

Letter of Comment No: 231
File Reference: 1204-001



INTERNATIONAL ACCOUNTING STANDARDS BOARD

PROPOSED AMENDMENTS TO IFRS 3 BUSINESS COMBINATIONS, IAS 27 CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS IAS 37 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS AND IAS 19 EMPLOYEE BENEFITS

CBI RESPONSE

October 2005

I INTRODUCTION AND SUMMARY OF CBI POSITION

Introduction

1. The CBI supports the objective of having a single set of high quality accounting standards applicable to listed companies as well as the objective of convergence with US standards. However, the accounting solutions must be at least as good as those they replace and they should be achievable with a reasonable amount of effort from preparers.
2. These exposure drafts propose a number of significant changes that have fundamental implications. For example, they contain significant requirements concerning the measurement of certain accounting items. Such major changes should not be implemented without full consideration of their implications on the Conceptual Framework or an in depth consultation by way of a discussion paper and roundtables. These proposals have also been issued in advance of the debate on measurement, that we understand that the IASB intends to initiate, and without any demand for them from users of financial statements. They are therefore premature and the CBI believes they should not have been proposed.
3. The exposure drafts mention improved relevance and reliability, but do not substantiate this claim. The use of fair values will often require a high degree of subjective judgement and use of measures for which there is a little or inadequate market information. Taking complexity and difficulties of implementation into account, it is not clear to CBI members what benefits users will achieve. It is highly unlikely that any benefits would exceed the considerable costs of applying some of the proposals in practice. Indeed, the extended use of subjective fair value for transactions could actually have a detrimental effect on the quality of the financial information provided.



INVESTOR IN PEOPLE

Clive Edrupt – Company Affairs
DL: +44 (0) 20 7395 8042 DF: +44 (0) 20 7836 1114 E: clive.edrupt@cbi.org.uk

CBI Centre Point 103 New Oxford Street London WC1A 1DU
T: +44 (0)20 7379 7400 F: +44 (0)20 7240 1578 W: www.cbi.org.uk

Director-General: Sir Digby Jones President: John Sunderland

Business combinations

4. The CBI does not agree with the adoption of the economic entity view of consolidated accounts. We consider that the consolidated financial statements should be primarily drawn up from the perspective of the parent company equity shareholders. The alternative view takes undue account of the non-controlling interests in subsidiaries and leads to an undesirable extension of fair valuation in respect of step acquisitions and partial disposals. Goodwill results from future economic benefits from assets that cannot be individually identified and the Board should avoid imposing unnecessary and unreliable valuations of it. We therefore agree with the views of the dissenting members as set out in AV1 to AV3.
5. We disagree with the proposal that all acquisition costs relating to a business combination should be expensed as incurred. Costs directly attributable to the acquisition of any asset should be included with the individual cost of that asset and any other treatment in respect of business combination would be perverse.

Proposed amendments to IAS 37 - Provisions, contingent liabilities and contingent assets

6. The exposure draft proposes that probability, which is currently taken into account in the recognition criteria, should henceforth be dealt with via measurement. This change would have a considerable impact and it will often be extremely difficult to implement. However, the CBI does not consider that it will result in more useful information to users and regrets that no field visits or tests were undertaken to explore the practical consequences of this proposal.
7. It is proposed that certain liabilities should be measured at the amount that an entity would rationally pay to settle the present obligation or to transfer it to a third party. Such a proposal has important implications. It will often not be practical to estimate the expected cash flow at the balance sheet date. Even where an amount can be calculated, this may be unhelpful and will often not result in any information that was not given to the user under the existing requirements. For example, if an entity were subject to a claim that it does not intend to settle and which it considers has only a small chance of success, it would have to recognise a liability of an amount for which the only certainty is that it would not be paid. The Board should not introduce such a system without further consideration of, and consultation on, its implications.
8. In view of the above, we do not consider that the Board should make the proposed changes to IAS 37. The proposals will not provide reliable or relevant information and they cannot be implemented in a way that achieves the necessary degree of consistent application.
9. We set out below our responses to the specific consultation questions.

II RESPONSES TO CONSULTATION QUESTIONS

ED OF PROPOSED AMENDMENTS TO IFRS 3 BUSINESS COMBINATIONS

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?

We have several difficulties with the proposed objective.

1. We believe that in practice there are true mergers and we believe that, in those cases, the application of the acquisition method, involving the identification of an 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 - is investigated as soon as possible.
2. 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. True mergers will not involve an acquirer controlling another entity and, as such, will not fall within the proposed new definition of a business combination. That apart, we have no difficulty with the revised definition of a 'business combination'.

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?

3. The proposed definition of a business is important because all assets acquired or liabilities assumed would be accounted for differently than if acquired separately, with substantial consequences (e.g. acquisition-related cost, goodwill). We understand that the proposed definition has been changed for convergence reasons and is broader than the current definition. However, we also agree with the Board in BC41 that, conceptually, acquisitions of groups of assets and acquisition of businesses should be accounted for in the same way, especially as the distinction between them can be a matter more of form than substance. This inconsistency should be addressed as a matter of priority.

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?

4. 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. In our view, the revised standard should continue to be based on the parent-only, cost-based approach of the current IFRS 3.
5. 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 benefits that outweigh the increased ‘softness’ of the goodwill and equity numbers caused by the proposals.
6. Furthermore in our view it is premature to propose a further move in the direction of fair value before having a comprehensive debate on the fair value measurement concept. It will often be impractical to fair value a non-listed acquiree. Benefits embodied in goodwill may not be shared proportionately between controlling and non-controlling interests (for example, synergies enjoyed in the parent entity only). Finally, we do not agree with the presumption that the fair value of an acquiree is the same for different acquirers.

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?

7. We consider that the paragraphs do not provide sufficient guidance on how to gross up fair value of the interest acquired to the fair value of the acquiree. In practice, it is often not possible to measure the fair value of an acquiree from quoted market prices; and in these cases the calculation will be dependent on a number of subjective inputs. This will have a direct impact on the reliability of the calculation.
8. The proposals also require entities to adopt a fair value concept that is not finalised and may be subject to further change in the near future. We are very concerned by this because we do not believe that the IASB should be seeking comments on a fair value concept that is subject to further change.

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?

9. In general we agree that the acquisition date fair value of the consideration (as opposed to the acquiree) transferred in exchange for the acquirer’s interest in the acquiree is the best evidence of the fair value of that interest. However, we believe that there may be a number of exceptions to the general principle and it should therefore be a rebuttable presumption.

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

10. We believe that contingent consideration often reflects situations where the buyer and seller are unable to agree a price and such changes should be adjustments to goodwill whenever they are made.

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?

11. We do not agree with this proposal because we believe that this is inconsistent with the treatment of direct acquisition related costs in other existing standards where the direct cost forms part of the carrying amount of the asset acquired. Such transaction costs can be a material amount and the acquirer must be sure that the fair value of the acquiree at least equals the consideration transferred plus directly related costs. The acquirer should not distinguish between the payment it has made for the acquisition and the directly related costs, as both are part of the value that the acquirer had to give to acquire the interest in the acquiree. It would be wrong for the accounting to distinguish between them.
12. We agree with the Board's view that the treatment of acquisition-related costs should be similar for acquisitions of individual assets, groups of assets and businesses. However, the Board is wrong to argue that the costs incurred 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.

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?

13. We generally agree with the initial recognition and measurement changes but we believe additional explanations on subsequent measurement of (contingent) intangible assets under would be useful. However, some contingent assets are not non-monetary items (for example, warranty claims) and, therefore, do not fall within IAS 38.

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?

14. 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. However we maintain our reservations concerning the fair value concept as proposed by the Board. There is a serious problem with deferred tax assets and liabilities, which as they are not discounted will not be at fair value, despite the fact that the purchase price will be established based, in part, on the underlying fair values. This is not an issue with the other examples of pensions and assets held for sale where the provisions of their standards will result in fair value anyway.

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?

15. We are not convinced that the use of fair value is appropriate – this will mainly be an issue for investments in associates because available for sale securities will already be in the books at fair value. Taking the interest in an associate up to fair value can be, in substance, a recognition of internally generated goodwill. We consider that a model based on the carrying values of the existing non-controlling elements (which is a mixed model) plus the fair value of the consideration now given for the additional interest is more appropriate. However, should the fair value proposals be adopted, the gains or losses (to the extent that they do not represent impairments) should be taken to equity.

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?

16. This limitation of gain recognition is inconsistent with the general fair value attribute and could lead to transactions being misrepresented. It is argued that this is necessary because otherwise it “could lead to other difficulties in practice”. However, this issue highlights the premature action of the Board in proposing to change the measurement basis before undertaking a thorough and comprehensive debate on all aspects of measurement.

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?

17. We consider that there may be cases where an overpayment is made, though it might be difficult to measure that overpayment reliably, in part because it is often difficult to measure the fair value of the acquiree reliably.

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?

18. We believe such measurement period adjustments are changes in accounting estimates and should be dealt with prospectively, with no changes to comparative (previously disclosed) information.

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?

19. The guidance appears to be drafted mainly to prevent abuse. Preparers will need to use judgement to make the assessment referred to and we consider that a clear principle is better than detailed and complex rules.

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?

20. The disclosure objectives are acceptable, but we believe that the minimum disclosure requirements are too extensive and may not meet the cost benefit criterion.

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?**

21. We do not believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill.

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?

22. 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.

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?

23. We regret that some divergence still remain, but understand the reasons for this.

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?

24. We find the bold type - plain type layout helpful.