Financial Accounting Standards
Board (FASB)
Technical Director
File Reference No. 1204-001
director@fasb.org

Dear Sir,

RE: JOINT PROJECT BUSINESS COMBINATIONS PHASE II - EXPOSED AMENDMENTS TO IFRS 3, IAS 27, IAS 37 AND IAS 19

UNICE is the voice of European business, representing more than 20 million small, medium and large companies in Europe. Our members are 39 central industrial and employers' federations from 32 European countries.

UNICE has demonstrated in the course of the last ten years a strong interest in accounting harmonisation efforts. UNICE supports all efforts made towards a single set of high quality principle based standards and is grateful to the IASB and FASB for their dedicated efforts toward convergence.

UNICE is a regular commentator on all IASB exposure drafts and discussion papers. We therefore believe it may be of interest to the FASB to receive the comments we make to proposals which result from joint efforts. We would have preferred that our first opportunity to submit our comments to the FASB would match the issuance of exposure drafts that we would support. Unfortunately, the proposals raise some major concerns as explained below. Please note that our analysis is based on the texts issued by the IASB.

1- The exposure drafts introduce fundamental changes to IFRS present underlying model without proper identification of potential benefits to users

Fundamental changes to standards should be proposed only when changes or supplements to the conceptual framework have been thoroughly discussed. We note that the Bases for Conclusions to the EDs take for granted conclusions yet to be drawn after a conceptual debate has been initiated and thoroughly conducted by the IASB. The Board indicates by mere assertions that the changes are for the better and that the benefits outweigh the costs, however this is nowhere demonstrated. We also note that the dissenting Board members have developed strong and well argued motives for offering alternative views.
2- None of these conceptual changes is needed for convergence.

None of the changes detailed and commented in paragraph 4 below is needed to allow convergence with FAS 141 and other pronouncements which form the scope of the Boards project. At a time when convergence is promoted and supported by all stakeholders which share the ultimate goal of a set of high quality principle-based standards, we believe the two Boards introduce a very anxious bias in communicating with their constituents. The scope for Business Combinations phase II was designed to set appropriate and convergent guidance as to how apply the acquisition method described in FAS 141 and IFRS 3. The EDs show that the two Boards have complied only on minor issues with the objective of the project, leaving without any accounting guidance issues like combinations under common control and the formation of joint ventures.

Moreover, IFRS 3 issued by the present Board no sooner than 18 months ago can be regarded as a robust standard, one which does not call for rapid changes necessitated by inadequate accounting by business entities.

3- Every fundamental change proposed pre-empt future conclusions in some already identified cross-cutting issues of the framework project.

As we have already mentioned, the Boards take for granted conclusions yet to arise from the active joint project on the conceptual framework. Although the IASB keeps claiming that its agenda for accounting change is not set and that no decision is made without the valuable input obtained via its due process, it continues to follow its un-debated and unapproved purpose of full fair valuing economic entities relying on a definition of control which is still under development.

To withdraw the core of the exposed proposals for change is the only route available to the IASB to be in phase with explanations given to constituents. Indeed Board members and the IASB Chairman himself have explained that the framework is a living document and where an issue comes up that identifies problems in the framework, the Board addresses both at the same time.

We urge the Board to be faithful to such a commitment. While we agree that completion of the whole conceptual framework project cannot reasonably hold any change or evolution in existing standards for five years, we are aware and support that the Board intends to issue separate discussion papers when reaching separate sets of conclusions on well identified conceptual issues. Once definition of elements and recognition criteria have been fully debated and conclusions are reached, amendments to existing standards can be prepared to reflect the decisions taken. The same applies to the economic entity concept which is next on the list of the issues both Boards are about to start deliberating or to measurement issues upon initial recognition which are subject for a discussion paper to be issued before the end of 2005.
4- At this stage of the debate, we reject everyone of these conceptual changes

a. Valuing a business combination on the basis of the fair value of the acquiree instead of at cost

i. Lack of relevance

Business Combinations are unique to one set of an acquirer and an acquiree. This has been acknowledged by the IASB in drafting the existing IFRS 3 (see existing IFRS 3, BC130) and is reaffirmed by dissenting Board members. The sum of the price paid and the costs incurred by the acquirer reflects the value of the business combination to the acquirer and the relevant basis on which return on capital employed should be measured, when reporting to the shareholders of the entity. We reject the assumption that the fair value of the consideration paid is equal to the fair value of the acquiree, first on the basis of our observation of how transactions take place, second because we do not believe that this is a necessary condition for the transaction to be based on a "fair" basis. A "fair" basis is the basis on which the two entities agreeing to the transaction maximise, under the constraints of the market forces, their shareholders' interests. A business is not easily exchangeable asset. The fair value of the acquiree is therefore no relevant basis for accounting for a business combination.

ii. Lack of reliability

We seriously question the reliability of estimates that could arise out of the process proposed in the standard. Deriving the fair value of the acquiree from the consideration paid would most certainly appear difficult in practice. Stripping out synergies that not all market participants could implement and valuing control premiums would in our view lead to very subjective estimates, of no benefit to users, at best not misleading.

iii. Lack of consistency with the accounting for other assets and group of assets

Although fair value has already been introduced in various areas of IFRS, only costs of acquiring financial assets held for trading are expensed (and this exception has pragmatic - not conceptual - grounds). We believe the IASB should extend its conclusions reached in BC41, i.e. that more research is needed before the change of measurement attribute is made.

We therefore believe that business combinations should remain accounted for on the basis of their cost to the acquirer, including direct acquisition costs, in full consistency with the accounting for other assets.

b. Adopting a full and unrestricted economic entity approach:

As part of the improvement project, the Board had formally concluded that minority interests did not meet the definition of a liability, and consequently should be shown as part of equity. We had agreed with
this analysis mandating appropriate changes to be made to IAS 27. However, we object to the conclusion, following from the point made at the time, that minority interests would have no differentiating feature from the parent's shareholders' interests in the group. We therefore object to the series of changes which are derived from this conclusion and fully agree with the members dissenting from both IFRS 3 and IAS 27 amendments and with their proposals.

i. Full goodwill
We understand the rationale leading to recording 100% of every single asset and liability of the acquiree, including goodwill. We object to it because it requires measuring a business combination at fair value, and we believe this measurement is neither relevant nor reliable. We also believe that applying the full goodwill method without any revaluation at each subsequent purchased share of interest lead to anomalous accounting. Deducting from the parent's share of equity the difference between the price paid for an increased share of interests and the corresponding book value may significantly distort the presentation of the entity's net assets.

ii. Ignoring the difference between equity interest in the group and equity interest in the subsidiaries
The objective of financial statements is, according to the framework, to provide information useful to their users, mainly investors. We believe that consolidated accounts are primarily (though not solely) designed to inform the shareholders "of the group", i.e. the shareholders, current and potential, of the parent company. Shareholders of the parent company are the only equity holders of residual interests in the group and minority interests held in subsidiaries are, from the group's viewpoint, third-parties to the group. We therefore believe that transactions between the group and those interests are of primary significance to the shareholders of the parent company and should be considered accordingly. They should be given as much prominence as the performance of the entity. We therefore believe that no partial change to the existing presentation requirements should be made, before conclusions are reached on the joint project on the presentation of financial statements. In the meantime we object to amendments being made to IAS 1 on a piecemeal basis and consequential basis. Preparers and users of IFRS financial statements are, in their vast majority, new to communicating on the basis of IFRS accounting. Partial changes are therefore likely to be overlooked and misinterpreted. We also wish to remind the Board that in Europe IFRS have not been made mandatory for separate financial statements.

iii. Electing control gain or loss as the only significant economic changes in the variations of interest of the parent in its investments
As mentioned above, we do not believe that gain and loss of control are the only significant economic events worth being reported upon. We also believe that there is no solid reason why gains and losses on shares of interest in subsidiaries
should be reported differently from gains and losses arising from available for sale assets. Therefore we object to revaluation gains and losses arising from the gain or loss of control being accounted for through P/L. On this issue also we agree with the dissenting members' proposals.

c. Departure from compliance with the framework on the issue of the probability recognition criterion in the accounting for non-financial liabilities and change of measurement attribute from "best estimate" to "legal lay-off amount".

i. Breaking the internal consistency of the underlying accounting model
We believe that none of the efforts made by the staff to justify compliance with the framework probability recognition criterion is convincing. Although we agree that unconditional obligations meet the definition of a liability, we believe the framework calls for their recognition only when the potential resulting outflow becomes probable. The framework is really clear: paragraph 91 states that "a liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation...". We believe definition of elements and recognition criteria ought to be thoroughly reviewed and potential adjustments be widely agreed before any departure from such fundamental principles is made.

ii. Lack of robust basis for identification of the obligating event
Although we agree with the Board that reporting unconditional obligations is in accordance with the definition of a liability, we believe that this change to the recognition criteria would dramatically modify the scope of recognised liabilities, as it would lead to recognising in the balance sheet items which are not even disclosed currently (i.e. all unconditional obligations which are not likely to result in any outflow of economic benefits). This raises the issue of identifying more clearly the obligating event. We note that the guidance given by the Board is not consistent on this issue and that from one example to the next the obligating event varies from the party obtaining knowledge that it has suffered a damage to the entity discovering that it has caused damage or the third-party starting official litigation. The need for a principle based approach to the identification of an obligating event is not new, it has been identified as one cross-cutting issue within the conceptual framework project. However, as of today, the need for the cash settlement to be more likely than not helps considerably in identifying what should be reported from what should not.

iii. Lack of relevance
The change of measurement attribute from "best estimate" to "legal lay-off" is not relevant. Nor is it relevant to account for every single risk or unconditional obligation, without any regard for the probability of the potential resulting outflow of economic benefits.
Users of accounts need to have a good understanding and visibility of an entity's liabilities. It is impossible to provide them with what they need, on the basis of a measurement attribute based on market values when market values are acknowledged not to exist (paragraph 30 of the ED). Non-financial liabilities will not, in the majority of cases, be settled by being transferred to others. We therefore believe that valuation of the potential outlay should be made on a cost approach, without any artificial estimate of any risk premium, unless there is market evidence that the risk can be discharged (i.e. agreement to the existing IAS-5).

Moreover, improbable outcomes of economic benefits would severely obscure the understanding of cost and constrained risks or obligations that are likely to trigger an outlay of resources.

Present accounting for provisions under IFRS requirements has not been identified as in need of improvement. IAS-37 is one of the few inherited IAS standards which has not been included in the improvement project. Nonetheless IOSCO has been satisfied with the quality of the stable platform. This would not have been the case if a standard of such considerable significance as IAS-37 had been flawed.

iv. Lack of reliability
As it is mentioned above, building artificial estimates necessary to apply the expected cash-flow approach would not yield reliable information. Necessary estimates would be subjective to an extent where neither verifiability nor neutrality would be met.

v. Divergence from US GAAP
Fundamental changes to IAS-37 as proposed create further divergence from FAS accounting requirements. Although we are aware that moves towards convergence have to be first initiated by the Board which has the older standard, we note that the FASB had not included at first any change to FAS 5 as part of Business Combinations phase II, clearly demonstrating that IASB voluntarily includes fundamental changes to standards under the convergence heading even when no convergence whatsoever is at stake. FASB has only recently issued IASB proposals for comments, with a deadline for receiving comments as of January 3. We therefore believe that recognition and measurement of contingencies should not be changed in IFRS before final discussions and analysis of all comments received, by both the FASB and IASB, are finalised.
d. **Weakening of the reliability criterion in the accounting for assets and liabilities.**

Finally, we are very concerned that IFRS 3 no longer contains any reliability recognition threshold. We cannot rely on 5C 98 for various reasons:

- the statement contained in the Basis that standards do not need to repeat the framework’s requirements is not applicable generally. The best evidence is the removal of any mention of the probability recognition criterion from the ED amending IAS 37 without the intent of seeing the framework apply to non-financial liabilities;

- standards have a higher mandatory status than the framework.

We therefore expressly request that either the requirement be included in the final standard (our preference) or an explicit reference to the framework recognition criteria be made in the standard.

Furthermore, we object to the removal of the reliability criterion for intangible assets acquired in a business combination. This issue had been debated at the time ED3 was being discussed and the Board had changed position after gathering evidence that intangible assets without any available reliable measurement would be part of business combinations.

After such a long list of strong concerns, we recommend the Board to:

1. Supplement the current IAS 27 in setting requirements for the accounting for increases and decreases of interest after control is gained or once control is lost, on the basis of the proposals made by the dissenting Board members;

2. Identify with the FASB how to amend IFRS 3 and FAS 141 in order to bring convergence where convergence is needed, without changing the underlying accounting model;

3. Adopt changes in IAS 37 and IAS 19 which bring convergence with the corresponding requirements in FAS literature, after re-discussing with the IASB on the basis of our comments (onerous contracts, constructive obligation, termination benefits, restructuring);

4. Drop (at least for the time being) the other changes proposed and bring them back after or along with proposals for amending or supplementing the existing conceptual framework.

We hope that the above-mentioned comments are taken into account and remain at your disposal should you need further clarification or background information.

Yours sincerely,

[Signature]

Jérôme P. Chauvin
Director, Legal Affairs Department