MEMORANDUM

Date: 4 November, 2005

From: Helen Thomson

Dear Mr. Teixeira,

Exposure Drafts:
Proposed Amendments to IFRS 3 Business Combinations
Proposed Amendments to IAS 27 Consolidated and Separate Financial Statements

We appreciate the opportunity to comment on the proposals of the International Accounting Standards Board (“IASB”) to amend the above accounting standards.

Process of Change

We support the IASB’s efforts to converge accounting standards internationally and its aim of promoting high quality accounting standards. However, we do not support the proposals for what are, in reality, very fundamental changes to the existing current accounting model. We are not convinced that the IASB has carried out sufficient research and analysis to support and justify its proposals and we are concerned that they have been issued as an exposure draft, with an intended application date of as early as 2007. In our view, the proposals should have been subject to full international debate, through the use of a Discussion Paper and extensive field testing, in advance of any exposure draft being issued. It is disappointing that the IASB has not adopted this approach.

We are also concerned that the IASB is seeking to introduce radical new accounting requirements at a time when many entities worldwide are adopting IFRS for the first time and are making associated significant changes to their accounting. It is unfortunate that the IASB should seek to make such changes to accounting requirements at this point. The international financial markets need stability of financial reporting and we are strongly of the view that, where (as is the case with the existing IFRS 3) an accounting standard gives high quality financial information and is not significantly flawed, it should not be changed to introduce new requirements that some (but by no means all) might regard as being technically superior.

Convergence

While we appreciate the IASB’s desire to achieve convergence with US GAAP and eliminate the need for a reconciliation in financial statements between IFRS and US GAAP, we believe that this should be achieved through the convergence of existing accounting requirements, other than where these are clearly flawed and result in inconsistent, or poor quality, financial information. We believe that this would be a more practical approach that would be more likely to be supported by users and preparers of financial statements. We do not believe that the approach being adopted, where both Boards move to a new and, in our view, flawed answer is appropriate.

Consequently, we believe that convergence largely to the approach set out in the current IFRS 3, which in certain respects is superior to the equivalent US GAAP guidance, would be a more
appropriate approach. Those who value a more purist view of accounting, in particular those who support as much of a full fair value approach as possible, might find the proposals in the exposure drafts attractive. However, we believe that they would result in considerably more subjectivity being brought to financial reporting, as well as a lack of consistency and a consequent lack of comparability among financial statements.

We urge the IASB to reconsider its approach.

**Economic Entity vs Parent Company Approach**

We note that the amendments proposed by the IFRS 3 Exposure Draft are based on the economic entity approach to consolidation. In our view, consolidated financial statements prepared under this approach do not provide information that is more relevant to users of financial statements. In particular, the requirement to fair value the whole of the acquiree is likely to lead to significantly more subjectivity in amounts included in financial statements. In contrast, the existing parent company approach looks to the fair value of consideration given by an acquirer when determining the total of amounts to be shown in the consolidated financial statements and consequent amount attributed to goodwill as a residual. The parent company approach is preferable and, in our view, superior.

The parent company approach depicts fairly the interest of the parent company shareholders in a non wholly owned subsidiary. In contrast, the proposed economic entity approach, (i.e. grossing up the parent company’s balance sheet) would not fairly represent the interests of shareholders in the consolidated group. There are also significant valuation concerns, which arise specifically for subsidiaries where less than 100% of the equity interests are acquired, as the guidance would suggest that the fair value of the whole is obtained simply by grossing up. That does not reflect economic reality; for example, a significant control premium might be applicable.

In addition, we do not believe that the existing parent company approach is one about which users and preparers of financial statements have expressed significant concerns. Nor are we aware of any research that has been carried out, which demonstrates that the economic entity approach (that the IASB is suggesting should be adopted) is superior to the existing parent company approach, in terms of the quality of financial information that it provides and its usefulness to the users of financial statements.

**Existing IFRS 3**

We have also considered whether the current IFRS 3 contains significant inconsistencies, or causes significant difficulties in its application, that require substantial modification to the standard and have concluded that it does not. While it is likely that, in the initial stages in particular, there will be inconsistencies in its application (such as the identification of separable intangible assets where preparers in certain jurisdictions argue that it is not possible separately to identify certain intangible assets), we do not consider that the standard is significantly flawed.

**Proposed Amendments to IAS 27**

Similarly, we do not support the proposed amendments to IAS 27. Certain of these changes appear to be linked to the apparently innocuous requirement of IAS 1 (revised 2003) that minority interest be recorded in equity. While we have no objection to this as a presentational point, as minority interest does not represent a liability, we do object to the implied rationale of it being an initial step in an argument to support the adoption of the economic entity approach to consolidation rather than the parent company approach.
We also believe that the various remeasurements to fair value, and recording of associated gains and losses in the income statement or equity, are inappropriate and inconsistent.

The proposals suggest that, where an entity sells part of its holding in a subsidiary but retains control, the gain or loss should be included within equity. An argument to support this might be that a parent entity with a valuable subsidiary might seek to manage its earnings by selling small portions of its subsidiary to boost its earnings in an otherwise poor year. In our view, this is a poor argument and the resulting accounting does not reflect the fact that the consolidated entity has entered into an exchange transaction with a third party that should properly be reflected in the income statement. If there are concerns about profits or losses on the partial disposal of a subsidiary being used to manipulate profits, this point could easily be addressed by requiring prominent, and separate, presentation of the gain or loss arising from the partial disposal in the income statement. A new accounting model is not required to deal with this particular mischief.

Where an entity obtains control over another, we believe that gains on the remeasurement of existing non-controlling holdings should be recorded in equity and not in profit or loss as suggested in the exposure draft. We disagree with the proposed approach, as the entity has not entered into an exchange transaction with a third party. No gain or loss should be recorded in the income statement that arises simply from a change in status. Whether an entity might choose to measure its investment in accordance with IAS 39 (and therefore potentially at fair value though profit or loss) is an entirely separate question.

**Conclusion**

As we note above, we do support the IASB’s efforts to converge accounting standards internationally and its aim of promoting high quality accounting standards. However, we believe it is imperative that, where radical changes to accounting are proposed, the IASB can demonstrate clearly that there is both a need and a demand for the changes being made, and that the costs of implementing the new requirements are commensurate with the benefits to companies and their shareholders.

Our more detailed responses to your specific questions are set out in the Appendix to this letter.

We would be pleased to discuss our comments and observations with you further if this would be helpful.

Yours sincerely,

Helen Thomson
Appendix

IFRS 3 Business Combinations

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 do not support the adoption of the economic entity approach instead of the parent entity approach. This is considered in more detail in our response to question 3 below. In addition to the points raised in our covering letter, we note that in many jurisdictions the legal requirement is to prepare the financial statements for the members of the parent company. Similarly, the auditors are required to report to those members. Extending the approach to an economic entity, rather than the parent entity, is inconsistent with such a requirement.

The exposure draft (“ED”) does not provide guidance in the case of true mergers, since the IASB assumes true mergers are very rare. While this low frequency may be true, we believe that in practice true mergers do exist, particularly in the area of combinations involving two or more mutual entities or combinations achieved by contract alone, and we believe that, in those cases, the application of the acquisition method, involving the identification of the 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, to which the IASB is committed (although it is not yet part of the active projects), is investigated as soon as possible and added to the IASB’s agendas.

In this respect, paragraph 4 taken with BC32 is confusing. Paragraph 4 states that a business combination is one in which an acquirer obtains control, thereby apparently excluding true mergers from being a business combination. However, BC32 notes that the proposed IFRS 3 will continue to require the acquisition method to be used, in those rare circumstances in which one of the combining entities does not obtain control. We fail to see how this can be the case, given the definition in paragraph 4.

BC32 goes on to note that, as a future phase, the IASB will be exploring fresh start accounting for those “rare circumstances” where one of the combining entities does not obtain control.

These proposals therefore seem to result in a position where true mergers are currently scoped out of IFRS 3, but are brought back within the scope by BC32 (although it is unclear how that is done given the definition in paragraph 4). Future indicated developments suggest that they will be taken out again in the future.

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?

We agree with the proposed definition of business, except for one matter of wording. The term ‘owners’ (of a business) is not compatible with the ‘entity view’ (versus the proprietary view). Under the terms of company law in many European countries, shareholders own shares, not a company or a business.
It would be helpful to include examples in the application guidance to illustrate the difference. For example, is the acquisition of a tenanted investment property intended to be the acquisition of an asset or a business? This difference may be key, given that related acquisition costs can be included in the cost of assets but not of a business (BC40), and when considering the deferred tax consequences in view of the current exemptions in IAS 12 paragraphs 15 and 24.

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?

We believe that the proposed approach is not appropriate for the reasons set out by the dissenting IASB 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.

Under that approach, 100% of the values of identifiable assets acquired and liabilities assumed is recognised at fair value at acquisition date, as per IFRS 3: 59, with the adjustment to the fair values relating to previously held interest being accounted for as a revaluation. The goodwill remains to be calculated as the residual element on a cost based approach, with the cost of each exchange transaction being compared with appropriate proportion of fair value of the acquirees identifiable assets acquired and liabilities assumed.

Under the parent company theory of consolidation, it is not appropriate to capitalise goodwill attributable to non-controlling interests.

The measurement of the acquiree as a whole is especially difficult where a holding less than 100% is acquired. This is because the acquirer might pay an additional price for synergies which do not affect minorities. It is therefore questionable whether the consideration transferred is a reliable indicator of the fair value of 100% of the acquiree and whether it is appropriate to allocate the full goodwill according to the percentage of shareholding to parent and minorities.

If the consideration transferred cannot be used to determine fair value, valuation techniques have to be applied in the absence of active markets. The IASB has not yet demonstrated that the additional information provided to users through the full goodwill method outweighs additional costs and provides more reliable information.

It is also questionable whether a further move in the direction of fair value should be made before the FASB issued its final statement on Fair Value Measurement and a discussion on the fair value measurement concept has taken place at the IASB.

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?

As noted in our response to question 3 above, we do not support the adoption of the economic entity approach. We support the parent entity approach. We believe that goodwill should be measured based on the costs of the acquisition under the current IFRS 3 model. Hence the fair value of the acquiree is not relevant. Nonetheless we comment on the points raised by this question below.
We think that the fair value approach for non-listed acquirees is too subjective to render reliable measurements. Example 3 in A15 illustrates this: even within such a stylisitic example, no unambiguous estimate of the fair value can be made. The solution merely refers to ill-defined market and income approaches.

In many cases, the consideration transferred will include amounts that only the individual acquirer would be prepared to pay (for example, for synergies). Also, transactions will typically include a control premium. There is not enough guidance on how to gross up the consideration transferred in such cases, and insufficient guidance on determining which cases it would not be appropriate to use the consideration transferred as an indicator of fair value.

**Question 5 - Is the acquisition-date fair value of the consideration transferred in exchange for the acquirer’s interest in the acquire 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?**

As noted in 3 above, we do not support the adoption of the economic entity approach instead of the parent entity approach. We would measure goodwill based on the costs of the acquisition under the current IFRS 3 model. Hence, the acquisition-date fair value consideration transferred is not relevant other than for the consideration transferred at the point control is achieved. In particular, we do not support revaluing non-controlling investment already held in the acquirer and recognising a gain in profit and loss. The definition of consideration transferred includes the acquisition-date fair value of non-controlling equity investments held by the acquirer even though no transfer has taken place at acquisition date for those non-controlling interests.

The ED presumes that both parties exchange equal values. We believe this is rarely the case. In fact, both parties believe they have gained from the transaction. The acquirer may believe that, as a result of gains to be achieved by synergies, the acquisition price is favourable to them and the shareholders of the acquired entity may well arrive at a deal which gives them a premium to the market value of their shares.

The IASB presumes that an acquirer will never pay an amount that is more than the fair value of its interest in the acquiree (i.e. overpayment, BC178). However, this is a rather simplistic assertion. Overpayment may occur:

- when the acquirer is more focused on short term effects on the growth figures on total assets or sales;
- when the business is acquired from a related party; or
- at the final stage of an acquisition in stages: based on the proposals in paragraph 56 of the ED, overpayment would result in a direct gain on the previous non-controlling equity investment, while the overpayment remains included in goodwill. This short-term income increasing feature of the ED might incite overpayment.

Even in cases where an overpayment can be ruled out, the acquirer is likely to have paid a control premium and may also have increased the consideration paid to take account of expected synergies (see our response to question 4). In these cases, the consideration transferred is not the best evidence of the fair value of a 100% holding.
Question 6 - Is the accounting for contingent consideration after the acquisition date appropriate? If not, what alternative do you propose and why?

The proposals for contingent consideration are inappropriate and should not be taken forward. The accounting treatment in the current version of IFRS 3 is preferable in our view. This requires contingent consideration to be adjusted against goodwill until settled.

Contingent consideration is just that – contingent. Neither the seller nor the buyer know what the final amount will be. Contingent consideration is included within sale and purchase agreements because of that uncertainty; in the absence of uncertainty, there would be little need for such arrangements. It is therefore wholly inappropriate to suggest that, in the event that the amount of contingent consideration is not determined before a certain point, variations should be taken to profit or loss rather than the recorded amount of goodwill.

We also note that the requirement to record changes in contingent consideration outside a 12 month hindsight period as gains or losses might encourage overstatement of contingent consideration, delays in finalising the amount payable, and consequent overstatement of income.

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?

As noted in our response to question 3 above, we do not support the adoption of the economic entity approach instead of the parent entity approach. We would measure goodwill based on the costs of the acquisition under the current IFRS 3 model.

We do not agree with the expensing of direct costs because (a) we believe that the proposed principle is inconsistent with the treatment of direct acquisition related cost in other existing standards, where the direct cost forms part of the carrying amount of the asset acquired, and (b) we disagree that such costs are not part of the overall consideration paid by the acquirer.

We note that, among other standards, it is only IAS 39 that requires transaction costs to be expensed immediately, and then only where a financial asset or liability is to be measured at fair value through profit or loss. In our view, it is inappropriate to apply the IAS 39 model to a business combination.

We believe that the acquirer will take transaction costs, which may be a significant amount, into consideration when determining the amount that it is prepared to pay the seller. The acquirer will not, overall, be prepared to pay more than it believes the entity acquired is worth. This means that, in general, the acquirer will be indifferent as to whether the payment it has made is for the acquisition itself or the acquisition-related costs. They are both part of the value that the acquirer had to give to acquire the interest in the acquiree.

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?

We generally agree with the initial recognition and measurement changes but we believe additional explanations on subsequent measurement of the contingent assets would be useful.

As noted in our response to the proposed amendments to IAS 37, we consider that contingent assets should continue to be within the scope of IAS 37 and should not be accounted for as intangible
assets. In particular, many contingent assets will be settled in cash (such as damages received through a court case) and therefore are not intangible assets as they are not non-monetary.

As regards the recognition criteria for assets acquired and liabilities assumed, we note that, in contrast to paragraphs 37 (a) to (c) of the current version of IFRS 3, the draft revised IFRS 3 (in paragraphs 28 to 31) no longer mentions the “reliability of measurement recognition criterion”. In BC98 of the draft revised IFRS 3, the IASB explains that it decided to drop the notion because an equivalent statement is already part of the recognition criteria in the Framework (paragraphs 86 – 88). Based on our understanding that the Framework cannot supersede a standard, and to prevent uncertainty, we recommend the IASB reinstates the “reliability of measurement recognition criterion” in the revised IFRS 3 or, as a minimum, include a direct reference to the Framework paragraph.

We also note that BC99 states that the IASB decided to remove the reliability of measurement criterion for intangible assets, because it “concluded that sufficient information should exist to measure reliably the fair value of an intangible asset”. This means that, under the new IFRS 3, it will not be possible to avoid capitalising an intangible in a business combination on the basis that it is not reliably measurable. We do agree with the proposal, as we do not believe that all intangible assets with indefinite useful lives can be measured reliably. We are also uncertain as to the relationship between BC98 and BC99. Despite the guidance in the proposals, is the impact of the Framework meant to restrict recognition of intangibles to those that can be measured reliably as well, or is the IASB content to implement an inconsistent approach?

The IASB adopts the same approach to recording non-financial liabilities in business combinations as for IAS 37 (see below). All the same theoretical and practical problems exist. Because the difference between the fair value of the liability recorded at the date of the business combination and the final settlement amount will be a gain or loss in earnings, companies will be motivated to develop the highest possible fair values at the date of the business combination, so that they are more likely to record gains than losses upon final settlement.

**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?**

We agree with the draft standard.

In addition, the ED should address the following recognition issues:

- **Classification of leases**: The ED should clarify in paragraph 38 that a lease of the acquiree retains the lease classification determined by the acquiree at the lease inception as if IFRS had been applied by the acquiree at the lease inception. Otherwise, it could be interpreted as that the classification based on the acquiree’s local GAAP can be maintained;

- **Reassessment of embedded derivatives**: We suggest that the ED should address whether embedded derivatives should be reassessed at acquisition date, especially when the acquirer and acquiree are both party to the host contract. The accounting method should be in line with the outcome of IFRIC ED D15.

With regard to non-current assets held for sale (IFRS 3, paragraph 43 and BC118), it should be made clearer that these assets can only be valued at fair value less cost to sell if, at acquisition date, the conditions of IFRS 5 are met.
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?

The proposal is not appropriate. We disagree with the proposed standard because (a) it is inconsistent with other types of transactions to record a gain on a purchase transaction and (b) it may incite overpayment. We refer to our response to question 5.

If an acquisition occurs in stages, paragraph 56 requires the buyer to record a gain or loss on its previous non-controlling interest. We believe this is open to abuse. For example, where a company holds a 49% interest and then buys an additional 2% to achieve control, the gain will be measured based on the price paid for the 2%. Companies may be motivated to overpay for the 2% to generate bigger gains.

We prefer the current IFRS approach. Under that approach, 100% of the values of identifiable assets acquired and liabilities assumed is recognised at fair value at acquisition date, as per IFRS 3: 59, with the adjustment to the fair values relating to previously held interest being accounted for as a revaluation. The goodwill remains to be calculated on a cost based approach, with the cost of each exchange transaction being compared with appropriate proportion of fair value of the acquiree’s identifiable assets acquired and liabilities assumed. At acquisition date, no exchange transaction has taken place for the previously held non-controlling interests. Therefore, no gains should be recorded in the income statement. On the other hand, the consolidated assets and liabilities of the subsidiary should not be measured on a mixed measurement basis (for example, 20% of the fair value as at the exchange date of the previously held non-controlling interest and 70% of the fair value as of the point in time where the acquirer obtained control). The current approach of IFRS 3 is therefore preferable.

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?

As noted elsewhere, we advocate retaining the parent-only, cost-based approach of the current IFRS 3. This would mean that a net negative residual goodwill figure would be recognised immediately in the income statement, as required by the current IFRS 3.

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?

We think such circumstances will be rare. They would depend on establishing a reliable basis for measuring the fair value of an acquisition for an acquirer.

We note that paragraph 72(d) of the ED requires disclosure of “the primary reasons for the business combination, including a description of the factors that contributed to the recognition of goodwill”. This implies that the IASB believes that an acquirer will be able to determine whether an overpayment has been made, as this overpayment would affect the amount of goodwill recorded. We are sceptical that this is the case.
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?

We agree with the proposed adjustments to comparative information.

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?

We agree with the proposed guidance.

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?

It should be considered whether some of the minimum disclosure requirements are too burdensome, taking into consideration costs and benefits (for example paragraph 76 (d)).

We doubt whether some disclosure requirements are meaningful. We refer to:
- paragraph 72 (k) (pre-existing relationships) seems to be quite extensive.
- paragraph 74 (b) will almost always be impracticable, since it requires a remeasurement of the acquisition on a different date, i.e. the beginning of the annual reporting period. Although paragraph 74 acknowledges this problem, we doubt whether it is meaningful to include a requirement that will almost never be fulfilled.
- the sole disclosure of the amount of goodwill that is expected to be deductible for tax purposes (para. 78) seems to have little information value.

We would also question:
- why the IASB is not proposing to create the same exception for paragraph 74 for non-listed firms, as in the FASB version of the ED, and
- why the guidance on results of operations for the purposes of paragraph 74 is given in the table of differences between the IASB and FASB ED and is not part of the ED.

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?

No, we do not believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill. We believe there are intangible assets, e.g. brands, patents or licences for one product, which cannot be sold, transferred, licensed, rented, or exchanged individually and do not generate separate cash flows. An example is a licence
to operate that cannot be sold without the consent of a regulator and would be revoked in the case of a change of control of the current holder.

In addition, we believe that active markets in many cases do not exist and we refer to paragraph 78 of IAS 38, where the IASB acknowledges that it is unusual that active markets exist for intangible assets (which we believe is the same case for intangible assets acquired in a business combination). Therefore, it is extremely difficult to determine the fair value without making use of valuation techniques. We are not convinced that the use of valuation techniques results in reliable information. Also, even if there are market transactions, the price paid for one asset may not provide sufficient evidence for the fair value of another asset.

The IASB should consider using field tests to establish whether different valuers arrive at a suitably narrow range of values, when asked to value an intangible, allowing for differences in models used and possibly assumptions applied. US GAAP has required separate measurement of identifiable intangibles for several years. It may be that the required evidence already exists.

Intangible assets with an indefinite useful life cannot be measured reliably in many cases. They should not be recorded separately from goodwill if a reliable measurement is not possible. It is unclear why, in Business Combinations Phase I, the IASB came to the conclusion that certain intangible assets with indefinite useful lives cannot be measured reliably and why, now, a different conclusion is reached (other than for convergence reasons).

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?

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?

We are not convinced that the EDs should differ on the disclosure requirements for non-listed firms. We suggest that the IFRS version of the ED also restricts the disclosures required by paragraph 74 to acquirers that are public business enterprises only.

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?

We agree with the proposed type style.

**IAS 27 Consolidated and Separate Financial Statements**

**Question 1** - Draft paragraph 30A proposes that changes in the parent’s ownership interest in a subsidiary after control is obtained that do not result in a loss of control should be accounted for as transactions with equity holders in their capacity as equity holders. As a result, no gain or loss on such changes would be recognised in profit or loss (see paragraph BC4 of the Basis for Conclusions).
Do you agree? If not, why not and what alternative would you propose?

We do not agree.

Following the parent company theory of consolidation, changes in the parent's controlling interest in an entity that do not result in a loss of control should be treated like other exchange transactions and not as transactions between equity holders. Gains or losses resulting from these transactions should therefore be recorded in the income statement.

Question 2 - Paragraph 30D proposes that on loss of control of a subsidiary any non-controlling equity investment remaining in the former subsidiary should be remeasured to its fair value in the consolidated financial statements at the date control is lost. Paragraph 30C proposes that the gain or loss on such remeasurement be included in the determination of the gain or loss arising on loss of control (see paragraph BC7 of the Basis for Conclusions).

Do you agree that the remaining non-controlling equity investment should be remeasured to fair value in these circumstances? If not, why not and what alternative would you propose?

Do you agree with the proposal to include any gain or loss resulting from such remeasurement in the calculation of the gain or loss arising on loss of control? If not, why not, and what alternative would you propose?

We do not agree.

The remaining non-controlling equity investment should not be remeasured to fair value at the date control is lost, and the resulting gain should not be included in the determination of the gain or loss arising on loss of control. With regard to the remaining interests, no exchange transaction has taken place and no gain or loss should result from the mere change in status. This does not mean that the remaining interest might not have to be subsequently measured at fair value according to IAS 39.

If the residual investment is to be equity accounted then, as at present, its carrying amount on loss of control should be the starting point for equity accounting.

While the proposed changes to IAS 27 might be capable of being applied if the investment is to be carried as a financial asset under IAS 39 and fair valued through profit and loss, that is not the only possible approach. However, if the residual is classified as an available-for-sale financial asset, it is unclear why the gain on loss of control should be recorded in profit or loss. If it is determined that the fair value cannot reliably be determined in accordance with IAS 39 paragraph 46 (c), then it is more difficult to see how the proposals could be applied.

Question 3 - As explained in Question 1, the Exposure Draft proposes that changes in a parent's ownership interest in a subsidiary that do not result in a loss of control should be treated as transactions with equity holders in their capacity as equity holders. Therefore, no gain or loss would be recognised in profit or loss. However, a decrease in the parent's ownership interest resulting in the loss of control of a subsidiary would result in any gain or loss being recognised in profit or loss for the period. The Board is aware that differences in accounting that depend on whether a change in control occurs could create opportunities for entities to structure transactions to achieve a particular accounting result. To reduce this risk, the Exposure Draft proposes that if one or more of the indicators in paragraph 30F are present, it is presumed that two or more disposal transactions or arrangements that result in a loss of control should be accounted for as a single transaction or arrangement. This
presumption can be overcome if the entity can demonstrate clearly that such accounting would be inappropriate (see paragraphs BC9-BC13 of the Basis for Conclusions).

Do you agree that it is appropriate to presume that multiple arrangements that result in a loss of control should be accounted for as a single arrangement when the indicators in paragraph 30F are present? Are the proposed factors suitable indicators? If not, what alternative indicators would you propose?

Multiple arrangements should be accounted for as a single arrangement, when the indicators of paragraph 30F are present. However, the problem that is to be avoided through the implementation of a rule for multiple arrangements, is created unnecessarily through the IASB’s proposals, and does not exist under the parent company approach to consolidation.

Question 4 - Paragraph 35 proposes that losses applicable to the non-controlling interest in a subsidiary should be allocated to the non-controlling interest even if such losses exceed the non-controlling interest in the subsidiary’s equity. Non-controlling interests are part of the equity of the group and, therefore, participate proportionally in the risks and rewards of investment in the subsidiary.

Do you agree with the proposed loss allocation? Do you agree that any guarantees or other support arrangements from the controlling and non-controlling interests should be accounted for separately? If not, why not, and what alternative treatment would you propose?

The current rule in the existing IAS 27 paragraph 35 should be maintained: losses that would result in negative non-controlling interests are only allocated to the non-controlling interests if the shareholder has a binding obligation and is able to make an additional investment to cover the losses.

Question 5 - The transitional provisions in the Exposure Draft propose that all of its requirements should apply retrospectively, except in limited circumstances in which the Board believes that retrospective application is likely to be impracticable.

Do you agree that proposed paragraphs 30A, 30C and 30D should apply on a prospective basis in the cases set out in paragraph 43B? Do you believe that retrospective application is inappropriate for any other proposals addressed by the Exposure Draft? If so, what other proposals do you believe should be applied prospectively and why?

We agree.
MEMORANDUM

To
Mr. Henry Rees
Project Manager
International Accounting Standards Board
30 Cannon St., London EC4M 6XH

via email: CommentLetters@iasb.org

Date
4 November, 2005

From
Helen Thomson

Dear Mr. Rees,

Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets, and IAS 19 Employee Benefits

We appreciate the opportunity to comment on the proposals of the International Accounting Standards Board (“IASB”) to amend the above accounting standards.

We support the IASB’s efforts to converge accounting standards internationally and its aim of promoting high quality accounting standards. However, we do not support the proposals for fundamental changes to the existing current accounting model.

We are concerned that the IASB is seeking to introduce radical new accounting requirements at a time when many entities worldwide are adopting IFRS for the first time and are making associated significant changes to their accounting. It is unfortunate that the IASB should seek to make such changes to accounting requirements at this point. The international financial markets need stability of financial reporting and we are strongly of the view that where (as is the case with the existing IAS 37) an accounting standard gives high quality financial information and is not significantly flawed, it should not be changed to introduce new requirements that some (but by no means all) might regard as being technically superior.

We do not consider that the existing IAS 37 contains any fundamental flaws that require the immediate attention of the IASB. While there are aspects where clarification would be helpful, such as certain interactions between IAS 37 and IAS 19 that are addressed in the exposure draft, and other interactions with (for example) IAS 18 and accounting for warranties which are not addressed in the exposure draft, in our view there is no need for a comprehensive change at this stage.

We note that the IASB has other projects covering Liabilities and Equity, and Revenue, and consider that it would be more appropriate to leave the proposed amendments to IAS 37 for the moment, and link any changes that might be found necessary to the outcome of those other projects.

With regard to the exposure draft itself, we disagree in particular with the proposals to recognise on the balance sheet, items that are currently termed contingent liabilities. This would result in entities initially recognising liabilities on the balance sheet at amounts which are guaranteed to be different from the amounts at which they will eventually be settled. We do not believe that this form of disclosure and measurement is useful to users of financial statements, nor do we believe that it would improve the quality of financial reporting.
Some have suggested that there is an inconsistency between the current IFRS 3 and IAS 37, as IFRS 3 requires the recognition of contingent liabilities on a business combination, while IAS 37 otherwise prohibits such recognition. We do not believe that this is a significant concern. As noted in the Basis for Conclusions to IFRS 3, the requirement for recognition of contingent liabilities on a business combination was introduced as a result of that standard’s proposals for negative goodwill and the consequent risk of credits appearing in the consolidated income statement where an entity with significant contingent liabilities was acquired. In our view, that is a practical solution to an issue that was properly anticipated by the IASB when IFRS 3 was published.

Our responses to your specific questions are set out in the Appendix to this letter.

We would be pleased to discuss our comments and observations with you further if this would be helpful.

Yours sincerely,

Helen Thomson
Appendix

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Question 1 – Scope of IAS 37 and terminology

(a) Do you agree that IAS 37 should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards? If not, for which type of liabilities do you regard its requirements as inappropriate and why?

(b) Do you agree with not using ‘provision’ as a defined term? If not, why not?

We agree that a standard is required to capture liabilities not within the scope of other standards.

We believe the term non-financial liability is misleading and confusing. Many of the liabilities within the scope of the revised IAS 37 may be required to be settled in cash, as for financial liabilities within the scope of IAS 32. We believe it would be preferable to retain the term “provision” and the IASB seems to accept this, as it notes the term may still be used in financial statements.

Question 2 – Contingent liabilities

(a) Do you agree with eliminating the term ‘contingent liability’? If not, why not?

(b) Do you agree that when the amount that will be required to settle a liability (unconditional obligation) is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability should be recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur)? If not, why not?

While we can see some conceptual merit in the proposed approach, it appears confusing and it is likely to give rise to problems on implementation in practice. To illustrate this point, the examples of a disputed lawsuit and a potential lawsuit in the Illustrative Examples are confusing. In particular, it is not clear whether it is the occurrence of the event giving rise to the claim, the acknowledgement of liability, or the start of legal proceedings that constitutes a past event.

Question 3 – Contingent assets

(a) Do you agree with eliminating the term ‘contingent asset’? If not, why not?

(b) Do you agree that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38? If not, why not?

It is not clear why an amount that might be recovered in a court case should be classed as intangible asset. We consider that the classification of such an item as a contingent asset is a better description of what the asset represents and is more easily understood by users of financial statements.

We do not believe that contingent assets should fall within the scope of IAS 38. In particular, many contingent assets will be settled in cash (such as damages received through a court case) and therefore are not intangible assets, as they are not non-monetary.
Question 4 – Constructive obligations

(a) Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not? How would you define one and why?

(b) Is the additional guidance for determining whether an entity has incurred a constructive obligation appropriate and helpful? If not, why not? Is it sufficient? If not, what other guidance should be provided?

We are not convinced that the proposed change adds clarity, nor that “reasonably rely” might be regarded as being a particularly stronger test than that set out in existing guidance.

Question 5 – Probability recognition criterion

Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?

We do not agree with the proposal. It is inappropriate for an accounting standard to be amended in a way that results in it being inconsistent with the Framework.

We are not convinced that the fundamental shift envisaged is necessary or that the costs involved justify the benefits.

For warranties and other similar items where the reporting entity has a large population of items, probability is reflected in measurement under paragraph 24.

Question 6 – Measurement

Do you agree with the proposed amendments to the measurement requirements? If not, why not? What measurement would you propose and why?

We are not convinced that the approach suggested is suitable for single obligations or small populations. The assumption that simply applying probabilities will give an amount at which a third party will buy the liability is unproven. In many cases, no such third party exists.

What is certain is that, by applying an expected cash flow basis to single items, the amount recorded will not equal the eventual cash flow. As such, its usefulness, relevance and reliability would appear questionable.

We consider that the “most likely” approach set out in the existing IAS 37 should be retained.

As an example, if a claim has a 90% probability of being settled for Euro 10 and a 10% probability of being settled for Euro 100, the probability weighted expected value is Euro 19, an amount that isn't even a possible outcome. Why is Euro 19 a useful measurement? It might be argued that it is useful because it is the best estimate of how much the entity would pay a third party to assume its obligation. However, because for most of these liabilities there is no such third party, we question the usefulness of the measurement. A liability of Euro 10, representing the likeliest outcome, with disclosure of the exposure to an additional loss of Euro 90, would appear more informative and more transparent. This approach would also be less vulnerable to manipulation by changing the subjective probabilities.
In addition, there is no guidance in the exposure draft as to whether, when discounting a liability, the discount rate should reflect the obligated entity's credit risk. This is a major issue and we believe that guidance should be included.

Question 7 – Reimbursements
Do you agree with the proposed amendment to the recognition requirements for reimbursements? If not, why not? What recognition requirements would you propose and why?

We agree.

Question 8 – Onerous contracts
(a) Do you agree with the proposed amendment that a liability for a contract that becomes onerous as a result of the entity’s own actions should be recognised only when the entity has taken that action? If not, when should it be recognised and why?

(b) Do you agree with the additional guidance for clarifying the measurement of a liability for an onerous operating lease? If not, why not? How would you measure the liability?

(c) If you do not agree, would you be prepared to accept the amendments to achieve convergence?

We find the guidance in paragraph 57 confusing. If an entity is the lessee in an operating lease, for a property where the required rentals now exceed the economic benefit from using the leased property, then that would appear to be an onerous contract. How is the liability measured? The entity can continue to use the property or it can cease using the property and attempt to sublease it. We believe that under the proposals (although it is not entirely clear), the liability would be measured at the lower of the two potential amounts arising from either continued use or cessation of use and subleasing (the least net cost). However, if the smaller loss amount is the loss arising from ceasing to use and subleasing, ceasing use is an event in the entity's control. The proposals note that if the event is in the entity's control, then a liability should not be recorded until the entity takes the necessary action (paragraph 57). We presume that events in the entity's control can be used to reduce a liability even if the entity has not taken the action (paragraph 58).

Question 9 – Restructuring provisions
(a) Do you agree that a liability for each cost associated with a restructuring should be recognised when the entity has a liability for that cost, in contrast to the current approach of recognising at a specified point a single liability for all of the costs associated with the restructuring? If not, why not?

(b) Is the guidance for applying the Standard’s principles to costs associated with a restructuring appropriate? If not, why not? Is it sufficient? If not, what other guidance should be added?

We do not agree with the proposal. It is questionable whether disaggregating and “delaying” recognition of certain costs associated with a committed restructuring results in a presentation that is beneficial to the users of the accounts.
IAS 19 Employee Benefits

Question 1 – Definition of termination benefits

The Exposure Draft proposes amending the definition of termination benefits to clarify that benefits that are offered in exchange for an employee’s decision to accept voluntary termination of employment are termination benefits only if they are offered for a short period (see paragraph 7). Other employee benefits that are offered to encourage employees to leave service before normal retirement date are post-employment benefits (see paragraph 135).

Do you agree with this amendment? If not, how would you characterise such benefits, and why?

Question 2 – Recognition of termination benefits

The Exposure Draft proposes that voluntary termination benefits should be recognised when employees accept the entity’s offer of those benefits (see paragraph 137). It also proposes that involuntary termination benefits, with the exception of those provided in exchange for employees’ future services, should be recognised when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria (see paragraph 138).

Is recognition of a liability for voluntary and involuntary termination benefits at these points appropriate? If not, when should they be recognised and why?

Question 3 – Recognition of involuntary termination benefits that relate to future service

The Exposure Draft proposes that if involuntary termination benefits are provided in exchange for employees’ future services, the liability for those benefits should be recognised over the period of the future service (see paragraph 139). The Exposure Draft proposes three criteria for determining whether involuntary termination benefits are provided in exchange for future services (see paragraph 140).

Do you agree with the criteria for determining whether involuntary termination benefits are provided in exchange for future services? If not, why not and what criteria would you propose? In these cases, is recognition of a liability over the future service period appropriate? If not, when should it be recognised and why?

We are generally in agreement with the IAS 19 revisions.