2 November 2005

Dear Ms Crisp,

FRED 36 - ‘Business Combinations (IFRS3)’ & Amendments to FRS2 Accounting for Subsidiary Undertakins (Parts of IAS27 Consolidated and Separate Financial Statements)

Introduction

The Quoted Companies Alliance (QCA) is a not-for-profit membership organisation representing, and dedicated to promoting the cause of, smaller quoted companies (“SQCs”) – defined as those 2,000+ quoted companies outside the FTSE 350 (including those on AIM and OFEX) and representing 85% of UK quoted companies by number.

The QCA believes that the UK’s future prosperity depends on business enterprise and is committed to improving the ability of its members to:-

- ensure that the regulatory environment in which they operate effectively balances the interests of members, investors and other legitimate interests.

- demonstrate value to both capital markets and the wider economy; and represent members’ interests and requirements.

The QCA is a founder member of UNIQUE, the Union of Issuers Quoted in Europe, which represents over 3,500 quoted companies in seven EU member states.

We appreciate the opportunity to participate in this consultation process which has been drafted by members of our Accounting Standards Committee.
General Comments

We believe that the principle underlying financial accounts is that they are prepared for the benefit of parent company shareholders. In the UK, management of a company are the agents of the shareholders, as opposed to a widely held view elsewhere that shareholders are just the suppliers of another input (capital) to a business controlled by its management.

If this is the agreed perspective then the intention within financial accounts must be to **minimise highly sensitive numbers that arise from hypothetical transactions with imaginary persons.** Exceptions should only occur where there are obvious benefits to the people that accounts are prepared for (the shareholders) for example: to clarify the effect of transactions, or enhance comparability. The potential benefits arising from the use of fictional numbers should always be weighed carefully against the added complexity and cost.

Since the accounts are being prepared for the benefit of parent company shareholders:

- Fair values should be from the perspective of the parent company, not some imaginary 3rd party.

- Legal & professional costs are elements of the value given away as part of the transaction and should be included as part of the cost of acquisition.

- Adjustments to contingent consideration are adjustments to a part of acquisition costs and should adjust goodwill.

- The impact of an acquisition on the carrying values of the acquirer’s assets and liabilities should be taken into account when calculating goodwill, as these are factors that are taken into account by management when calculating how much the company is prepared to pay for the acquisition.

- Similarly, reorganisation costs arising as a result of acquisitions are part of the “cost” to the acquiring company of the acquisition, and (as for contingent consideration) adjustments to these provisions should adjust acquisition cost rather than flow through the P&L.

- Transactions with Minority Interests can give rise to a profit or loss from the perspective of the parent company and its shareholders.

There is no correct, objective, value for goodwill arising on an acquisition. The amount of goodwill that an acquirer will pay depends on its circumstances and purpose, and the circumstances and purpose of the vendor. Often the amount paid is less than the maximum that the acquirer would be prepared to pay. In the light of this, there is no significant benefit arising from grossing up goodwill for a minority’s share or from revaluing previous consideration (in step acquisitions). The amount of goodwill in a company’s balance sheet shows (a) the type of businesses being acquired (asset backed, people/services etc.) and (b) how good the company is at buying businesses (especially since acquisitions are often value destroying for the acquirer). It does not show how much the subsidiary is “worth”. Different companies do not make the same acquisition at the same time, so any comparability argument in favour of grossing up goodwill is specious. As far as we are aware, users of accounts are not demanding these adjustments to enable them to compare different companies.
Comments on proposed changes to IFRS 3.

ASB 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.

The preference would be to defer implementation of the business combinations package. There are a number of significant changes in the proposals and we would prefer smaller companies to have the chance to see the impact before it is fully implemented in the UK.

ASB 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?

Our view is that having the option to amortise goodwill will lead to less volatility. Furthermore this is an option that we believe should be in the International Financial Reporting Standard.

ASB 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.

We agree that merger accounting should be retained for group reconstructions.

ASB 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 IFRS5 Non-current Assets Held for Sale and Discontinued Operations. IFRS2 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 FRS7 that were previously applicable. Do you agree with this proposal?

The treatment of non current assets held for resale seems reasonable.

IASB 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 agree with the objective and definition of a business combination.

IASB 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?
The definition of a business and the additional guidance that is given is sufficient for our members.

**IASB 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?

Please see our general comments above. This represents a change where companies acquire less than 100% of the equity of another business. We are concerned that where a company acquires less than 100% of the equity of another business, it is not possible to reliably measure the goodwill that has not been acquired. Where for example a company acquires 80% of a business it is not necessarily correct to assume that the goodwill for the remaining 20% should be valued pro rata to the 80%; in order to buy the remaining 20% the company may well need to pay a premium, or alternatively, since it already has control, may only be prepared to pay a discounted price.

There is also concern that if there is an impairment of goodwill, 100% of the charge will be reflected through the profit and loss account with an adjustment made at the level of minority interests, which will often be ignored by analysts.

**IASB 4:** Do paragraphs A8-A26 in conjunction with Appendix E provide sufficient guidance for measuring the fair value of the acquiree? If not, what additional guidance is needed?

Please see our general comments above. We consider that fair values should be calculated from the perspective of the acquirer and not some imaginary 3rd party. Also values are more logically the lower of replacement cost or net recoverable amount, rather than an exit valuation, and this should be the rebuttable assumption when valuing assets acquired.

We are concerned that there may be changes to the fair value guidance arising from FASB’s consultations that the IASB introduces without the opportunity for further consultation.

**IASB 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?

Please see our general comments above. We do not believe that where there is a step acquisition, consideration previously paid should be re-measured to arrive at a present day “fair value”. This, and grossing up for minority interests, introduces unnecessary complexity for no benefit. Please note that our members are more often buying private businesses rather than companies with shares in quoted companies so market prices are not usually available.

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

Please see our general comments above. The proposal to account for contingent consideration in respect of changes in the fair value of liabilities through the profit and loss account does not seem appropriate or reasonable. If the value of the liabilities changes, then this should be reflected as a change in the value of the consideration and hence any change should be reflected through the goodwill. The change in the value of liabilities bears no relation to the trading performance of the company and it would be mis-leading to put this through the profit and loss account.
IASB 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 not?

Please see our general comments above. It is self-evident that the costs incurred by the acquirer are not part of the assets of the acquiree. However, this does not mean that they are not part of the value of the acquiree. The valuation should be considered from the perspective of the acquiror not the vendor. (If we are looking at the value from the perspective of the vendor, then the most logical value will be net of the vendor's transaction costs as this is the value received by the vendor.) When an acquiring company is assessing the merits of a proposed acquisition the acquisition costs are always considered as part of the total cost as this will impact cash flow and also potentially earnings per share because it will be included in the goodwill figure – subject to either amortisation or impairment. The proposed method of accounting for acquisition costs is likely to cause small companies in particular considerable concern. The costs incurred in an acquisition can be very material in the context of a small cap company's profit and loss account. For a smaller company to grow into a larger cap, acquisitions are often the only way of getting there. We are concerned that this method of accounting could discourage small companies from undertaking acquisitions and this proposal must be reconsidered. Most acquirers will only incur significant transaction costs when they are reasonably confident of the transaction proceeding successfully. Significant abortive transaction costs are not normal items of expenditure, so this does not create a precedent for the treatment of significant successful transaction costs.

IASB 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?

(a) We do not consider that this is practical for large books of receivables. A general bad debt provision is often necessary.

(b) We agree with the proposed method of valuing contingencies.

IASB 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 welcome these exceptions to the fair value measurement principle.

IASB 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?

Please see our general comments above. We disagree with the proposal for accounting for changes in the value of the non-controlling equity investments to be reflected in the profit and loss account. We consider it is more appropriate for these to be recognised through reserves.

IASB 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?

In a situation where the acquiree discovers that the consideration transferred is less than the fair value this appears to be similar to a revaluation and as such the more appropriate treatment would be to make the adjustment through reserves.
IASB 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?

If it is possible to determine a value for an underpayment it should logically be equally possible to determine an accurate valuation of an overpayment. An example would be where the acquiree discovers that there is a liability that was not discovered through the due-diligence process. Another possibility is where there is a material event between the agreement date and the acquisition date which reduces the value of the acquiree, but where the acquirer has no option to abort the transaction.

IASB 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?

The treatment of comparative periods for adjustments made during the measurement period seems reasonable.

IASB 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?

Please see our general comments above. The costs and benefits of the acquisition should be viewed from the perspective of the acquirer and should include changes in the valuation of the acquirer’s assets and liabilities as a result of the acquisition.

IASB 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?

The disclosure objectives and requirements seem reasonable.

IASB 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, transferrer, 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?

It is hard to believe that all intangible assets, especially those described as being of a marketing nature, can be measured with sufficient reliability.

IASB 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 not?

Please see our general comments above. The tax position of an acquiree and how the acquisition will impact on the tax position of the acquirer are factors taken into account in determining how much to pay for a business. This may make the acquisition more or less valuable to the acquirer and may make the acquisition more or less likely to proceed. Certainly in
the view of the acquirer the tax impact on the Group is very much a part of the value of the acquisition and should not be accounted for separately.

IASB 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 concerned about the priority that is being placed on the project of convergence with FASB. The emphasis at this stage should be on ensuring that the standards themselves are appropriate and based on correct principles. Convergence can come later.

IASB 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?

Yes bold type is helpful.

Comments on proposed changes to IAS 27:

General comments:

In future we would prefer separate consultation documents for separate standards (other than minor consequential changes), even if they do cross refer. Consultation documents are getting so long that it is too easy to overlook consultations included after the appendices relating to other standards.

The change in terminology from “Minority” to “Non-controlling” interests is unnecessary and potentially confusing, especially to those who are not regular users of accounts. The term “Minority” should be retained.

IASB 1: Do you agree? If not, why not and what alternative would you propose?

Please see our general comments on FRED 36 above. From the parent company’s perspective, transactions with minority interests can give rise to a gain or loss. The difference between the transaction value and the carrying value should be recognised as a gain or loss in the profit and loss account.

IASB 2: Do you agree that the remaining non-controlling equity investment should be re-measured to fair value in these circumstances? If not, why not and what alternative would you propose?

We agree that the proposals regarding re-measurement of a remaining investment on loss of control.

IASB 3: Do you agree that it is appropriate that multiple arrangements that result in a loss of control should be accounted for as a single arrangement when the indicators in paragraph 47 are present? Are the proposed factors suitable indicators? If not, what alternative indicators would you propose?

We agree with the proposed anti-avoidance measures, but would prefer the principles in the standard to be of sufficient clarity that anti-avoidance measures were not required.

IASB 4: Do you agree with the proposed loss allocation? Do you agree any guarantees or other support arrangements from the controlling and non-controlling should be accounted for separately? If not, why not, and what alternative would you propose?
If a subsidiary is liquidated, then the parent company will normally be expected to make good any deficit on that subsidiary's shareholders' funds. Any minority interest will not normally be compelled to contribute and the burden of the shortfall will usually be borne in full by the parent company. Unless there are enforceable measures in place to require minority interests in a subsidiary to make contributions to defray a shortfall in that subsidiary's shareholders funds, then the minority interest should not be shown as less than zero. The extent of any negative valuation should be limited to the amount of the enforceable contributions. These potential contributions reduce the minority interest and should not be shown separately as e.g. a contingent asset. It would be misleading to show in minority interests a debit for their share of a deficit on shareholders funds, and to show elsewhere in the balance sheet a provision relating to the parent company's responsibility to make good that deficit.

IASB 5: Do you agree that drafts paragraphs 51, 46 and 46A should apply on a prospective basis in the cases set out in draft paragraph 55B? 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?

All provisions should be retrospective to the extent that it is practical. Specific exceptions can be made relating to the paragraphs quoted, available for those that require them. The clarity of accounts is improved if one common approach is used throughout.

If you require further information or clarification, then please let me know.

Yours sincerely,

John Pierce
Chief Executive