Korea Accounting Association (KAA)

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Re: Comments on the Exposure Draft IFRS 3 "Business Combination"

Dear Sir/Madame:

We are pleased to comment on the exposure draft IFRS 3 "Business Combination." We appreciate most of the spirit and principles underlying the draft. We do, however, have some comments on three specific subjects: goodwill, business combinations involving entities under common control, and contingent liabilities. We summarize our comments and rationale for each issue. We hope that our comments prove to be pertinent to the clarification and improvement of the exposure draft.

1. Goodwill (Accounting for excess)

This comment is about accounting for the excess of the acquirer's interest in the net fair value of the identifiable assets, liabilities, and contingent liabilities over the cost of the business combination. Overall, we believe that the conceptual basis underlying IFRS 3 is more solid than that of SFAS 141 in accounting for the "excess."

IFRS 3 stipulates that the acquirer reassess the identification and measurement of the acquiree's identifiable assets, liabilities, contingent liabilities and the measurement of the cost of the combination, and recognize immediately in profit or loss any excess remaining after that reassessment (in paragraph 56). The conceptual basis of IFRS 3's immediate recognition of the excess in profit or loss is to enhance representational faithfulness. The International Accounting Standards Board (IASB) considered recognizing the excess as a reduction in the values attributed to some net assets (BC151-BC153), recognizing it as a separate liability (BC154), or recognizing it

immediately in profit or loss (BC155-BC156). It concluded that the most representationally faithful treatment of the excess is immediate recognition in profit or loss. Particularly, it states that even though the reduction in the values is consistent with the historical cost accounting method (in that it does not recognize the total net assets acquired above the total cost of those assets), such a reduction would inevitably be arbitrary and, therefore, not representationally faithful (BC151). The resulting amount recognized for each item would not be cost, nor would it be fair value.

In contrast, SFAS 141 stipulates that the excess be allocated on a pro rata basis to all acquired assets except financial assets and some other categories of assets (B188). Only any excess remaining after those assets are reduced to zero should be recognized as an extraordinary gain (B189). SFAS 141's rationale for this treatment is that the excess should be used to adjust the amounts initially assigned to certain assets because, in most cases, the excess is due to measurement errors in the purchase price allocation (B188). In contrast, IFRS 3 enumerates the components of the excess as (a) measurement errors, (b) a requirement in an accounting standard, or (c) a bargain purchase (BC148). The bargain purchase can arise when firm-specific assets are purchased by another firm that does not value such firm-specificity of the purchased assets. To be representationally faithful, the part of an excess arising from a bargain purchase should be recognized in profit or loss, whereas the part of an excess arising from measurement errors and accounting standard requirement should be used to adjust the asset values. However, SFAS 141 concluded that separately identifying the amount of an excess that is attributable to the measurement errors and accounting standard requirement is not feasible (BC155).

2. Business combinations involving entities under common control

We believe that IFRS 3 needs to elaborate the accounting method for the business combinations involving entities under common control. IFRS 3 describes that such business combinations are outside the scope of IFRS 3 (paragraph 11), without providing any further guidance on the accounting for such business combinations. As a result, it is ambiguous whether such business combinations will be dealt with in other IFRS statements, or whether a method other than the purchase method (e.g., the method acceptable in U.S. GAAP) is more appropriate for such business combinations.

In contrast, SFAS 141 excludes transfers of net assets or exchanges of shares between entities under common control from the term business combination (D11). Furthermore, it stipulates that, when accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer (D12). SFAS 141 presents some specific examples of business combinations between entities under common control involving the acquisition of non-controlling equity interests in a subsidiary, and elaborates the accounting methods for such examples (Paragraphs 11 and 14, A5, A6, A7, D13, D14, D15, D16). For example, D15 describes the instances that the acquirer and the acquiree use different accounting methods for similar assets

and liabilities, and requires that the carrying values of the assets and liabilities transferred may be adjusted to the basis of accounting used by the acquirer. D16 deals with the accounting for the period from the beginning of the fiscal year to the date of the combination when the combination is completed in the middle of a fiscal year.

Business entities under common control are more prevalent outside the U.S., especially in East Asia. Therefore, we hope that IFRS provides more detailed guidance about the business combinations involving entities under common control than U.S. standards do.

3. Contingent liabilities

The conceptual basis to discriminate between a contractual payment and a restructuring plan, both of which are conditional on the business combination, appears to be tenuous. IFRS 3 stipulates that a payment that the acquiree is contractually required to make to its employees or suppliers in the event it is acquired in a business combination be recognized as a liability of the acquiree (paragraph 42). Therefore, when the business combination is effected, that liability of the acquiree should be recognized by the acquirer. The rationale is that this contractual payment is a present obligation of the acquiree that is regarded as a contingent liability until it becomes probable that a business combination will take place.

In contrast, it requires that an acquirer not recognize a liability for the restructuring plans whose execution is conditional on a business combination (paragraph 43). The rationale is that such plans are not, immediately before the business combination, a present obligation of the acquiree. Nor is it a contingent liability of the acquiree immediately before the combination, because it is not a possible obligation arising from a past event whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the acquiree.

However, the contractual payment is neither a present obligation nor a contingent liability of the acquiree on the same logic (that is, it is not a present obligation of the acquiree immediately before the business combination because it is only conditional on the business combination, nor is it a contingent liability of the acquiree immediately before the combination).

Two differences exist between a contractual payment and restructuring plans. First, a contractual payment to employees or suppliers is fixed in amount, but the cost related to future restructuring is not. Second, the contractual payment is a "contract" that cannot be canceled by the acquirer but the restructuring is just a "plan" that might be canceled by the acquirer.

The first difference does not seem to justify the discrimination, since the draft requires that the acquirer, on a business combination, recognize liabilities when the acquiree has, at acquisition date, an existing liability for restructuring (paragraph 41). The second difference supports the rationale for the discrimination to some extent. Nevertheless, a

contractual payment and a restructuring plan essentially are the same with respect to whether they are present obligations of the acquiree or not, and whether they are contingent liabilities of the acquiree or not. Therefore, we believe that the draft should state differences of the second type more explicitly.

Please let us know if you have any questions on our comments.

Yours Faithfully

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Chairman of IFRS Review Committee