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Dear Paul

Business combinations

1. This letter sets out the ASB's comments on EFRAG's draft comment letter to the IASB's Exposure Draft addressing the second phase of the Business Combinations project. Our main points are set out below. Appendix One contains our responses to the EFRAG questions contained in the draft letter. Appendix two sets out our comments on the draft EFRAG responses to IASB questions.

General comments

2. The draft is admirably wide-ranging, and we agree with many of the points that it makes. Specifically we agree that:

   - the Exposure Drafts introduce a number of significant changes that have important implications which in the case of proposed changes to the recognition criteria of IAS 37 go beyond accounting for business combinations (paragraph 1(3));

   - it is regrettable that the IASB did not issue a Discussion Paper regarding the proposals before issuing the Exposure Drafts (paragraph 1(3));

   - it is not clear from the Exposure Drafts what benefits are gained by requiring the acquirer to recognise the acquiree at fair value or by adopting a full goodwill approach (paragraph 6(b)); a

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- the ‘economic entity view’ is not necessarily superior to the current ‘parent entity view’ (paragraph 16).

3. Whilst we share EFRAG’s worries about many aspects of the proposals, we believe a response that is more constructive may be more productive. Where the draft disagrees with a proposal the response should, if possible, set out what alternative solutions would be preferred.

Relationship between the proposed standards and the Framework (draft response, paragraph 5)

Introducing new principles

4. We share the concern expressed in the draft that the IASB’s proposed amendments to accounting standards reflect fundamental new principles and so create the risk that these will not be fully debated, as they must be, in the course of the IASB/FASB Conceptual Framework project. The fear is that, if the standards are finalised as proposed, there will be little or no consideration of these principles later. It will be presumed that the Framework should reflect the requirements of current standards, particularly those that have been recently developed. We do not support the conversion of these Exposure Drafts into International Financial Reporting Standards (IFRSs) until proper debate on the concepts being introduced has been undertaken, and believe EFRAG’s letter should state this clearly. (However, as explained in paragraphs 8 to 10 below, in our view the draft letter overstates its case by arguing that proposals for new accounting standards can never go beyond the Framework.)

5. IASB did not undertake any consultation with its constituents before entering the Norwalk agreement with FASB in October 2002. This seemed understandable: if IASB/FASB convergence could be achieved quickly and easily, and lead to unambiguous improvements in financial reporting, there would be no case to oppose it. But, as the present Exposure Drafts demonstrate, IASB/FASB convergence may entail complex, difficult and controversial proposals. Because of the lack of consultation, IASB is in a poor position to judge the value that should be placed on convergence and what cost and compromise is justified in its pursuit. Whilst we are no better placed than IASB to make this judgement, it is at least plausible that the current proposals go beyond the benefits reasonably to be expected from convergence with US GAAP. We believe that EFRAG’s letter should make this point.

6. We would cite the following examples of new principles that are being implied in the Exposure Drafts:

- the requirement to measure the acquiree at fair value, which we consider extends the use of fair value principle and implies that, conceptually, transactions should be recorded at fair value, rather than cost. We are disconcerted to note that the IASB states that it has embraced this general principle[1] without full discussion and debate;

- the change from the 'parent entity' to the 'economic entity concept'; and

- the principle, in the proposals for amendments to IAS 37, that liabilities should be measured at fair value—and that this means settlement, or 'exit' values. Whilst there are some exceptions to the proposed requirement, the exceptions seem to be made on pragmatic grounds.

7. We have not included in the above examples the change as regards the probability recognition criterion in IAS 37 because, whilst we share EFRAG's concern about the practicability of what is proposed, it is arguable that the changes are in accordance with the existing Framework. (See our answer to EFRAG Question 8 in Appendix one.)

Consistency with the Framework

8. Paragraph 5 as drafted suggests that the main problem is that the new concepts being proposed are inconsistent with the Framework. But this is not on point. Firstly, as explained more fully below, we do not believe it is essential that all proposals for new Standards are entirely in line with the Framework: differences can and should be tolerated in some instances. Secondly, some of the new concepts that these Standards are proposing to introduce go beyond the content of IASB's current Framework, so there is no inconsistency.

9. In our view it is sensible for work on the Conceptual Framework and work on Standards to be undertaken simultaneously, with work on one informing work on the other. Thus we do not agree with paragraph 5 of the draft comment letter which suggests that all changes should be made to the Framework first.

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1 See IFRS 3, BC 52, last sentence.

10. It follows from our view that Standards and the Framework will sometimes be out of step, with Standards sometimes being ahead of the Framework. We do not agree that this gives rise to a problem when considered in the light of the hierarchy: IAS 8 is clear that the specific requirements of a Standard or interpretation must be applied (IAS 8.7) irrespective of the Framework, and then the requirements and guidance of Standards and Interpretations dealing with similar and related issues. Entities need only apply consider the Framework in the absence of such a Standard or Interpretation. For example, it is difficult to reconcile the distinction between debt and equity set out in IAS 32 with the Framework. Clearly this difference must be addressed in due course, but this does not seem to give rise to any practical problems.

Summary

11. Where it can be demonstrated that changes to accounting standards will bring about sufficient benefits from convergence and improvements in financial reporting, it would be acceptable to issue them, even where they introduce new principles that are inconsistent with or go beyond the Framework. But the more radical are the new principles the greater the benefits have to be. We do not believe the current proposals meet this test and therefore should not be developed into IFRSs. Even if IASB makes a different judgement on this point, it must still be committed to ensuring those principles are fully debated in the Framework project.

Fresh start accounting

12. We would wish to emphasise our strong agreement that it is inappropriate to require a single method of accounting for all business combinations. Acquisition accounting is capable of providing a representationally faithful depiction of reporting the acquisition of one business by another. It is, however, not a representationally faithful way of reporting a business combination in which one entity does not acquire another—no party to the transaction is an acquirer and accounting should not be based on the fiction that one of them is. For this reason ASB continues to advocate research into 'fresh start accounting', and is pleased to note that EFRAG's draft response also expresses support for it.

13. If any further clarification of our position would be helpful, please contact Andrew Lennard or Michelle Crisp.

Yours sincerely

Ian Mackintosh
Chairman

Appendix One: Response to EFRAG questions addressing IASB Business Combinations

Section A: EFRAG General concerns

Question 1 – Structure and process of the project

(a) Do you agree that fundamental changes to concepts should first be discussed in the context of the Framework as a whole before being introduced in new IFRSs?

As set out in our covering letter we do not consider changes to concepts need necessarily be discussed in the context of the Framework before being introduced in new IFRSs. We do however consider the proposals set out in the Exposure Drafts are of such a fundamental nature that they should not proceed to IFRSs until proper debate on the concepts being introduced has taken place.

(b) Should changes to the Framework be proposed before or at the same time (in parallel) as they are proposed in Exposure Drafts of IFRSs, or is it acceptable for them to be proposed later?

We also note in our covering letter that it is our view that IFRSs and the Framework may sometimes be "out of step". Our main concern is that where a new principle is introduced in any particular IFRS this does not preclude debate in the Conceptual Framework project and the work being undertaken on Measurement. That is, we consider the principle should be re-debated in the wider context of financial reporting before being adopted more generally.

In relation to the principles being introduced in the Business Combinations project we consider that these are of such a fundament nature that they should be re-debated as part of the Conceptual Framework project before being introduced as IFRSs.

Question 2 - Use of fair value

Do you see sufficient benefits of the proposed approach compared to costs incurred? If yes, what do you perceive those benefits to be?

We have been unable to identify significant benefits in the proposed approach; specifically we agree with your draft response that the proposals result in increased use of fair value leading to a higher degree of subjectivity. We are also concerned as to whether the increased level of subjectivity improves the reliability in financial reporting.

It is our view that the Exposure Drafts do not clearly articulate the specific deficiencies in existing IFRSs that they seek to address. It then follows that the Exposure Drafts do not stipulate how the proposals address these deficiencies and hence the benefits derived.

In our opinion the proposals set out in the Exposure Drafts are not well articulated as a cost benefit argument alone, because the benefits are not evident. Whilst we accept some increase in the level of costs we do not necessarily consider this will be significant.

Question 3 - Reasons for issuing the EDs, objectives, benefits and costs

(a) Do you agree with the reasons for issuing the EDs as expressed by the Board and do you believe the overall objectives of the EDs will be achieved?

We agree with the comment in your letter that "true mergers" do exist. The application of a single method of accounting for all business combinations will not necessarily result in more comparable and transparent financial statements as the nature of the transaction may not be faithfully represented by the application of the acquisition method of accounting. As such we are disappointed the IASB has not, as part of the second phase of the Business Combinations project, undertaken research into "fresh start" accounting.

We are, similarly, not convinced that recognition of an acquired business at its fair value improves the relevance and reliability of financial statements. We are of the view that recognition of 100 per cent of the acquiree, where an acquirer holds less than 100 per cent, requires a hypothetical transaction to be recognised. We fail to understand how the recognition of a hypothetical transaction, which will often require subjective measurement, improves the reliability of financial information.

We would therefore agree with your conclusion in support of the objective to increasing and improving the relevance, reliability, comparability and transparency of financial information but question whether the proposals in the Exposure Drafts achieve this objective.

(b) Do you agree with the Board's analysis of benefits and costs of the EDs?

The IASB states in paragraph IN10 that the costs imposed to apply the Exposure Draft, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. As noted previously, whilst recognising the proposals will increase costs, we do not necessarily agree the increase in costs will be significant. As a consequence we consider it is important to focus on whether significant benefits are gained from the proposals.

In paragraphs IN11 and IN12 of the Exposure Draft the IASB sets out the benefits it perceives arise from the proposals. The benefits set out by the IASB include:

- improved international consistency such that an entity's competitive position as a potential bidder is not affected by differences in accounting for business combinations. Improved international consistency is a precursor for the adoption of IFRSs and therefore arguably any new proposal must improve international consistency (especially as this is the first joint FASB and IASB Standard); and

- costs to prepare financial statements will be reduce. Similar to the above this could be true of any new IFRS.

It appears to us the benefits from the proposals are limited and the Exposure Draft does not identify a specific financial reporting deficiency that has arisen from historical abuse or lack of guidance that they seek to rectify. We thereby question the cost and benefit analysis set out in the Exposure Draft.

Section B Proposed Amendments to IFRS 3

Question 4 – Scope - Definition of a Business Combination

(a) Do you believe that the scope of the ED of proposed amendments to IFRS 3 is sufficiently clear and consistent with the definition of a business combination?

We acknowledge the matter raised in the draft letter that a "true merger" may not meet the definition of a business combinations and therefore an element of uncertainty is introduced into the scope of the Exposure Draft.

(b) Do you agree that requiring one accounting method – the acquisition method - for all business combinations will result in a faithful representation of economic reality in all combinations?

As noted above in certain circumstances it may not be possible to identify an acquirer and therefore the use of acquisition accounting (which reflects the acquisition of one entity by another) may not faithfully represent the business combination.

We are also disappointed that the IASB does not have as part of its active agenda research into 'fresh start accounting'. We therefore believe that faithful representation of economic reality may not be achieved if all business combinations are accounted for using one method of accounting.

Question 5 - Definition of a Business

Is the conceptual inconsistency referred to in the previous paragraph such a practical problem that you believe the scope should be extended to acquisitions of all asset groups before the proposals of the EDs become mandatory?

We agree that there is a fine distinction between the acquisition of groups of assets that are businesses and the acquisition of groups of assets that are not businesses. We do not, however, consider that the inconsistency in the accounting treatment for these transactions should necessarily be eliminated. We consider further research is required into these transactions. As such we do not agree the scope of the Exposure Drafts should be extended before the proposals succeed to a Standard.

Question 6 - Transitional Provisions

Do you agree that the main provision of the EDs should be applied prospectively and not retrospectively?

We agree with the transitional provisions.

Section C Proposed Amendments to IAS 27

Question 7 – Economic entity and parent entity

Do you agree with the change from a parent entity perspective to an economic entity view for consolidated accounts and do you believe that the entity view results in better information provided on a consolidated level?

We do not agree with the change from a parent entity perspective to an economic entity view for consolidated financial statements. We believe that the parent entity view provides a better focus for financial reporting and recognises the role of investors who are the ultimate providers of capital and risk takers.

Section D Proposed Amendments to IAS 37

Question 8 – Probability criterion

(a) Do you believe the move of the probability recognition criterion to measurement is a conceptual change and is not in conformity with the Framework?

We note the IASB's argument in BC48, which we have interpreted to mean that when the probability criterion is applied to the unconditional obligation it is always satisfied. We therefore have some sympathy with the IASB that there is no conceptual change.

(b) Do you believe that the new analysis provides adequate guidance on when an unconditional obligation should be recognised (obligating event) and, in particular, what level of uncertainty would preclude recognition?

In our opinion the elimination of the probability criterion from the Exposure Draft results in the draft Standard not adequately addressing element uncertainty. In a business environment uncertainty exists on a continuum so the recognition process involves selecting the point on the continuum at which uncertainly becomes acceptable. The exact location on the continuum will vary depending on circumstances and be based on the evidence available. Whilst accepting that sufficient evidence is a matter of judgement it appears incorrect for the draft Standard to fail to provide any guidance as to when element uncertainty is considered to be satisfied. We accept the Exposure Draft provides greater guidance on meeting the definition of a liability, however, we do not believe this guidance addresses element uncertainty.

In addition we are concerned that the implications of these proposals give rise to practical difficulties. In particular:

(i) it may be difficult in practice to ensure all liabilities are recognised;
(ii) there is an increase in the level of subjectivity in measuring liabilities which may increase volatility; and
(iii) we are concerned the earlier recognition of a liability could be prejudicial to the outcome (ie in a litigation case).

In view of the above we consider the proposed amendments to IAS 37 would be better deferred until further research into the practical implications of the proposals has been completed.

(c) Do you agree with the proposals to the measurement of non-financial liabilities?

We are concerned that the proposals imply a principle of measuring all liabilities at 'exit value.' It is arguable whether exit values are appropriate for general use in financial reporting and as noted we consider the proposals should be deferred until further research into the implications of the proposals is complete.

Appendix Two: Comments of EFRAG Business Combinations response to IASB

This appendix sets out some specific issues regarding the draft comment letter to the IASB. The appendix focuses on areas where it is considered that the draft comment letter inaccurately reflects or has an omission to a specific IASB question.

Use of fair value – section A

We note that in paragraph 6(b) of the draft comment letter it is stated *"there is no explanation of why financial statements prepared under the proposals are more relevant and more reliable"*. We would however draw your attention to paragraphs BC16 and BC17 of the Exposure Draft of proposed amendments to IFRS 3 Business Combinations which state:

"… the amount of goodwill recognised in a business combination achieved in stages and in a business combination achieved in a single transaction will not be the same…

The Board believes these inconsistencies result in information that is not as complete or as useful as it would be without them."

You may wish to consider reflecting these comments in section 2 of the draft covering letter to the IASB. We accept that the benefits are not well articulated in the Exposure Draft but it appears these comments provide some insight into the IASB's thinking about the relevance and reliability.

IAS 37 Measurement – section C

We note that the current IAS 37 states, in paragraph 37, *"the best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the balance sheet date …"*. We are therefore concerned that paragraph 21 of the draft comment letter does not accurately reflect the changes proposed to IAS 37.

We would also like to bring to your attention that paragraph 23 of the draft comment letter states "*when an entity receives payment for performance in advance of that performance taking place, the entity would recognise a liability for the amount it would rationally pay to legally lay-off the performance"*. However BC75 of the Exposure Draft of proposed an amendment to IAS 37 states that "*the Board (IASB) noted that for an obligation that an entity is paid to assume, IAS 37 requires revenue to be recognise in accordance with IAS 18"*. These two statements appear to be at odds and you may therefore wish to reconsider paragraph 23.

Comments on responses to the Exposure Draft of proposed amendments to IFRS 3

Question 2 We note that you propose to accept the amendments to the definition of a business. We however have a concern as to how "capable of being conducted" can be interpreted.

Question 11 We note your draft response, however, in our view the accounting for business combinations in which the consideration is less than the fair value of the acquiree is a complex accounting issue and we propose to accept the IASB's pragmatic approach in this instance.

Question 12 In your draft response you note that an overpayment exists where a market leader acquirers a competitor just to close it down, reducing market competition. In such instances it is possible for the acquirer to argue that they would gain from increased market share – especially since the acquisition would provide the acquirer with access to customer information. We do not therefore agree that this circumstance necessarily represents an overpayment.

We believe that it is fundamentally difficult to identify an overpayment and consider the focus of financial reporting should be on disclosing impairments that arise on acquisitions shortly after the acquisition date.

Question 13 We do not agree that comparative information should be adjusted for the effects of measurement period adjustments. We consider these adjustments represent "changes in accounting estimates" and should be accounted for in accordance with IAS 8.

Question 15 Our response to the IASB identifies that the fair value table previously required by paragraph 68(f) of IFRS 3 has been omitted and that we consider the disclosure requirements do not secure adequate information.

Question 18 We note that you have not identified which differences should be eliminated or set out how this should be achieved.

Comments on responses to the Exposure Draft of proposed amendments to IAS 27

Question 4 We propose to agree with this proposal as it is consistent with the existing requirements of FRS 2 *Accounting for Subsidiary Undertakings.* As stated in paragraph 81 of FRS 2, *"to do otherwise would obscure the comparison between the assets and liabilities and results of attributable to minority interests and those attributable to the group".*

Comments on responses to the Exposure Draft of proposed amendments to IAS 37

Question 6 Our proposed response to this question focuses on the introduction of measuring liabilities at 'exit value'. We consider that change to the measurement criteria elevates rationally pay from best estimate of the expenditure required to settle the obligation in the current Standard to the principle measurement criteria and is not a fundamental change to the measurement objective.

Comments on responses to the Exposure Draft of proposed amendments to IAS 19

Question 2 In our response we set out the argument that an offer of termination benefits may obligate an entity rather than when employees accept the entity's offer.