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Letter of Comment No: 123 File Reference: 1204-001

Dear Sir and Madam,

IASB's Exposure Drafts of Proposed Amendments to IFRS 3 Business Combinations and IAS 27 Consolidated and Separate Financial Statements and FASB's Proposed Statements of Financial Accounting Standards, Business Combinations; a replacement of FASB Statement No. 141 and Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries; a replacement of ARB No. 51

The global organisation of Ernst & Young is pleased to provide its comments on the above exposure drafts.

We wish to make it clear at the outset that Ernst & Young strongly supports the long-term objective of convergence of International and U.S. accounting standards. In order to achieve convergence, however, the Boards need to convince their constituents that proposals involving major changes in accounting practice will significantly improve the quality (ie the understandability, relevance, reliability and comparability) of the information provided in financial statements. This is particularly true at this time, when preparers and users in many countries are grappling with the challenge of conversion to IFRS and need a period of relative stability in accounting standards for preparers to embed their new accounting policies and processes and for users to become familiar with IFRS financial reports.

In our view, the Boards have not made a sufficiently compelling case for the fundamental change in approach to accounting for business combinations that they are proposing. In the light of this, we do not consider it appropriate for us to respond to the detailed questions

asked by the Boards. Rather, we describe below our underlying concerns with the exposure drafts that we believe must be addressed before a meaningful dialogue on the more specific issues can take place.

## Due process

There are fundamentally different views of the proposals among the Boards' constituents around the world. These differences appear to be the result of many factors, including differences from country to country in the extent to which non-controlling interests in subsidiaries exist, differences in how the reporting entity is viewed, differences in historical accounting background, different legal environments in which the proposals would need to be applied, and the differing perspectives that exist on the use of fair value as an appropriate measurement attribute (and related differences in view regarding the reliability of fair value measurements for accounting purposes).

Given the magnitude of the proposed changes, as well as the significant number of organizations around the world who would be subject to them, we would have expected the Boards to publish a joint discussion document for public comment instead of issuing exposure drafts of the proposals. For the same reasons, we would have expected both Boards to conduct more extensive field visits with preparers, users and the investment community (ie not just analysts) in order to understand the benefits (and to assess the costs) that would result from implementing the proposals as well as to learn about any practical implications that should be considered. In our view, more extensive field visits with a geographically diverse sample of preparers and representatives of the investment community should be carried out and the proposals re-exposed in the light of the findings.

## View of the reporting entity

The Boards' proposals would involve major changes in approach to accounting for business combinations. In particular, they reflect a major shift away from the "parent company extension" concept towards the "economic entity" concept as the basis on which consolidated financial statements are prepared. This fundamental change in how the reporting entity is viewed drives many of the specific changes proposed in the exposure drafts, including recognition of the non-controlling interest's share of goodwill (ie "the full goodwill approach"), loss attribution among controlling and non-controlling interests, and the accounting for increases and decreases in ownership interests in a subsidiary after control is obtained.

While we agree with the Boards that non-controlling interests do not meet the definition of a liability in the IASB Framework/FASB Concepts Statements, we are not convinced that this should necessarily lead to the rejection of the parent company extension concept in favour

<sup>&</sup>lt;sup>1</sup> See Baxter, George C. /Spinney, James C., A Closer Look at Consolidated Financial Statement Theory, in: CA magazin, January 1975, S. 31-36 for further referencing to the concepts as we recognise that the respective models seem to be named and interpreted inconsistently worldwide.

of the economic entity concept. In that regard, we believe that the Boards need to explain in greater detail the accounting theory and conceptual support for each approach and the reasons why the economic entity view of consolidated financial statements is believed by the Boards to be superior to the parent company view.

Although the Boards assert that application of the fundamental principles on which the proposals are based will improve the completeness, relevance and comparability of financial statements, the exposure drafts do not adequately explain why this is the case. The Boards state "financial reporting and the relevance of information about business combinations could be improved significantly by developing fundamental principles that focus on the underlying economic circumstances that exist when a business is acquired and applying them consistently". However, this view is based on a particular conception of what constitutes "the underlying economic circumstances" and the Boards do not explain why they equate "the underlying economic circumstances" with the economic entity concept rather than the parent company extension concept.

Accounting for a 'fair value exchange' as opposed to the cost of a business combination

The proposals would replace the current approach of allocating the cost of the acquired entity to the assets acquired and liabilities assumed with an approach under which the acquirer would recognise the fair value of the business acquired.

Some of the practical difficulties of determining the fair value of an acquired business are illustrated by the application/implementation guidance in the proposed standards. The fair value of the acquiree is the price that a knowledgeable, unrelated, willing party would pay. However, Example 3 gives greater emphasis to quoted share prices than to amounts that other potential acquirers might be prepared to pay, while in the discussion of the "market approach" in paragraph A20, no distinction is made between day-to-day share prices and prices in other business combinations involving comparable businesses, despite the very different values that they are likely to yield. In paragraph A15 it is said that AC assessed TC as a whole to be worth between CU110 million and CU130 million - a range of almost 20%. In our view such a range is quite possible as measurement of the fair value of a business is highly judgmental. Under the proposed standard, as the goodwill allocated to the non-controlling interests is the residue after allocating goodwill to the acquirer's interest, the entire uncertainty associated with measuring the fair value of the acquiree will be reflected in the amount allocated to the non-controlling interest. Furthermore, the goodwill allocated to the acquirer will include any synergies unique to the acquirer but these are not reflected in the fair value of the acquired business. As a result, the goodwill allocated to the non-controlling interest is meaningless - it is merely the residue of a residual based on a different measurement concept for the same category of asset. We do not understand how this can be regarded as sufficiently relevant or reliable to be recognised in financial statements. We note in this connection that even countries that are familiar with the economic entity approach have in general not introduced the full goodwill method, perhaps because there are concerns regarding the reliability of the fair value measurements it requires.

The rationale for the full goodwill approach is that goodwill is an asset and it is inconsistent to recognise all of the acquiree's other assets and liabilities at their full fair values but only the acquirer's portion of the goodwill. However, given the fact that purchased goodwill is unique to the particular acquirer, has no separate existence and is merely a residual, the "consistency" argument is not persuasive. Partly for the same reasons, and also because goodwill in financial statements is a point-in-time amount the relevance of which is quickly reduced, users of financial statements regard goodwill as having far less information value than other assets and in the light of this it is questionable whether the benefits of the proposed approach outweigh the costs associated with applying it.

Although the Boards claim that the proposed approach to accounting for business combinations focuses on "the underlying economic circumstances", it does result in some accounting treatments that do not reflect economic reality, such as the recognition as gains and losses in income of the effect of revaluing a non-controlling investment held by the acquirer prior to the business combination. Also, where a non-controlling interest in a successful subsidiary is acquired some time after control was first obtained, the additional goodwill built up since control was acquired would, under the proposals, reduce equity and it is likely that the more successful the subsidiary has been, the greater will be the reduction in equity. It is not clear to us how the information generated by this accounting treatment is relevant.

In summary, we do not believe that the Boards have either carried out sufficient due process or made a sufficiently compelling case for the adoption of the "economic entity" approach rather than the "parent company" approach and the associated change from viewing business combination accounting as a process of allocating the cost of a business combination to one of accounting for a business combination as a fair value exchange.

The potential impact of further changes in accounting for business combinations and the scope of consolidated financial statements

We note that the concept of control currently differs between U.S. GAAP and IFRS and, therefore, in order to achieve full convergence in the accounting for business combinations the Boards would need to adopt a common view. Moreover, the IASB wishes to make significant changes to the criteria in IFRS giving rise to the presumption of control. These changes would increase the number of transactions or events that are accounted for as business combinations and, in addition, would increase the differences between U.S. GAAP and IFRS in this area. The current FASB and IASB proposals, however, give no indication as to how the Boards expect to proceed on this issue.

We also note that the IASB has indicated that it is committed to exploring in a future phase of its business combinations project whether the "fresh start" method might be applied to certain combinations, while the FASB has already discussed and rejected this method as part of the first phase of its project. Particularly for companies that are having to cope with fundamental accounting changes arising from their adoption of IFRS, the prospect of successive major changes in accounting for business combinations is very unattractive. In our view, preparers and users of financial statements need to be given sufficient information

about the full scope of potential changes in accounting for business combinations in order to understand how current proposals might be affected by subsequent phases. Preferably, however, changes in the circumstances that give rise to the presumption of control, new basis issues and perhaps even equity accounting should be addressed now rather than deferred to a later phase of the project. Furthermore, in the case of the IASB, the need to address known areas relating to business combinations in which IFRS is lacking, such as combinations involving entities under common control and the creation of joint ventures, is more urgent than the need to change its existing standard on business combinations.

## The definition of a business

The proposed definition of a business is in our view too broad. In particular, the phrase "capable of" will be difficult to apply and result in inconsistencies in practice. For example, a single oil exploration area where oil has been found but development has not yet been started could be regarded as a business under the proposed definition because a "willing party" may be capable of producing outputs by integrating that input with its own inputs and processes. We believe that the existing definition in IFRS 3 would be sufficient to address many of the problems that are currently encountered under US GAAP, such as the inability to account for the acquisition of development stage companies as business combinations. We also believe that the proposals should include several examples of activities and assets that are businesses and others that are not businesses in order to assist preparers in applying the guidance.

## Intangible assets acquired in a business combination

We are concerned about some aspects of the proposals relating to the recognition and measurement of intangible assets acquired in a business combination. We do not believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill. The measurement of intangible assets involves judgment. Active markets do not exist for most intangible assets held by commercial enterprises, or even for analogous assets, and in most cases there are few if any exchange transactions for similar assets (other than as part of a business combination). Information in financial statements is ultimately only useful if it is sufficiently reliable. It does not matter to a user whether the unreliability arises because the fair value is uncertain due to a wide range of possible outcomes with different probabilities or because measurement is inherently unreliable due to lack of reliable data. Accordingly, we strongly encourage the Boards to re-examine their view that all identifiable intangible assets can be measured with sufficient reliability to be recognized separately from goodwill.

We also believe that the Boards should comprehensively re-evaluate the accounting for customer-related intangibles in a business combination. In our view, the expected cash flows generated from these relationships are inextricably linked to the ongoing activities of the entity and, therefore, are part of goodwill. It is not clear to us how a buyer controls the economic benefit of an at-will customer relationship when that customer can stop purchasing goods or services at any time and solely at its discretion. Measurement difficulties encountered over the years have further convinced us that any attempt to

separate this asset from goodwill and assign a value to it is essentially an arbitrary exercise. As part of their re-deliberation of this matter, we believe it will be important that the Boards address and reconcile their view that the fair value of an at-will customer relationship can be reliably measured whereas the fair value of an employee workforce cannot be reliably measured (and is therefore subsumed in goodwill).

Should you wish to discuss the contents of this letter with us, please contact David Lindsell at (0044) 20 7980 0106 or David Holman at (001) 212 773 2326.

Yours faithfully

Ernst & Young