28 October 2005

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Dear Sir

EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IFRS 3 – BUSINESS COMBINATIONS, AND AMENDMENTS TO IAS 27(AC 132) – CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

In response to your request for comments on the exposure draft of Proposed Amendments to IFRS 3 – Business Combinations, and Amendments to IAS 27(AC 132) – Consolidated and Separate Financial Statements, attached please find the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but is also secretariat for the Accounting Practices Board, the official accounting standard setting body in South Africa.

We thank you for the opportunity to provide comments on this document. We have, in addition to our responses to the questions raised, also included general comments on aspects not specifically dealt with in the questions.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Doug Brooking (Chairman of the Accounting Practices Board)
    Prof Alex Watson (Chairperson of the Accounting Practices Committee)
AMENDMENTS TO IFRS 3 – BUSINESS COMBINATIONS

GENERAL COMMENTS

We do not agree with these proposed major amendments as these would cause fundamental changes to the accounting for business combinations and consolidations, which we do not believe will achieve more relevant and reliable information.

Economic entity approach

The proposals would require consolidated financial statements to be prepared using the ‘economic entity’ approach rather than the ‘parent company’ approach. This is a fundamental change in how the reporting entity is viewed and will result in many other changes, including recognising the non-controlling shareholders’ share of goodwill (i.e. the ‘full goodwill’ method), loss attribution among controlling and non-controlling interests, and accounting for increases or decreases in ownership interests in a subsidiary after control is obtained. Whilst we agree with the Board that non-controlling interests do not meet the definition of a liability as per the IASB Framework/FASB Concepts Statements, we are not convinced that this fact alone should lead to the rejection of the parent company approach in favour of the economic entity approach.

The reasons for our disagreement with the economic entity concept and with the full goodwill method are captured in the alternative view expressed in paragraphs AV2 to AV7 of the IFRS 3 exposure draft, some parts of which are repeated below:

• The full goodwill method treats goodwill as an asset that can be identified separately and measured at fair value, like any other asset of the subsidiary. Goodwill, however is different from other assets, because it is a component of the value of the business as a whole, rather than having a separate existence.

• The process of measuring goodwill is extremely difficult. The total value of the acquired business is an extremely subjective measure, based upon the acquirer’s judgement of the potential returns that it will generate.

• The allocation of the goodwill between the parent and the subsidiary is also problematic, and this adds to the difficulty of measuring the goodwill attributable to the non-controlling interest in the subsidiary. The ‘parent-only’ approach to goodwill in IFRS 3 avoids this difficulty by measuring goodwill as the difference between the fair value of the consideration paid by the parent for the subsidiary and its share of the fair value of the identifiable net assets of the subsidiary. The measurement of the goodwill attributable to the non-controlling interest is likely to be extremely unreliable or even misleading, and it is doubtful if it will confer any informational benefit on users of financial statements.

Determining the fair value of the total goodwill and the amount associated with the non-controlling interest is a difficult process and the benefit of the financial information
provided to the investors in the parent, the primary users of the consolidated financial statements, does not exceed the costs.

**Definition of control**

A further reason for our disagreement is the fact that the proposals appear to be based on *de facto* control rather than the power to control (refer to our comments to Question 1 where we express concern about the wording of paragraph 12(c)(2)). In our view a *de facto* control approach is both incorrect and impossible to apply in practice.

**Practical problems with the current IFRSs**

We do not support further major amendments to IFRS 3 at this stage, for the following reasons:

- Preparers need more time to absorb the practical implications of the accounting in terms of the existing IFRS 3.
- Before further changes are made to IFRS 3, at least some of the current problems which have arisen in implementing the existing IFRS 3 should be addressed by the Board and IFRIC. We have highlighted these problems below:
  - The purchase price allocation to intangible assets with indefinite useful lives acquired in a business combination. Allocating the purchase price to intangible assets rather than to goodwill can be a very subjective exercise.
  - The purchase price allocation to intangible assets with short useful lives in a business combination. In the post acquisition period, the group is obliged to amortise these assets without being able to recognise any intangible assets created in their place. Intended as an anti-abuse provision, the existing IFRS 3 requirements, together with IAS 38, result in abnormal write-offs being reported in the post-acquisition accounting period.
  - Divergent interpretations on whether the purchase of investment properties with current leases meets the definition of a business. For example one investment property with one lease versus one investment property, like a shopping mall, with many leases. The question that arises is, at what point, if any, does the investment property with leases constitute a business as defined in IFRS 3.
- The Board should rather address the areas not covered by this phase of the business combinations project and this exposure draft as guidance is urgently needed by the financial reporting community for the areas note below:
  - common control transactions (including management buy-out transactions);
  - true mergers of equal entities;
  - accounting for joint ventures;
  - accounting for associates; and
  - the use of new companies and non-operating companies.
• The conclusions in this exposure draft are based on projects the Board has not yet finalised. Examples are:
  o the fair value project
  o the conceptual framework project
  o the performance reporting project
  o the liabilities and equity project.

• Whilst we support the objective of international convergence, we do not believe that these proposals are a result of true convergence. IFRS 3 as currently drafted, is acceptable and merely requires some implementation issues to be addressed. These proposals constitute a move away from the IASB Framework and towards incorrect principles and rules.

• Furthermore, considering that many companies have recently adopted IFRS, we believe that the costs clearly outweigh the benefits of changing the current model.

SPECIFIC COMMENTS ON QUESTIONS RAISED

Question 1 – Objective, definition and scope

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?

The definition of a ‘business combination’ in the proposed amendment to IFRS 3 has been changed to focus on control, the words being “…acquirer obtains control.....”. This change effectively makes the definition much narrower, as the current definition merely refers to “the bringing together of separate entities”. On the other hand the proposed amendments include in the scope, business combinations achieved by contract alone, which were not included in the existing IFRS 3. This appears contradictory seeing that it is easier to fit entities brought together by contract into the previous definition of a business combination than the proposed definition.

We understand this concept of ‘by contract alone’ to apply generally to dual listed companies (DLCs) where there are two distinct parts to the business that are just traded together. However, generally speaking, DLCs are run or managed as a combined business, therefore, the view is that all assets and liabilities of this combined business or entity should be recognised together (entity concept).

We are concerned with the proposed change of definition. Even though the new definition focuses on control, all business combinations included in the scope of the existing IFRS 3 would be within the scope of the proposed revised IFRS 3. The Basis for Conclusions (BC32) states that “Even though the new definition focuses on control, all business combinations included in the scope of IFRS 3 are within the scope of the draft revised IFRS 3.” It appears as if principles are set in the Basis for Conclusions and is
contradictory to the proposed narrowing of the definition to focus on control. Should this narrowing not be intended, this statement must be made more clearly in the definition, and not hidden in the Basis for Conclusions.

With the change of the definition of a business combination in the proposed amendments to IFRS 3 to focus on control by the acquirer, clarity is required as to whether the acquirer, as defined, is the legal or accounting acquirer. The existing IFRS 3 requires two or more businesses or separate entities to be brought together, the proposed changed definition implies that only one business is needed to be scoped into the standard. For example if a new entity is formed to acquire an existing business, it must be questioned whether a business combination, as defined, can occur. If the new entity did not comprise a business there is no acquiree because paragraph 16 of the proposed revised IFRS 3, which is the same as paragraph 22 of the existing IFRS 3, requires the entity that existed before the business combination to be identified as the acquirer if the new entity issues equity instruments to effect the combination. There is no similar requirement if the new entity settles the purchase price in cash. However, this entity cannot be both acquirer and acquiree and therefore there cannot be a business combination.

Although paragraph 3 of the proposed revised IFRS 3, provides that control is defined in IAS 27, we are concerned that the application of control may be different from that in IAS 27, which could lead to inconsistencies. In particular, we are concerned with paragraph 12(c)(2), which concludes that the acquirer may be the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity when no other owner or organised group of owners has a significant voting interest. It appears that control in the draft revised IFRS 3 may be based on de facto control rather than the power to control as required by IAS 27.

**Question 2 – Definition of a business**

*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?*

The definition of a business in the existing IFRS 3 has a second paragraph, referring to the fact that a business generally consists of inputs, processes and outputs. This wording has been excluded from the definition in paragraph 3(d) of the proposed amendments to IFRS 3. Instead, this wording is included in Appendix A paragraph A2.

We recommend that the following sentence in A2 be included in paragraph 3 (d): "A business consists of inputs and processes applied to those inputs that have the ability to create outputs." While this may seem insignificant as the wording is included in the appendix, we believe that this sentence is a key part of the definition of a business and should be included in the main body of the standard.
The proposed revised definition of a business appears to be wider than in IFRS 3, which may result in more groups of assets being treated as business combinations. If the groups of assets are not business combinations, the cost allocation method is still applied, whereas the fair value approach needs to be applied if it is a business combination. The Board needs to be aware of the practical implementation issues if the wording is not clear.

Based on a literal reading of the proposed standard, it appears that single asset acquisitions, such as a non-producing oil field or a single piece of real estate which would currently not be treated as a business combination, may be treated as a business combination in terms of the exposure draft. It is not certain that this is what was intended when proposing the revised wording.

In addition the exposure draft retains the presumption that if goodwill is present in a transferred set of activities and assets that this is a business combination. However in some cases, whether there is goodwill or not, depends on whether there is deferred tax, in which case the assessment becomes circular whether there is deferred tax or not depends on whether the acquisition is classified as a business combination.

Question 3 to 7 – Measuring the fair value of the acquiree

Question 3

In a business combination in which the acquirer holds less than 100 per cent of the equity interests of the acquiree at the acquisition date, is it appropriate to recognise 100 per cent of the acquisition-date fair value of the acquiree, including 100 per cent of the values of identifiable assets acquired, liabilities assumed and goodwill, which would include the goodwill attributable to the non-controlling interest? If not, what alternative do you propose and why?

We do not agree with these proposals and refer you to our general comments and to our reference to the alternative view in paragraphs AV2 to AV7. We propose the existing IFRS 3 approach. The proposals support 'what if' accounting, using a hypothetical valuation model to determine what price would be paid if 10% of the business were acquired when in fact less than 10% was acquired. The premium paid for control is what was paid for that portion of control gained, and should not be extrapolated to derive a full fair value for goodwill.

Furthermore, this accounting is contrary to the qualitative characteristic of substance over form, per the Framework. Paragraph 35 of the Framework states that, “If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other event is not always consistent with that which is apparent from their legal or contrived form.” The use of a hypothetical valuation model to derive a full fair value for goodwill is not substance over form, but fiction over form.
What this method is proposing is two fair value exercises. A fair value exercise is already required for the identifiable assets and liabilities on acquisition, this would require a further fair value exercise to value the consideration. Whilst consideration paid is a factual number, requiring the entire entity to be fair valued based on what would have been paid for 10% of the entity would result in information that might not be relevant or reliable. The Board should take cognisance of the fact that performing valuations of acquirees is a difficult and costly process in practice. There are very few 'IFRS valuers' able to provide appropriate valuations in terms of what IFRS now require. We also question whether the costs of obtaining and providing this information to the shareholders of the parent (the primary users of the consolidated financial statements) do not currently exceed the benefits. A further consideration is the fact that it will be very difficult for auditors to audit the valuations and we question whether these hypothetical valuations will not be accompanied by qualified audit opinions as a matter of routine.

**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?

We have not commented on this question as we do not support the full goodwill method. Our reasons are noted in the general comments on this exposure draft and the answer to Question 3.

**Question 5**

Is the acquisition-date fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree the best evidence of the fair value of that interest? If not, which forms of consideration should be measured on a date other than the acquisition date, when should they be measured, and why?

Yes. We believe the acquisition date fair value of the consideration transferred in exchange for control is the best evidence of the fair value of the interest acquired at that date. This is based on the exchange date being the date of effective control. The proposals, however, fail to give adequate guidance as to when control is achieved.

We are concerned that the proposals do not clearly address the situation in which an exchange date which is delayed by formalities may result in an inappropriate alteration to the amount of the consideration transferred. This is illustrated by the following example:

An entity enters into a scheme of arrangement to acquire a business and this scheme requires court sanction. The court sanction could be given only after a number of months, which could straddle a reporting period. The question is the date when control passes. Change of control could pass on any date between the agreement date and the exchange date once the potential acquirer has the power to initiate transactions or has dominant influence.
Question 6

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

We understand that at acquisition date it is often difficult to reliably measure contingent considerations and hence it is logical that re-measurement is required after the acquisition date. We believe, however, that this re-measurement should be taken to goodwill as this better reflects it is an adjustment for what was paid. Since the contingent consideration was taken into account in determining the purchase consideration any adjustment should be to goodwill and not to the income statement. This would result in more relevant reporting. This answer is based on our assertion that the full goodwill method is inappropriate.

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?

We do not agree with this principle. In all the other IFRSs which refer to acquisition costs, these can be capitalised. We refer to IAS 2 – Inventories, IAS 40 – Investment Property, and IAS 16 – Property, Plant and Equipment.

Furthermore, these costs are often significant and the proposals will, in our view, discourage the good practice of obtaining suitably qualified professionals to assist in the objective valuation of a business.

Question 8 and 9 – Measuring and recognising the assets acquired and the liabilities assumed

Question 8

Do you believe that these proposed changes to the accounting for business combinations are appropriate? If not, which changes do you believe are inappropriate, why, and what alternatives do you propose? (Paragraphs 28-41 and BC111-116).

Generally we agree. However, we would like more guidance on the measurement of contingent assets and contingent liabilities.

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? (Paragraphs 42-51 and BC 117-150).
Generally we agree with the proposals. We do not agree with the exceptions for goodwill as these are based on the presumption of the full goodwill method, which we reject.

**Question 10 – 12 – Additional guidance for applying the acquisition method to particular types of business combinations**

**Question 10**

*Is it appropriate for the acquirer to recognise in profit or loss any gain or loss on previously acquired non-controlling equity investments on the date it obtains control of the acquiree? If not, what alternative do you propose and why?*

No, we do not agree for the reasons set out in AV11 to AV13 of the proposed amendments to IFRS 3. We have repeated the wording of these paragraphs below as they capture our views too.

"Two of these Board members also disagree with the requirement in paragraph 56 that:"

in a business combination achieved in stages, the acquirer shall remeasure its non-controlling equity investment in the acquiree at fair value as of the acquisition date and recognise any gains or losses in profit or loss. If, before the business combination, the acquirer recognised changes in the value of its non-controlling equity investment directly in equity (for example, the investment was designated as available for sale) the amount that was recognised directly in equity shall be reclassified and included in the calculation of any gain or loss as of the acquisition date."

Although these Board members agree that the acquisition of a controlling interest is an event that requires remeasurement of the investment to its fair value, they disagree that it results in derecognition of the investment. The acquirer has obtained rights to direct the use of the underlying net assets of acquiree as a result of the purchase of an additional investment that achieves a controlling interest. It has not disposed of the original investment, and it is therefore inappropriate to reclassify past gains or losses on that investment to profit or loss, as would be done if they were realised by disposal.

"These Board members would recognise the gain or loss on remeasurement of the non-controlling interest directly in equity, in the manner required by paragraph 55(b) of IAS 39 for available-for-sale financial assets."

**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?*

We are concerned that, although paragraph 59 implies that there may be a bargain purchase because of the requirement to measure particular assets acquired or liabilities
assumed in accordance with other IFRSs rather than at fair value, the exposure draft is not specific enough. We believe that the final standard should address the situation where the fair value of the acquiree as a whole is less than the net amount of the recognised identifiable assets and liabilities, even though the fair value of the acquirer's interest does not exceed the fair value of the consideration transferred.

In addition, we note that paragraph 61 requires the amount of goodwill that otherwise would be recognised to be reduced by any excess of the fair value of the acquirer’s interest over the consideration transferred. If the goodwill related to the business combination is reduced to zero, any remaining excess shall be recognised as a gain attributable to the acquirer. We understand this to mean the total amount of goodwill and not only the portion of the goodwill allocated to the acquirer. However, in example 6, the portion of goodwill allocated to the acquirer is reduced to zero and the remaining excess is recognised as the gain. We believe that the final standard should clarify the correct approach. It is also not clear, based on the inconsistency between paragraph 61 and example 6, what the correct approach should be if the excess is less than the total amount of goodwill, but is equal to or greater than the portion of goodwill allocated to the acquirer. It would be useful if the final standard clarified this.

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?

No, we do not believe an overpayment can be measured reliably at acquisition date. In fact, this inability to measure reliably at acquisition date underlines the unreliability of the full fair value method. We believe that the acknowledgement in BC178 sows the seeds for rejecting the full fair value method. BC178 states that: “The Board considered whether the draft revised IFRS3 should include requirements for accounting for a business combination in which the acquirer pays an amount that is more than the fair value of its interest in the acquiree. The Board observed that this circumstance indicates that the business combination is not an exchange of equal values. However, the Board observed that although an overpayment by the acquirer is a theoretical possibility, it believes that in practice, if it occurs, it will not be detectable or known at the acquisition date. That is to say, the Board is not aware of instances in which a buyer knowingly overpays a seller to acquire a business or is otherwise compelled to make such an overpayment. Rather, the Board believes that an acquirer’s overpayment, although rare, occurs unknowingly and generally as a result of misinformation at the acquisition date. Thus, the Board concluded that in practice it might not be possible to identify and measure reliably an overpayment at the acquisition date. The Board concluded that the accounting for overpayments is best addressed through subsequent impairment testing when evidence of a potential overpayment first arises.”

We are concerned about the accounting of overpayments and request clarity regarding the issue highlighted in the example below, which is based on amended figures applied to example 6 in the exposure draft.
Example

Fair value of identifiable net assets 200
80% interest is acquired for cash of 190
Fair value of 100% 225
Fair value of 80% 180
Total goodwill = 225 - 200 = 25

Acquirer’s share of goodwill = 190 - (80% x 200) = 30

Journal entries:

Dr identifiable net assets 200
Dr Goodwill 30
Cr Consideration paid 190
Cr NCI (20% x 200) 40

In the example above, the controlling interest pays more than the fair value of its acquired interest (overpayment). In terms of paragraph A62 the goodwill allocated to the controlling interest should be the difference between the fair value of the acquired interest and the controlling interest’s share of the fair values of the net identifiable assets: (180 - (80% x 200) = 20), which means that goodwill of 5 should be allocated to the non-controlling interest.

Dr Identifiable assets 200
Dr Goodwill 25
Dr (???) 10
Cr Consideration paid 190
Cr NCI (20% x 200) + 5 45

The debit of 10 represents the amount paid by the controlling interest in excess of the fair value of its interest. Should this be debited to goodwill? Paragraph A62 states that the goodwill allocated to the controlling interest cannot be greater than the total goodwill calculated in accordance with paragraph 49. Therefore, it would appear that the 10 cannot be debited to goodwill.

One approach would be to say that because the controlling interest paid an amount of 10 in excess of the fair value of its interest, the non-controlling interest effectively acquired its interest at a discount of 10. This discount (bargain purchase) should be allocated to the non-controlling interest:
Alternatively, if paragraph A62 did not limit the goodwill allocated to the acquirer, the additional premium of 10 paid by the acquirer should be debited to goodwill and allocated to the acquirer. This would mean that the non-controlling interest would be recognised at 45.

The correct approach to be followed in these circumstances should be clarified in the final standard.

**Question 13 – Measurement period**

*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?*

Yes, we agree.

**Question 14 – Assessing what is part of the exchange for the acquiree**

*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?*

At this stage we have no comment. We are however concerned that if we have to implement these changes that some of the examples should be more practical as the principles contained therein are difficult to grasp.

**Question 15 – Disclosures**

*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?*

We agree with the disclosure objectives and the minimum disclosure requirements.

Paragraph 72(d) requires disclosure of a description of the factors that contributed to goodwill. It is unclear what such factors might be other than that the cost of the business combination exceeded the fair value of the identifiable net assets acquired.
Paragraph 72(f)(5) requires disclosure of the method of determining the fair value of equity instruments included in consideration transferred. The Board should consider requiring disclosure of the methods of determining the fair value of other items or components of consideration (e.g. contingent consideration, debt instruments, etc.).

Clarity should be provided as to whether actual or adjusted revenue and profit and loss is required in paragraph 74(b)(i).

If the final standard is based on the parent company model, we believe that certain disclosures should be modified, specifically:

- Paragraph 72(f)(6) should be removed as the previously acquired non-controlling investment would not be included in the consideration transferred because the cost of the business combination is the aggregate of each exchange transaction.

- Paragraph 72(j) should be modified to require disclosure of the amount of any revaluation gain or loss recorded in equity.

- Paragraph 72(l) should be modified to require disclosure of the amount of transaction costs included in the cost of the business combination.

**Question 16 – 18 – The IASB’s and the FASB’s convergence decisions**

**Question 16**

Do you believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill? If not, why? Do you have any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics:

(a) the intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability; and

(b) cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole?

No. In our experience it is not always possible to reliably measure an intangible asset. A unique asset which has never been the subject of an exchange is probably not capable of being reliably measured.

**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?

Yes, we agree that this proposal is appropriate.
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?

No. We believe that a joint project between the IASB and the FASB should result in harmonised disclosures with few, if any, differences.

Question 19 – Style of the exposure draft

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 believe that the use of bold and grey text is very helpful. It makes the standard easier to read, understand and apply.