure Draft**

*The Exposure Draft was prepared in a style similar to the style used by the IASB in its standards in which paragraphs in **bold type** state the main principles. All paragraphs have equal authority.*

*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?*

38. We assume that this question is only included to generate a response from the US constituency. Use of bold type is well established in IFRS standards, and the benefit of improved navigation within standards is well established. Accordingly, any change to IASB use of bold type format would be unhelpful.

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## ICAEW REP 10/05

### PROPOSED AMENDMENTS TO IAS 27 CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

*Memorandum of comment submitted in October 2005 by the Institute of Chartered Accountants in England and Wales, in response to International Accounting Standards Board exposure draft Proposed Amendments to IAS 27 Consolidated and Separate Financial Statements, published on 30 June 2005*

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## **INTRODUCTION**

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the exposure draft *Proposed Amendments to IAS 27 Consolidated and Separate Financial Statements*, published by the International Accounting Standards Board on 30 June 2005.

## **WHO WE ARE**

2. The Institute of Chartered Accountants in England and Wales (the 'Institute') is the largest accountancy body in Europe, with more than 125,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

## **MAJOR ISSUES**

### **Process**

4. We are concerned that the IASB issued an exposure draft proposing to introduce major changes to IFRS GAAP without first issuing a discussion paper. We believe that it is essential to allow time for constituents to consider and debate the fundamental conceptual changes proposed.

### **Non-controlling interests and changes in ownership interest**

5. The Board appears to consider that inclusion of non-controlling interests within equity is an agreed position. However, we note from the version of IAS 27 that was issued following the improvements project (paragraph DO3) that this was, at best, a tentative conclusion which a dissenting Board member noted was predetermining the outcome of the debate supposedly taking place later. We agree with the three Board members' alternative views expressed in paragraphs AV1 - AV3.
6. Consequently, we do not agree with the proposal that changes in a 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. The most useful information for shareholders in the parent company, to whom the consolidated accounts are primarily addressed, is the performance achieved by the controlling interest. It is therefore appropriate to reflect appropriate adjustments to goodwill, or record gains or losses in the income statement (see paragraph 7 below). We would

agree that additional guidance on the treatment of such transactions would be useful, especially in step acquisitions, since there is divergence in practice.

### **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?*

7. We disagree with the proposed treatment. In principle, we believe that the consolidated financial statements are intended primarily for the shareholders in the parent company. The most relevant information for these shareholders is performance from the perspective of the controlling interest, and so it is appropriate (as set out in the Alternative View) to report gains or losses in the parent's ownership interest in a subsidiary after control is obtained, that do not result in a loss of control, in profit or loss. In the absence of an informed debate about the advantages of the entity model over the parent model, we can see no conceptual basis for moving to a different model.

### **Question 2**

*Paragraph 30D proposes that on loss of control of a subsidiary any non-controlling equity investment remaining in the former subsidiary should be remeasured to its fair value in the consolidated financial statements at the date control is lost. Paragraph 30C proposes that the gain or loss on such remeasurement be included in the determination of the gain or loss arising on loss of control (see paragraph BC7 of the Basis for Conclusions).*

*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?*

8. We can accept that the remaining non-controlling equity investment might be remeasured to fair value, although we question whether it is necessary, since the entity has a continuing interest in the remaining stake. In our view, any resulting gain should not be taken to the income statement, since by its nature it is a revaluation gain.

### **Question 3**

*As explained in Question 1, the Exposure Draft proposes that changes in a parent's ownership interest in a subsidiary that do not result in a loss of*

*control should be treated as transactions with equity holders in their capacity as equity holders. Therefore, no gain or loss would be recognised in profit or loss.*

*However, a decrease in the parent's ownership interest resulting in the loss of control of a subsidiary would result in any gain or loss being recognised in profit or loss for the period. The Board is aware that differences in accounting that depend on whether a change in control occurs could create opportunities for entities to structure transactions to achieve a particular accounting result.*

*To reduce this risk, the Exposure Draft proposes that if one or more of the indicators in paragraph 30F are present, it is presumed that two or more disposal transactions or arrangements that result in a loss of control should be accounted for as a single transaction or arrangement. This presumption can be overcome if the entity can demonstrate clearly that such accounting would be inappropriate (see paragraphs BC9-BC13 of the Basis for Conclusions).*

*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?*

9. We 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. However, we believe that paragraph 30F is too rigid as drafted. In order to minimise the potential for structuring transactions specifically to avoid the listed indicators, it should be redrafted to clarify that the indicators given are merely examples and do not comprise a closed list.

#### **Question 4**

*Paragraph 35 proposes that losses applicable to the non-controlling interest in a subsidiary should be allocated to the non-controlling interest even if such losses exceed the non-controlling interest in the subsidiary's equity. Non-controlling interests are part of the equity of the group and, therefore, participate proportionally in the risks and rewards of investment in the subsidiary.*

*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?*

10. We agree that losses applicable to the non-controlling interest should be allocated to that interest, although we do not agree with the basis for it suggested by the IASB: that is, that non-controlling interests are part of the equity of the group. We believe that this should be done in order to indicate

the future allocation of any profits arising in the subsidiary in which the non-controlling interest exists. We agree that guarantees and other support arrangements should be considered separately, and may consequently affect any accumulated loss carried as a non-controlling interest.

#### **Question 5**

*The transitional provisions in the Exposure Draft propose that all of its requirements should apply retrospectively, except in limited circumstances in which the Board believes that retrospective application is likely to be impracticable.*

*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?*

11. We agree that the prospective basis should apply in the cases specified.

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