

4 November 2005

Email to: FRED36@frc-asb.org.uk

Ian Mackintosh
Chairman
Accounting Standards Board
5th Floor, Aldwych House
71-91 Aldwych
London WC2B 4HN

Letter of Comment No: 269
File Reference: 1204-001

Dear Ian

FRED 36, Business Combinations (IFRS3) & Amendments to FRS2 Accounting for Subsidiary Undertakings (parts of IAS 27, Consolidated and Separate Financial Statements)

The IMA is the trade body representing the UK asset management industry. IMA Members include independent fund managers, the asset management arms of retail banks, life insurers, investment banks and occupational pension scheme managers. They are responsible for the management of approximately £2 trillion of funds (based in the UK, Europe and elsewhere), including institutional funds (for example, pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members manage 99% of UK-authorized investment funds.

In managing assets for both retail and institutional investors, IMA Members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in the requirements governing how such companies prepare their accounts and the information disclosed to our Members as users.

On the project overall we welcome the fact that it has been split into two phases and that the acquisition method of accounting is being reconsidered in Phase II. As regards implementation, we support option ii in ASB question 1, and that implementation should not be immediate but reconsidered as a package a period of time after IFRS have been in effect. This would allow the practical implications to be more fully researched.

However, we have reservations about certain of the proposals. Our main concerns are set out below.

The "entity" as opposed to the "parent" concept

Currently in the UK, accounting is based on the "parent entity concept", whereby the assets and liabilities of an entity, even if that entity is not fully owned, are consolidated in full, and minority interests (which are being renamed non-controlling

interests) and transactions with non-controlling interests are separately identified in the accounts.

The FRED proposes moving to the "entity concept", which considers the Group as a single entity and combines the interests of equity shareholders and non controlling interests (minorities) together as a unit to form the reporting entity. We understand that the aim is to provide information to a wide and diverse range of users, rather than focus on the needs of the shareholders. We consider that this approach is fundamentally flawed and we would urge it to be reconsidered. Our reasons are set out below.

- Accounts should be prepared to reflect what the current shareholders of the consolidated parent company actually own rather than look top-down at the entity. The shareholders are the ultimate providers of risk capital and bear the residual risk. Failing to focus on their needs will serve only to undermine the whole framework of financial reporting. That in turn could increase the cost of capital and undermine the benefit of having a common set of international accounting standards.
- Focusing on the needs of shareholders is also important in terms of influencing the debate on stewardship and institutional shareholders' responsibilities as owners of the company. Shareholders do not want simply to value companies and assess whether they should sell or buy the shares, they want to assess management and the strategies adopted for the business for the longer term. Accounts provide shareholders with some of the crucial information to enable them to discharge these responsibilities and as such, we consider accounts should focus on them.
- The entity concept has peculiar consequences. For example:
 - the income statement looks at the entity's total income rather than the income attributable to the parent company's owners – we firmly believe that the income statement should be a basis for reporting financial performance to the ultimate providers of risk capital, the shareholders of the parent company;
 - transactions in the equity of subsidiaries are transactions with owners and do not result in a profit or loss; and
 - instead of recognising only a proportion of the goodwill in respect of a part-owned subsidiary, the goodwill is recognised in full at 100 per cent.
- We recognise that reporting is being expected to fulfil a growing set of needs and that there are a wide range of users, ranging from current and potential investors through to creditors, employees, bankers, customers and suppliers. However, if the needs of the current shareholders are satisfied, then we believe the needs of other external users should generally be satisfied also. In the event that other users' needs are so specialised that they are not satisfied then we consider that specific reporting should be developed to address them.

Due to the importance we attach to this, we will be writing to the IASB and the FASB setting out our concerns about the "entity concept".

Goodwill

FRED 36 proposes that goodwill arising on a business combination should be recognised in full as an asset and not amortised but tested annually for impairment.

The main objection to amortisation is that the period over which goodwill is amortised is arbitrary. However we consider that amortisation and the "rebuttable presumption that, as with intangible assets, goodwill has a useful economic life of 20 years or less" is the simplest and cheapest way acquirers can account for goodwill and is particularly helpful for small companies. It also results in robust financial reporting.

On the other hand, impairment tests rely on forecasts that are often subjective. We are concerned about the robustness of such tests and their complexity. We do not believe that impairment testing would necessarily provide better financial reporting than simple amortisation.

Negative goodwill

We also consider it strange that in the future negative goodwill will be treated as an immediate profit. If markets work, we do not believe there are bargain purchases and instant profits. If positive goodwill (when the price paid exceeds the fair value of the assets) is an asset, why is negative goodwill not a liability? Alternatively if negative goodwill is a credit to equity why is "positive" goodwill not a debit to equity? This goes to the heart of the debate about the nature of goodwill.

Please do contact me if you require any clarification of the points in this letter or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall
Senior Adviser – Corporate Governance