Ms Michelle Crisp  
Accounting Standards Board  
5th Floor, Aldwych House  
71 - 91 Aldwych  
LONDON  
WC2B 4HN  
Email: fred36@frc-asb.org.uk

21 November 2005

Dear Michelle

ASB EXPOSURE DRAFT: FRED 36 BUSINESS COMBINATIONS (IFRS 3) AND AMENDMENTS TO FRS 2 ACCOUNTING FOR SUBSIDIARY UNDERTAKINGS (PARTS OF IAS 27 CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS)

The Institute's Accounting Standards Committee has considered the above Exposure Draft and I am pleased to set out its comments below.

Significant Concerns

Lack of Due Process
We consider that the subject matter of this exposure draft should first have been exposed as a discussion paper rather than proceeding straight to an exposure draft as we consider that the proposals would involve a fundamental change to existing practice. We are concerned that no indication has been given of why it is believed necessary to move away from the existing parent entity view and we believe that it is essential that a change such as this should have been opened to proper debate via a discussion paper prior to an exposure draft being issued. We firmly believe that the argument for this fundamental change has not been made by the proposals contained in the exposure draft and we will require to see reasoned argument before we can be persuaded that this change is necessary to improve the quality of financial reporting. In our view, if a principles-based approach to standard setting is desired, then it is essential that the principles should form the basis of the argument.
Minority Interests
We further consider that the presentational step of classing minority interests as equity rather than a liability has then been used to justify a change in the basis of measurement. In particular, paragraph BC18 makes a number of assertions that we consider should have been the subject of a discussion paper prior to being included in an exposure draft.

Goodwill
We are also concerned about the proposal to include 100% of goodwill even when the subsidiary concerned is only partially owned. Our concern in this regard is that even if we accept 100% goodwill, rather than goodwill only on the part owned, we would question whether the 100% can be measured with sufficient reliability for inclusion in the financial statements. We note that in paragraph 46(c) of IAS 39 and paragraphs AG80 to AG81 in Appendix A to IAS 39 the IASB explains that the fair value of equity instruments that do not have a quoted price in an active market is not reliably measurable if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, in which case such equity instruments must be accounted for at cost rather than fair value. Therefore, it appears to us that the IASB has already acknowledged in another standard that the fair value of some unquoted shares is not a sufficiently reliable measurement for inclusion in the financial statements, and therefore has provided an alternative basis of accounting for shares of this nature. We believe that many subsidiary companies will be unquoted and therefore where less than 100% of such shares are acquired we do not believe that the fair value of the whole can be measured with sufficient reliability for inclusion in the financial statements. We are therefore concerned that the proposals on business combinations do not appear to envisage this situation arising in spite of the fact that it has clearly been considered to be a possibility in the context of IAS 39.

Recognition of Uplift
Paragraphs 21, 22 and 56 of the exposure draft together require the uplift from book value to fair value of shares in the acquiree previously held to be recognised in the income statement. Even if we accept the entity concept, we would prefer such an uplift to be recognised directly in equity.

Recommendation
In view of these major concerns, we recommend that the IASB should abandon this standard and instead open the subject to debate through a discussion paper that properly addresses the points that we have raised above. Only when a proper and thorough debate on the principles involved has taken place will it be appropriate to move towards an exposure draft for a standard.

With regard to the ASB, because of the significant concerns that we have identified above, we believe that the Board should take a stand in opposition to this standard with the IASB. We suggest that the Board should call for the rejection of this exposure draft until such time as a proper debate of the principles involved has taken place. We would therefore like to express our support for any action the Board might like to take in this regard.
Our responses to certain of the specific questions contained in the Exposure Draft are set out in the attached appendices. Please note that we have only answered those questions where we believed it necessary to illustrate our views.

If you wish to discuss our comments further, please do not hesitate to contact me.

Yours sincerely

[Signature]

JAMES E BARBOUR
Director, Accounting and Auditing
APPENDIX A

INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND
ACCOUNTING STANDARDS COMMITTEE

RESPONSE TO THE ASB’s SPECIFIC QUESTIONS CONTAINED IN ‘FRED 36
BUSINESS COMBINATIONS (IFRS 3) & AMENDMENTS TO FRS 2 ACCOUNTING
FOR SUBSIDIARY UNDERTAKINGS (PARTS OF IAS 27 CONSOLIDATED AND
SEPARATE FINANCIAL STATEMENTS)’

1. Should the IASB proposals succeed to a Standard the ASB would prefer to defer implementation until the full impact of the proposal can be evaluated through practical implementation. The following options for implementation into UK accounting standards have been identified, which would you prefer? Please explain your preference.
   i. implement the Business Combinations ‘package’ in full simultaneously with the IASB (i.e. 1 January 2007);
   ii. not to implement immediately but reconsider implementation of the Business Combinations ‘package’ after a period of time has lapsed and the IFRS have been in effect. This would allow consideration of the practical implications to be more fully researched;
   iii. issue Phase I (FRED 37 Intangible Assets and FRED 38 Impairment of Assets) to be effective 1 January 2007 but defer Phase II (FRED 36 Business Combinations and FRED 39 Amendments to FRS 12 and FRS 17) until after the IFRS are effective and consideration of the practical implications are more fully researched; and
   iv. issue Phase I (as in (iii) above) plus FRED 39. It might be noted that the Preface to FRED 39 sets out some concerns the Board has in relation to the proposed amendments to FRS 12.

We would prefer a more radical approach which would be to reject this standard completely.

2. Do you support the proposal, as set out in paragraphs 54 and 55, that the UK IFRS based-standard should include an option, to allow goodwill having a limited useful life to be amortised over its useful life?

The Committee considers that if the Board has an alternative treatment in mind, this should be shown in a full standard. Otherwise, the Committee’s preference is that either the IFRS as a whole is adopted if it is considered by the Board to be acceptable or else it is rejected if it is not believed to be an acceptable standard. The Committee considers that tinkering with the IASB’s standards is undesirable and will only lead to confusion.
3. The draft FRS excludes from its scope the accounting for business combinations under common control. The Board is considering whether to include additional guidance in the UK IFRS-based standard that would retain some of the provisions of FRS 6. FRS 6 permitted group reconstructions to be accounted for by applying merger accounting. Do you consider the Board should retain those provisions of FRS 6 that permit the use of merger accounting for group reconstructions? Do you consider that any guidance is needed? If so please provide details for the type of the guidance you consider necessary.

The Committee suggests that the Board should issue a separate ASB standard on merger accounting if this is considered desirable or necessary. However this will depend on what the guidance says as we believe that the Board will not be able to prescribe any treatment that companies would not have to follow under IFRSs. The Committee considers that this would be a risky strategy for the Board to adopt as companies may decide to opt for implementation of full IFRSs in preference to ASB standards. The Committee considers that if such an approach was widespread, the ASB would be left exposed.

4. The draft IFRS sets out in paragraph 43 that an acquirer shall measure and recognise, separately from goodwill, an acquired non-current asset (or disposal group) that is classified as held for sale as of the acquisition date in accordance with paragraphs 7-11 of IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. IFRS 5 is not an adopted UK IFRS-based standard. Previously FRS 7 required business operations to be sold within one year of the acquisition date to be treated as a single asset and the fair value to be based on the net proceeds of sale. The draft UK IFRS-based standard proposes to retain those paragraphs of FRS 7 that were previously applicable. Do you agree with this proposal?

Please refer to our answer to ASB question 2 above.
INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND
ACCOUNTING STANDARDS COMMITTEE

RESPONSE TO THE IASB’s SPECIFIC QUESTIONS CONTAINED IN
THE EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IFRS 3 BUSINESS
COMBINATIONS AND THE EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO
IAS 27 CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS

Our responses to certain of the specific questions in the Exposure Draft are set out below.

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 agree with the entity concept as a basis of accounting for a business combination where the primary reporting responsibility is to the shareholders of the parent company.

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?

No. We are concerned that under this definition in some circumstances the acquisition of assets will be classified instead as the acquisition of a business. For example, the purchase of a non-producing oilfield would be treated as a business acquisition under this definition whereas we believe that this should be treated as the purchase of an asset only. Similarly, the purchase of tangible fixed assets and inventory from the liquidator of a company would also be treated by this definition as the acquisition of a business rather than simply as an asset purchase.

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?

As detailed in the comments in our covering letter, we do not accept this premise. Furthermore, we are not convinced that measurement under this premise will be reliable. The Committee could accept that measurement will be reliable where an offer is made for the full 100% of the equity interests but where the purchase made is of a lower proportion we are not convinced that the calculation of the 100% equivalent would be reliable. Also, we noted that the examples given in the exposure draft assume that the company concerned is listed whereas in practice many companies involved in such transactions are likely to be unlisted.
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?

No, as noted in response to question 3 above, we are concerned about the reliability of the measurement calculations.

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?

While we have no concerns about reference to any contingent consideration in this regard, we are concerned about the use of equity interests issued by the acquirer.

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

We believe that the existing provisions for contingent considerations contained in IFRS 3 and the UK Financial Reporting Standard 7 are appropriate. Any adjustment should be made to goodwill.

Please note that we have not answered any of the specific questions contained in the exposure draft of proposed amendments to IAS 27 Consolidated and Separate Financial Statements.