26 November 2005

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Proposed Amendments to IFRS-3—Business Combinations

Dear Sir David:

The Corporate Disclosure Policy Council (CDPC) of the CFA Institute Centre for Financial Market Integrity (Centre)\(^1\) appreciates the opportunity to comment on the International Accounting Standards Board’s (IASB) Proposed Amendments to International Financial Reporting Standard 3: *Business Combinations*. Among the major objectives of the Centre and the CDPC is to foster the integrity of financial markets through their efforts to address issues affecting the quality of financial reporting and disclosure worldwide.

**General Comments**

We support the fundamental provisions of this Exposure Draft and believe that it represents a major improvement in financial reporting for business combinations. Indeed, the recommendations and suggestions

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\(^1\) With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute (formerly, the Association for Investment Management and Research\(^2\)) is a non-profit professional association of 80,000 financial analysts, portfolio managers, and other investment professionals in 119 countries of which 66,000 are holders of the Chartered Financial Analyst\(^3\) (CFA\(^4\)) designation. The CFA Institute membership also includes 132 Member Societies and Chapters in 52 countries and territories. The CFA Centre develops, promulgates, and maintains the highest ethical standards for the investment community including the CFA Institute *Code of Ethics and Standards of Professional Conduct*. The Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education, and licensing requirements for investment professionals, and the efficiency of global financial markets.
that we offer below are intended to strengthen these basic provisions, and to enhance the clarity and usefulness of the resulting recognition, measurement, and disclosure to investors and other users, rather than to propose major change to the provisions. We believe that full application of this standard will, in general, result in much greater consistency and comparability in reporting of mergers, and a better understanding of the effects of companies’ business combinations on their ongoing operations.

**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 agree with the objective and definition of a business combination and believe that these are appropriate for all business combinations. We also agree that:

- the acquirer should record the acquired assets and liabilities at fair value, regardless of the percentage of the equity interests of the acquiree it holds at the acquisition date;
- the appropriate date for recognition and measurement is the date the acquirer obtains control of the acquiree;
- the appropriate measurement attribute should be fair value rather than cost accumulation and allocation or some other attribute; and that
- recognition of the consideration transferred in exchange for the acquiree should be measured at fair value and should include the fair value of all contingent consideration given, which should be estimated at the acquisition date (date of transfer of control).

However, we believe that the usefulness of the information provided to investors and other users under the standard could be considerably enhanced if:

- the acquisition date estimate of contingent consideration given were required to be remeasured and recognized periodically until all contingencies have been resolved;
- the disclosures regarding contingent consideration should continue to be provided on a quarterly basis showing the accumulated consideration given until all contingencies have been resolved; and if
- the disclosures were to make clear what the cumulative total cost of the acquisition has been.

Contingent consideration is an important part of the total acquisition cost in many acquisitions. Such consideration represents a commitment by the managers of the acquirer to transfer a portion of the wealth belonging to the consolidated entity, and hence, to the shareowners of the entity, to the third-party sellers of the acquired assets. We agree that the amount of the contingent consideration pledged to the sellers at the acquisition date should be estimated at that date. However, the full economic cost to the company and its investors of that commitment, that is the full cost of the acquired assets, won’t be known until the contingency period has passed and related measurements have been completed. Consequently, we believe that the contingent consideration should continue to be remeasured and restated until all such contingencies have been
resolved. To fail to recognize such remeasured costs will have the effect of understating the full cost of the acquired assets in many acquisitions, and may cause investors to be misled in evaluating the effects of such merger activity on the operations of the company. Such remeasurement is consistent with full fair value recognition as compared to historic cost recognition and measurement.

We are also concerned that if the standard requires that the fair value of contingent consideration be estimated and recognized only for the first year then managers will have an even greater incentive than they now do to structure acquisitions using significant amounts of contingent consideration. Moreover, they would have an additional incentive to bias downward their estimates of the amounts to be paid in future periods. We believe that such a provision could significantly undermine the fair value objectives of this standard and could greatly reduce the usefulness of the resulting financial reporting.

Finally, because the acquirer’s managers will have to continue to calculate the amounts of the consideration in order to fulfill their acquisition commitment to the sellers and distribute the payments, the cost of providing such information to investors in the financial statements, with related disclosures in the notes, should be minimal.

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?

The guidance in the Exposure Draft and the additional material provided in paragraphs A2-A7 of Appendix A seem to us to be indicating that a “business” must have operations of some sort. That is, there must be an “input,” and/or “processes,” and/or “outputs.” However, it is not clear to us what would not qualify as a business and some clarification in this regard, perhaps in the form of examples, along with explanations as to why the examples would not qualify under these provisions, would be helpful.

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 recognize 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 agree that it is appropriate, where the acquirer holds less than 100 per cent of the equity interests of the acquiree at the acquisition date, that the acquirer recognize 100 per cent of the fair values of the identifiable assets acquired, liabilities assumed, and goodwill, including goodwill attributable to the non-controlling interest. We believe that full and complete transparency require that 100 per cent of the assets acquired be recorded at fair value at the date of acquisition (transfer of control), including any interests of the non-controlling equity holders. Similarly, all of the interests, claims, and obligations must be fully recognized and measured at fair value as of the acquisition date on the right-hand-side of the balance sheet. These amounts would include the fair value of the non-controlling interest assumed by the company, which should be measured at fair value, including goodwill. In short, we believe that the transfer of control of the acquiree to the acquirer is a major economic event and should result in the revaluation of all interests to fair value, including any prior equity interests of the acquirer as well as those of the non-controlling interests.
A particular advantage of this approach to the recognition and measurement is that all such acquisitions will be recognized and measured in a similar manner with 100% recognition of all acquired assets at fair value, and with full recognition of the various claims and interests in those assets. That is, financial reporting will not depend upon the particular structure, method or terms of an acquisition. We believe that this approach will result in greater clarity, comparability and usefulness of the information to investors and other users.

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?

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?

We will consider Questions 4 and 5 jointly.

We agree with the presumption that the best evidence of the fair value of the acquirer’s interest in the acquiree would be the fair values of all items of consideration transferred by the acquirer in exchange for that interest, measured as of the acquisition date. However, this presumption contains a second embedded assumption: that all of the fair values can be obtained at the date of acquisition. When that is not the case (for example, contingent consideration) the fair value of such consideration should be estimated at the acquisition date, and should continue to be marked to market as better information is obtained, until no contingencies remain (see the disclosures related to such consideration that we propose in response to Question 15).

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

We believe that contingent consideration, including payment in the form of equity instruments, should be remeasured until all of the contingencies are resolved. That is, we believe that recognition and measurement should be based upon the underlying economics of transactions, and not on the form of currency (cash, debt instruments, or equity instruments) used for payment. From the perspective of the owners and ultimate risk-bearers in the acquirer, the common shareowners, the economic cost of consideration, contingent or otherwise, is the fair value of the consideration given at the date the payment is transferred or made, not the estimated value at the date the commitment is made, or, as in this case, the date that control passes to the acquirer. We believe that this view is consistent with provisions in the soon-to-be-issued fair value measurement standard. Specifically, the highest quality measurement in the hierarchy is that measured by an actual market transaction (such as the actual payment made to the third-party seller in this case), not manager’s estimates of what this payment will be at some future date, which is the lowest level in the hierarchy.

Furthermore, if contingent consideration in the form of equity instruments is not required to be remeasured, then at least some acquirers will tend to structure acquisitions in order to receive the favorable (and we believe less transparent) accounting treatment accorded equity instruments under these provisions.

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 agree that costs incurred in connection with a business combination are not assets and should be excluded from the measurement of the consideration transferred for the acquiree. That is, we do not believe that measurement and recognition based on “all costs incurred” is appropriate where the stated measurement objective, with which we agree, is fair value.

Question 8—Do you believe that these proposed changes [regarding reserves] 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 believe that these changes are appropriate. Measurement of assets and liabilities at fair value is not consistent with recording of “reserves” of any sort. We observe that this treatment is consistent with the provisions of recent standards that require fair value measurement, such as IAS 39, and SFAS 133, as well as statements of position on specific fair value recognition issues.

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?

As a matter of policy we do not believe, that there should be any exceptions to fair value measurement. Nor do we believe that management’s intent for an asset, that is, whether to sell it or to retain it for use in the business or to hold it for investment purposes, should affect the accounting treatment accorded the asset. We believe that assets held for sale should be measured at fair value. However, we recognize that GAAP standards for some assets and liabilities, for example, pension obligations and deferred taxes, do not currently provide for fair value measurement, and that these involve major issues in the application of fair value recognition and measurement that must be considered apart from the provisions of this business combinations standard. Therefore, we would agree that in the interim, until the GAAP standards for such items are brought into conformity with the soon-to-be-issued fair value standards, that these exceptions cannot be avoided.

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?

We agree that any previously acquired equity investments should be remeasured to fair value at the acquisition date, the date that control is acquired, with recognition of any gain or loss in income. Part of the consideration given by the acquirer to gain control is the acquirer’s prior equity investment in the acquiree.

Put slightly differently, we do not believe that the so-called “cost accumulation” approach is either appropriate or consistent with fair value reporting for transactions, including reporting for business combinations.

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 agree with this treatment in general. At the same time, we recognize that their may be economic reasons for the apparent bargain purchase including, for example, unrecognized liabilities or commitments, and liquidity or other credit concerns that will consume additional resources of the acquirer, thus reducing the consideration that the acquirer is willing to pay for the assets.

**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 believe that there may be circumstances in which the amount of overpayment could be measured reliably at the acquisition date and do not find the arguments in paragraph BC 178 compelling, that is, that the only way that a company could knowingly overpay for an acquisition is through error, and that such error would not be known until well after the acquisition date. Some factors that enter into the acquisition decision may not be measurable as GAAP assets and liabilities.

We recognize that motivations for the apparent “overpayment” may include, for example, desires to increase market share and reduce competition, and that the amount of overpayment may be deemed in this circumstance to be an otherwise unidentifiable, nonseparable and nontransferable quasi-asset, increased competitive advantage. However, as a general principle, we do not believe that any item that is not identifiable or separable, and that is not transferable, such as goodwill, should be recognized as an asset.

We also do not believe that capitalization of such items as assets should be permitted based on the rationale that it will enable investors to calculate ratios such as return on invested capital. To the contrary, we believe that only items meeting the definition of an asset should be recorded. Hence, we believe that in general any unidentifiable, nonseparable, and nontransferable amounts should be recognized as a loss at acquisition.

**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 believe strongly that comparative information for prior periods presented in financial statements should be adjusted for the effects of measurement period adjustments. If such prior period adjustments were not made, comparability would be reduced, substantially in some cases, and the usefulness of the statements would be reduced.

**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?

Although considerable “guidance” is provided in this area, it would be very helpful if we could understand what the recognition and measurement objective is for this section and the related paragraphs, 69, 70, A87-A109, and BC154-BC160. The principle, reflected in BC 156 and following paragraphs, does not shed a great deal of light on this issue: “…if a transaction or arrangement is designed primarily for the economic benefit of the acquirer or the combined entity (rather than the acquiree or its former owners), that transaction or arrangement is not part of the exchange for the acquiree.”
We assume from the examples provided that a common thread running through such transactions is a desire by the acquirer to unwind or “clean up” existing acquiree contractual arrangements with employees or others. However, if we assume that such contractual arrangements would not normally be wound up at the time of the acquisition in the absence of the deal, it is not clear to us why they would not be considered to be part of the acquisition, and, therefore, the exchange transaction. A better understanding of the objective to be achieved would be helpful in this area.

Finally, we are aware of instances of abuse of such opportunities to “window-dress” the balance sheets of acquirees just prior to the acquisition. Examples include the unexplained massive write-down or reduction to zero of major assets or asset categories held by the acquiree, and other suspect major adjustments to the financial statements. We believe that such adjustments should be made only on fair value measurement bases and fully-explained as part of the acquisition accounting.

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?

In general, we believe that the proposed disclosures are excellent and will provide very useful information. However, we have some observations and recommendations for the disclosures.

1. We believe that the goal should be complete transparency for all acquisitions. Hence, all of the information investors and other users may require so that they can fully understand the acquisition, its terms and conditions, the total consideration given, and the assets acquired, should be disclosed in a clear and accessible format:

   - Information provided in conjunction with paragraphs 71-81 should be required to be presented in a single note, rather than being distributed across the notes and other disclosures and filings;

   - Whenever possible, tabular presentation should be used rather than to scatter the disclosures through lengthy prose sections.

   These requirements would improve the transparency of the disclosures at little or no cost to preparers.

2. Unfortunately, and perhaps as a result of historic reporting biases, short shrift has been given to what could be the most important and relevant information of all, cash flow information for the acquiree for the reporting period in which the acquisition occurs. Specifically, the following information should be provided at a minimum:

   - Cash flow from operations for the acquiree included in the consolidated cash flow from operations for the period;
   - Capital expenditures for the acquiree for the period;
   - Asset sales for the acquiree for the period; and
   - Net cash inflow/outflow for financing for the acquiree for the current period.
These disclosures would permit users to understand both the marginal effects of the acquiree on the cash flows of the acquirer and post-acquisition transactions that affect significant balance sheet elements (such as debt).

3. In order for (condensed) balance sheet information to be useful to investors and other users, the information should be presented on a basis consistent with the parent's balance sheet. Ideally, the information would be provided in the form of a consolidating balance sheet. Because the acquirer must have such information available in order to consolidate the acquiree in the first place, the cost of providing such information to investors would be trivial. For the same reasons, we believe that a consolidating income statement should be provided. That would enable users to understand the effect of the acquisition on key balance sheet elements (such as inventories, accounts receivable, accounts payable, and debt) and ratios (such as turnover ratios) based on such elements.

4. Regarding paragraph 76-b, contingent consideration, we have made clear in earlier questions that:
   - We support not only the proposed roll-forward and fair value remeasurement of the estimated amount for the first annual period following the acquisition, but that we believe that such remeasurements should be continued until all commitments and contingencies have been satisfied; also
   - The remeasurements and disclosures should be reported on an interim basis.

5. With regard to the disclosures proposed in paragraph 72, we believe that the cumulative total amount of consideration transferred (total costs incurred) should be disclosed in each period. We would also wish to know how much has been expensed in each period.

6. In paragraph 72-h, the discussion should include a description of the nature of the contingency.

7. In paragraph 72-k, we would wish to know the amount of inter-company revenue or expense previously recorded by one or more of the merger companies. The elimination of inter-company transactions in consolidation can distort the trends of such key income statement elements as revenue, expense, and gross margin.

8. In paragraph 74-b-2, we believe that prior period pro forma comparative financial statements should be provided for each period covered in the report. Pro forma financial statements provide a baseline that users can use to separate operating effects on financial data from acquisition effects.

9. In paragraph 76-a, managers should provide the information they are awaiting to complete the measurement.
10. In paragraph 76-a-3, we would wish a reconciliation of the amounts and adjustments.

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?

We believe that all identifiable intangibles can be reliably measured. Indeed, fair value is so important (relevant) to financial decision-making that we would accept more subjectivity in these measures in order to obtain the information. We do not have an example of an intangible asset that would meet both of the characteristics above.

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?

Our reasoning here is essentially the same as that in our response to Question 14. Given that the adjustments would not have been required absent the acquisition, we believe that the adjustment should be accounted for as part of the acquisition accounting. Put slightly differently, the change in the acquirer’s deferred tax benefits was occasioned solely by the acquisition of the acquiree’s operations, including the assets and liabilities. Hence, it should be accounted for as part of the transaction. Such adjustments do not affect the reporting of the fair values of other assets, liabilities, and equities involved in the acquisition. However, providing the adjustments in conjunction with the other acquisition accounting will make it possible for users of the statements to fully understand the effects of the merger.

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 believe that all such pre-existing differences should be resolved in this standard and would encourage the two Boards to work to achieve a fully converged standard, including for disclosure differences. Indeed, because we strongly support the convergence project, and believe that such resulting standards will be highly beneficial to global financial markets, we hope that this will be the model for future joint standards.

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?
There is an increasing tendency among standard-setting organizations, including CFA Institute, to use bold type for required items (that is, compliance cannot be claimed unless all bold type items are strictly adhered to), and regular type for optional guidance that is not strictly required. Hence, we believe that the distinctions between the two in this context are not particularly useful and could be misconstrued, result in inconsistent application of the standard, and could be harmful. If all of the provisions are intended to be applied fully and with equal force, then we see no reason to distinguish among the provisions.

Respectfully,

/s/ Patricia A. McConnell
Chair, Corporate Disclosure Policy Council
CFA Institute Centre for Financial Market Integrity

/s/ Rebecca T. McEnally, CFA
Director, Capital Markets Policy Group
CFA Institute Centre for Financial Market Integrity

Cc: Jeffrey Diermeier, CFA, Chief Executive Officer, CFA Institute
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