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Dear Alan

Exposure Drafts of Proposed Amendments to IFRS 3 *Business Combinations*, IAS 27 *Consolidated and Separate Financial Statements*, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*

1. This letter sets out the Accounting Standards Board's views on the above Exposure Drafts. Our main points are set out below. Our responses to the specific questions raised in each of the Exposure Drafts are set out in Appendices to this letter.

2. The ASB continues to have strong reservations whether the proposals, overall, will lead to a significant improvement in financial reporting. In our view, the proposals introduce new concepts and we do not support the conversion of the Exposure Drafts into International Financial Reporting Standards (IFRSs) until a proper debate on these concepts has been undertaken.

Relationship with the Framework

3. Where it can be demonstrated that the proposals being introduced into IFRSs will bring about sufficient benefits, in terms of convergence and improvements in financial reporting, it would be acceptable to issue standards which introduce principles that are inconsistent with or go beyond the Framework (including re-interpretation of existing principles). However we are concerned that the proposals within these Exposure Drafts introduce new principles into IFRSs and may pre-empt in-depth debate within the Conceptual Framework project and within the work that is being undertaken

on Measurement. As discussed in paragraphs 7 to 9 below, the ASB believes that the benefits of the proposals are questionable.

4. The Conceptual Framework project and the work regarding Measurement are addressing the core principles of financial reporting. It is therefore essential that these more fundamental projects do not have predetermined conclusions as a result of the Business Combinations project. Should the current proposals be developed into IFRSs (despite our reservations) it is essential that the principles being introduced are re-debated as part of these far reaching and fundamental projects. We believe that such principles are being introduced through:

- the application of the "entity approach". The ASB continues to believe that the "parent entity approach" provides a better focus for financial reporting than the entity approach. We consider that reporting transactions between the parent entity and non-controlling interests merely as transfers within equity fails to recognise that the primary objective of consolidated financial statements is to provide information about the financial performance of an entity to the investors in the parent entity. The information requirements of non-controlling equity interests are in our view better satisfied by the financial statements presented by the entity in which they hold their interests;

- the requirement to measure the acquiree at fair value. This extends the use of the 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; and

- the proposed 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.

Proposed amendments to IAS 37

5. We have further concerns about the proposed amendments to IAS 37. The amendments arise from two projects; the Business Combinations project and the Short-term Convergence project. The amendments that arise from the Business Combinations project result in the elimination of the terms 'contingent liabilities' and 'contingent assets' and a new analysis is applied to such items. The implications of these proposals may give rise to practical difficulties. In particular, in the absence of a threshold for recognition, it may

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[1] See IFRS 3, BC52, last sentence.

be difficult to ensure all liabilities are recognised. Also the proposals, arguably, introduce a greater degree of subjectivity in measuring liabilities. Whilst the draft Standard requires that only liabilities that can be reliably measured be recognised, a significant degree of judgement will sometimes be required both as to whether that criterion is met and, if so, the appropriate amount at which the liability should be stated. We consider these amendments need not be introduced as part of the second phase of the Business Combinations project. As such we believe it might be better to delay the proposed amendments to IAS 37 until further analysis, including field-testing of the proposals, has been completed on the practical implications that arise.

Fresh start accounting

6. We wish to emphasise that in our view 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'.

Benefits of the proposals

7. We are not sure of the extent to which the Exposure Drafts address a deficiency in financial reporting and thereby what contribution the proposals make to the improvement of financial reporting:

- we recognise that one consequence will be that goodwill is reported at the same amount whether an acquisition is achieved in stages or in a single transaction— however we doubt that, if this is a deficiency of current financial reporting, it seriously undermines the workings of the capital markets;

- we note that the amendments to IAS 37 will result in contingent liabilities being stated at similar amounts whether or not they arose from a business combination. However, it is not unusual for a discontinuity in financial reporting to arise in the case of a business combination, and, if this is a deficiency, it is not obvious that it is significant in practice; and

- it may perhaps be preferable to treat minority interests as equity rather than as liabilities—but to do so involves the introduction of detailed requirements explaining whether transactions are to be regarded as linked, and so accounted for as a single transaction or dealt with independently. This is an important issue that needs resolution—but it arises in a far wider range of transactions than business combinations and needs to be addressed at a fundamental level, and not re-debated in the context of each Standard.

8. Although there is obviously some benefit for those entities reporting under both IFRS and US GAAP, views differ on the extent of those benefits, and in any event similar benefits could be achieved by closer alignment of existing IASB and FASB Standards. We are not clear what benefits the proposals bring to those reporting only under IFRS. We also have a concern that the proposals may be difficult for smaller entities to comply with.

9. We have the impression that IASB considers the other advantage of its proposals to be the wider use of 'fair value'—but we do not believe the IASB has a mandate for this at this stage, given the confusion that exists as to what 'fair value' represents and how it should be measured. We consider that further research and in-depth debate on the appropriateness of the fair value measurement basis is required before the proposals are adopted.

Due process

10. As noted above we are concerned that by introducing principles as part of the Business Combinations project wider debate is pre-empted in the more fundamental projects. We also query why the IASB chose to propose such significant changes to existing Standards without issuing a discussion paper on the proposals before an Exposure Draft. Specifically we note the IASC Foundation Constitution (July 2005) states the IASB shall:

> *"publish an Exposure Draft on all projects and normally publish a discussion document for public comment on major projects"*

11. We would also like to take this opportunity to record our concern regarding the Board's decision at its September 2005 meeting to issue the FASB's final statement on fair value measurement as an IASB Exposure Draft with an Invitation to Comment. As detailed in 'IASB Update' the IASB will only be briefed on and discuss the FASB document in order to identify issues that should be included in the Invitation to Comment before issuing the Exposure Draft. Only after the comment period for the Exposure Draft will the Board debate the issues identified by the Board and constituents, and make any required changes to the Exposure Draft before issuing an IFRS. We consider that it is incumbent on the IASB only to issue an Exposure Draft when it has fully debated the issues and is satisfied it has fulfilled its objective to develop high quality, understandable and enforceable global accounting standards.

Suggested way forward

12. As set out in paragraph 2 we do not consider the proposals should proceed in their current form to IFRSs. We suggest the following course of action:

    - in relation to the Exposure Drafts of proposed amendments to IFRS 3 and IAS 27 the significant changes of principle outlined in paragraph 4 above should be debated in relation to the Conceptual Framework Project and work being undertaken in relation to Measurement. Only once these proposals have been debated and conclusions drawn should the Exposure Drafts be developed into IFRSs;

    - we also suggest that in the interim period, whilst these exposure drafts are deferred, the proposals are more extensively researched and field testing is carried out. At the same time research into 'fresh start accounting' should take place;

    - in relation to the Exposure Draft of proposed changes to IAS 37 we consider:

        - the new analysis applied to contingent assets and contingent liabilities (including changes made to the probability recognition criterion) is a conceptual improvement but we are concerned as to the practical implications of these proposals. We consider these proposals should be deferred until after further analysis and field testing has been completed on the practical implications that may arise;

        - we do however consider the changes that arise from the Short-term Convergence project should amend the Standard.

    - in relation to the Exposure Draft of proposed changes to IAS 19 we consider these proposals, subject to our comments in Section D of Appendix 4 to this letter, should amend the Standard.

13. The ASB has issued the outputs from Phase I and the proposals from Phase II of the Business Combinations project as a package of UK and Republic of Ireland Financial Reporting Exposure Drafts (FREDs 36 to 39). We have invited comments on these FREDs by 28 October 2005. We have forwarded to you all comment letters received to date, other than those that are confidential. As our response date is simultaneous with that of the IASB's we have not finished analysing comment letters, thereby this letter (and its appendices) makes no attempt to summarise the comment letters received to date or to make comment on them.

14. We hope that our comments contribute to your discussions. Should you have any questions regarding the contents of this letter please do not hesitate to contact either Andrew Lennard (020 7492 2430) or Michelle Crisp (020 7492 2432).

Yours sincerely

Ian Mackintosh
Chairman

Section A: Exposure Draft of Proposed Amendments to IFRS 3 Business Combinations

1 Objective, definition and scope

The proposed objective of the Exposure Draft is:

> …that all business combinations be accounted for by applying the acquisition method. A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses (the acquiree). In accordance with the acquisition method, the acquirer measures and recognises the acquiree, as a whole, and the assets acquired and liabilities assumed at their fair values as of the acquisition date. [paragraph 1]

The objective provides the basic elements of the acquisition method of accounting for a business combination (formerly called the purchase method) by describing:

(a) what is to be measured and recognised. An acquiring entity would measure and recognise the acquired business at its fair value, regardless of the percentage of the equity interests of the acquiree it holds at the acquisition date. That objective also provides the foundation for determining whether specific assets acquired or liabilities assumed are part of an acquiree and would be accounted for as part of the business combination.

(b) when to measure and recognise the acquiree. Recognition and measurement of a business combination would be as of the acquisition date, which is the date the acquirer obtains control of the acquiree.

(c) the measurement attribute as fair value, rather than as cost accumulation and allocation. The acquiree and the assets acquired and liabilities assumed would be measured at fair value as of the acquisition date, with limited exceptions. Consequently, the consideration transferred in exchange for the acquiree, including contingent consideration, would also be measured at fair value as of the acquisition date.

The objective and definition of a business combination would apply to all business combinations in the scope of the proposed IFRS, including business combinations:

(a) involving only mutual entities

(b) achieved by contract alone

(c) achieved in stages (commonly called step acquisitions)

(d) in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date.

(See paragraphs 52-58 and paragraphs BC42-BC46 of the Basis for Conclusions.)

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?*

As set out in our response to ED 3 we have reservations about requiring the acquisition method for *all* business combinations. In certain circumstances it may not be possible to identify an acquirer and therefore the use of acquisition accounting (which reflects that acquisition of one entity by another) may not faithfully represent the business combination. We consider that "true" mergers do occur and therefore we do not agree that a business combination is necessarily a transaction or other event in which an acquirer obtains control of one or more businesses.

The measurement of the acquiree, as a whole, results in the recognition of goodwill attributable to non-controlling interests. We have set out our concerns in relation to the recognition of goodwill attributable to non-controlling interests in response to question 3.

As set out in our covering letter, we are concerned that the requirement to measure, the acquiree at fair value extends the application of the fair value measurement principle and implies that, conceptually, transactions should be measured at fair value, rather than cost.

We do not consider the objective is appropriate. We consider that the IASB should actively pursue research into 'fresh start accounting' as a potential alternative to the acquisition method where an acquirer cannot be identified.

2 Definition of a business

The Exposure Draft proposes to define a *business* as follows:

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:

(1) a return to investors, or

(2) dividends, lower costs, or other economic benefits directly and proportionately to owners, members, or participants. [paragraph 3(d)]

Paragraphs A2-A7 of Appendix A provides additional guidance for applying this definition. The proposed IFRS would amend the definition of a business in IFRS 3. (See paragraphs BC34-BC41.)

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?*

We consider the three elements (inputs, processes and outputs) are well placed and provide a useful tool to determine whether an integrated set of activities represents a business. It is our view that the acquiree must meet the definition of a business as set out in paragraph 3(d) of the draft Standard. In this regard we are concerned with the use of the expression "capable of being conducted and managed…". We consider this expression is too wide: it could embrace circumstances where an acquirer is able to demonstrate that a particular set of assets is "capable of being conducted as a business" although alone the set of assets is not a business. Consider the example of an entity that operates in the outsourced catering market acquiring a canteen currently managed as an in-house canteen. The set of assets (canteen) is capable of being managed as a business although the assets are not currently managed as a business. As the assets are capable of being conducted as a business it might be argued that, if the assets are acquired above fair value, goodwill should be recognised which would be inappropriate. We consider the definition and application guidance should be modified such that the term "capable of being conducted and managed" is replaced with "are conducted and managed".

We note that paragraph A7 states that if goodwill is present in a particular set of assets and activities then (in the absence of evidence to the contrary) the set shall be presumed to be a business. In our view this allows paragraphs A2 to A6 to be circumvented. It would appear that the acquisition of a set of assets above fair value should "raise the question" whether the set of assets acquired is a business – then paragraphs A2 to A6 should be applied. The possible existence of goodwill follows from the conclusion that what has been acquired is a business.

3 Measuring the fair value of the acquiree

The Exposure Draft proposes that in a business combination that is an exchange of equal values, the acquirer should measure and recognise 100 per cent of the fair value of the acquiree as of the acquisition date. This applies even in business combinations in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at that date. In those business combinations, the acquirer would measure and recognise the non-controlling interest as the sum of the non-controlling interest's proportional interest in the acquisition-date values of the identifiable assets acquired and liabilities assumed plus the goodwill attributable to the non-controlling interest. (See paragraphs 19, 58 and BC52-BC54.)

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 are of the view that the recognition of 100 per cent of the acquiree, where an acquirer holds less than 100 per cent, requires a hypothetical transaction to be recognised. Paragraph 82 of FRS 2 'Accounting for subsidiary undertakings' sets out that recognition of goodwill attributable to minority interests would in effect recognise an amount of goodwill attributable to the minority interest that is hypothetical because the minority is not a party to the transaction by which the subsidiary undertaking is acquired.

Similarly, we do not recognise a parallel between the recognition of full goodwill and the recognition of 100 per cent of the value of other identifiable assets acquired and liabilities assumed. The ASB does not consider goodwill to be a separable asset – but part of a larger asset, the investment. Under the parent entity concept goodwill relates to the cost of the investment and provides useful information for users of the financial statements on the decisions and actions management has made. The recognition of full goodwill introduces a "notional" item into the Balance Sheet and distracts from the existing clarity of financial statements.

We note that the Basis for Conclusions states the amount of goodwill recognised in a business combination achieved in stages and that achieved in a single transaction will not be the same because goodwill is a mixture of some current exchange prices and some carry-forward book values. This gives rise to inconsistent information that is not as complete or as useful as it would be without them. The Basis for Conclusion does not identify the negative impact on financial reporting that these inconsistencies create.

In view of the above we do not concur with the IASB's view. We consider further research is required into the impact on financial reporting that results from the inconsistencies identified. These findings should then be balanced against the proposals in the Exposure Draft which we consider requires the recognition of a hypothetical transaction and which will often require subjective measurement.

In the absence of further evidence to support the IASB proposals we would retain the existing requirements of IFRS 3 whereby the business combination is measured at its transactional cost and only goodwill attributable to the parent entity is recognised.

4 Measuring the fair value of the acquiree

The Exposure Draft proposes that a business combination is usually an arm's length transaction in which knowledgeable, unrelated willing parties are presumed to exchange equal values. In such transactions, the fair value of the consideration transferred by the acquirer on the acquisition date is the best evidence of the fair value of the acquirer's interest in the acquiree, in the absence of evidence to the contrary. Accordingly, in most business combinations, the fair value of the consideration transferred by the acquirer would be used as the basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree. However, in some business combinations, either no consideration is transferred on the acquisition date or the evidence indicates that the consideration transferred is not the best basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree. In those business combinations, the acquirer would measure the acquisition-date fair value of its interest in the acquiree and the acquisition-date fair value of the acquiree using other valuation techniques. (See paragraphs 19, 20 and A8-A26, Appendix E and paragraphs BC52-BC89.)

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 consider the guidance provided in paragraphs A8 to A26 is inconclusive. We are concerned that measuring the fair value of an acquiree is particularly subjective and attempting to provide detailed guidance may not be practical.

We note that the IASB has recently decided to issue the FASB final statement on Fair Value Measurement as an IASB Exposure Draft with an Invitation to Comment. We presume Appendix E of the Exposure Draft will be revised in light of this decision. We consider this is a better alternative to that proposed in the Exposure Draft of proposed amendments to IFRS 3 which suggests that the IASB could amend the guidance without further consultation prior to issuing the IFRS. We are however concerned that the IASB has decided to issue a FASB document and, only after the comment period for the Exposure Draft has expired, will the IASB debate the issues identified by the IASB and its constituents. This may require changes to the Exposure Draft and thereby require further consultation prior to issuing the final IFRS.

5 Is the consideration transferred the best evidence of the fair value of the acquiree?

The Exposure Draft proposes a 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, including:

(a) contingent consideration;

(b) equity interests issued by the acquirer; and

(c) any non-controlling equity investment in the acquiree that the acquirer owned immediately before the acquisition date.

(See paragraphs 20-25 and BC55-BC58.)

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 are of the view that where a controlling interest is acquired but less than 100 per cent of a business is acquired, estimating the fair value of the acquiree had 100 per cent been acquired is extremely subjective. Using the consideration transferred to estimate the fair value of the acquiree may not be appropriate because:

(i) it may fail to recognise any control premium included in the consideration transferred. The control premium may be difficult to measure with sufficient reliability; and

(ii) the consideration transferred is based on the acquirer's assessment of future returns it anticipates the investment will generate. These returns may include an assessment of future synergy benefits the acquirer anticipates it will achieve. Some of the synergy benefits may benefit the parent entity rather than the acquired entity and thereby have little or no relevance to the non-controlling interests in the acquired entity.

As noted in our earlier comments we are concerned about the extension of the fair value principle; it thereby follows that we have concerns about the remeasurement of non-controlling equity investments immediately before the acquisition date (see also our responses to questions 6 and 10).

6 Contingent consideration

The Exposure Draft proposes that after initial recognition, contingent consideration classified as:

(a) equity would not be remeasured.

(b) liabilities would be remeasured with changes in fair value recognised in profit or loss unless those liabilities are in the scope of IAS 39 *Financial Instruments: Recognition and Measurement* or [draft] IAS 37 *Non-financial Liabilities.* Those liabilities would be accounted for after the acquisition date in accordance with those IFRSs.

(See paragraphs 26 and BC64-BC89.)

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

The proposed treatment of contingent consideration reflects the view that changes that revise the estimate for contingent consideration and have arisen since the acquisition date represent events that have occurred since the date of acquisition. It is our view that contingent consideration arrangements often arise where the acquirer and vendor are unable to agree the level of consideration at the acquisition date due to a measurement uncertainty – for example the level of sales. We therefore consider a revision to the estimate for contingent consideration may provide more information about conditions that existed at the date of acquisition and should, in such circumstances, be reported as a change in the fair value of consideration and a corresponding change to goodwill.

We further believe that it is inevitable that managements will exercise extreme caution in determining at the outset the provision for any contingent consideration so as to give rise to future profits rather than losses.

7 Acquisition costs

The Exposure Draft proposes that the costs that the acquirer incurs in connection with a business combination (also called acquisition-related costs) should be excluded from the measurement of the consideration transferred for the acquiree because those costs are not part of the fair value of the acquiree and are not assets. Such costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; the cost of issuing debt and equity instruments; and general administrative costs, including the costs of maintaining an internal acquisitions department. The acquirer would account for those costs separately from the business combination accounting. (See paragraphs 27 and BC84-BC89.)

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 the logic the IASB has developed for the treatment of acquisition related costs. We agree such costs are not assets themselves but note that they arise directly from the decision to acquire the asset; an input price (replacement cost) perspective justifies treating these costs as part of the cost of the asset. Further, we consider the inclusion of acquisition related expenses provides a more economically significant benchmark against which to assess the return on investment. Where the costs of acquisition are excluded from the investment cost managers are, in subsequent accounting periods, not held accountable for the full costs of acquisition as such cost will have been charged to the profit and loss when incurred.

We agree with the dissenting opinions in paragraph AV18 of the Exposure Draft that the proposed treatment creates an inconsistency with the accounting for purchases of property, plant and equipment and non-controlling equity investments. In our view the accounting for these assets is correct.

8 Changes to exceptions to the fair value measurement principle from IFRS 3

The Exposure Draft proposes that an acquirer measure and recognise as of the acquisition date the fair value of the assets acquired and liabilities assumed as part of the business combination, with limited exceptions. (See paragraphs 28-41 and BC111-BC116.) That requirement would result in the following significant changes to accounting for business combinations:

(a) Receivables (including loans) acquired in a business combination would be measured at fair value. Therefore, the acquirer would not recognise a separate valuation allowance for uncollectible amounts as of the acquisition date.

(b) An identifiable asset or liability (contingency) would be measured and recognised at fair value at the acquisition date even if the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. After initial recognition, such an asset would be accounted for in accordance with IAS 38 *Intangible Assets* or IAS 39 *Financial Instruments: Recognition and Measurement*, as appropriate, and such a liability would be accounted for in accordance with [draft] IAS 37 or other IFRSs as appropriate.

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?*

We agree with the proposed changes to measurement of receivables. In relation to identifiable assets or liabilities (contingencies) we agree with the requirements to measure these at fair value but we refer to our response on the Exposure Draft of proposed amendments to IAS 37.

9 Exceptions to the fair value measurement principle

The Exposure Draft proposes limited exceptions to the fair value measurement principle. Therefore, some assets acquired and liabilities assumed (for example, those related to deferred taxes, assets held for sale, or employee benefits) would continue to be measured and recognised in accordance with other IFRSs rather than at fair value. (See paragraphs 42-51 and BC117-BC150.)

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?*

In general we agree with the exceptions to the application of the fair value measurement principle. We would like to take this opportunity to express our view that there is an urgent requirement to review (outside the current convergence project) the fundamental principles of accounting for deferred tax.

10 Remeasurement of non-controlling equity investments held immediately before acquisition

The Exposure Draft proposes that, for the purposes of applying the acquisition method, the fair value of the consideration transferred by the acquirer would include the fair value of the acquirer's non-controlling equity investment in the acquiree at acquisition date that the acquirer owned immediately before the acquisition date. Accordingly, in a business combination achieved in stages (step acquisition) the acquirer would remeasure its non-controlling equity investment in the acquiree at fair value as of the acquisition date and recognise any gain or loss 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 would be reclassified and included in the calculation of any gain or loss as of the acquisition date. (See paragraphs 55, 56 and BC151-BC153.)

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 have highlighted in both our covering letter and our responses to specific questions that we are concerned that the requirement to measure the acquiree at fair value is an extension of the fair value principle. In our opinion the acquisition should be measured at the carrying value of any non-controlling equity investment at the acquisition date plus the consideration transferred at the acquisition date. We do not consider it appropriate to remeasure non-controlling equity investments held immediately before the the Business Combination (although they may be held at fair value).

We consider the measurement of the business combination at cost more appropriately reflects the transactions that management has entered into in a particular accounting period. By obtaining control through additional investment or other means, management acquire the right to direct the entity; it has not disposed of the original non-controlling investment. We do not consider the recognition of a gain or loss arising on the remeasurement of non-controlling equity investments held at the acquisition date reflects the value of a transaction that management has entered into.

Should this treatment be adopted we question why the gain or loss is recognised in the profit and loss account. The gain or loss arising on the remeasurement is not realised and is comparable to the revaluation of property, plant and equipment and should therefore be recognised directly in equity.

We note the Basis for Conclusions to the Exposure Draft explains the gain or loss arises as a result of the mixed attribute accounting model that exists today for financial instruments (ie the gain or loss recognised at acquisition is merely delayed recognition of an economic gain or loss present in the financial instrument). We are happy to debate and consider the accounting measurement of assets, including financial instruments, but do not consider fair value should be introduced on a piecemeal basis.

11 Business combination in which the consideration transferred for the acquirer‘s interest in the acquiree is less than the fair value of that interest

The Exposure Draft proposes that in a business combination in which the consideration transferred for the acquirer’s interest in the acquiree is less than the fair value of that interest (referred to as a bargain purchase) any excess of the fair value of the acquirer’s interest in the acquiree over the fair value of the consideration transferred for that interest would reduce goodwill until the goodwill related to that business combination is reduced to zero, and any remaining excess would be recognised in profit or loss on the acquisition date. (See paragraphs 59-61 and paragraphs BC164-BC177.) However, the proposed IFRS would not permit the acquirer to recognise a loss at the acquisition date if the acquirer is able to determine that a portion of the consideration transferred represents an overpayment for the acquiree. The boards acknowledge that an acquirer might overpay to acquire a business, but they concluded that it is not possible to measure such an overpayment reliably at the acquisition date. (See paragraph BC178.)

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 accept that the accounting for business combinations in which the consideration transferred is less than the fair value of the acquiree is a complex accounting issue where the IASB has attempted to be pragmatic.

We also note that limiting a gain recognised by reducing goodwill is not consistent with the fair value measurement principle, and calls into question the extended use of the fair value measurement principle.

12 Overpayments

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?*

The ASB is of the view that perceived overpayments are often economically justified due to "entity specific" circumstances such as synergistic benefits to the acquirer. In such circumstances the acquirer will recognise the acquiree at cost and generate returns that justify the cost of the investment. Were the acquirer required to impair the cost of the investment (ie reduce the cost to a market determined fair value) future returns generated by the investment could be overstated. This indicates that cost is a more appropriate measure than the fair value model proposed in the Exposure Draft.

We believe an alternative to the treatment proposed is to require additional disclosures in IAS 36 *Impairment of Assets* of an impairment that arises within a specified time period (say two years) from the acquisition date. Disclosure should be made of the reason for the impairment together with the investment rationale leading to the acquisition.

13 Measurement period

The Exposure Draft proposes that an acquirer should recognise adjustments made during the measurement period to the provisional values of the assets acquired and liabilities assumed as if the accounting for the business combination had been completed at the acquisition date. Thus, comparative information for prior periods presented in financial statements would be adjusted, including any change in depreciation, amortisation or other profit or loss effect recognised as a result of completing the initial accounting. (See paragraphs 62-68 and BC161-BC163.)

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 acknowledge that the proposals do not amend IFRS 3 but we do not agree that comparative information should be adjusted for the effects of measurement period adjustments. We consider that comparative information should not be adjusted but that the adjustments should be made in accordance with IAS 8 and specifically "changes in accounting estimates". We do however consider that supplementary disclosure should be made where there is significant estimate uncertainty to the provisional values of the assets acquired and liabilities assumed.

14 Assessing what is part of the exchange for the acquiree

The Exposure Draft proposes that an acquirer assess whether any portion of the transaction price (payments or other arrangements) and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred by the acquirer and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree would be included in the business combination accounting. (See paragraphs 69, 70, A87-A109 and BC154-BC160.)

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?*

The guidance is a little detailed - in practice it will often be a matter of judgement as to what is and what is not part of the business combination. We do however consider the guidance to be useful.

We would, however, note that we disagree with paragraph 41 of the Exposure Draft. In our opinion the acquisition of a right that the acquirer had previously granted should not give rise to the recognition of an intangible asset because it is internally generated.

15 Disclosures

The Exposure Draft proposes broad disclosure objectives that are intended to ensure that users of financial statements are provided with adequate information to enable them to evaluate the nature and financial effects of business combinations. Those objectives are supplemented by specific minimum disclosure requirements. In most instances, the objectives would be met by the minimum disclosure requirements that follow each of the broad objectives. However, in some circumstances, an acquirer might be required to disclose additional information necessary to meet the disclosure objectives. (See paragraphs 71-81 and BC200-BC203.)

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?*

We disagree that the disclosure requirements secure adequate information and in particular note that the fair value table previously required by paragraph 68(f) of IFRS 3 is no longer required. Although we accept the information provided by the table does not provide information about an economic transaction, it does provide a valuable insight into management's assessment of the fair value of assets acquired and liabilities assumed. The information is of a similar character to that required by IFRS 1 paragraphs 38 and 39.

16 Reliable measurement of intangible assets

The Exposure Draft is the result of the boards' projects to improve the accounting for business combinations. The first phase of those projects led to the issue of IFRS 3 and FASB Statement No. 141. In 2002, the FASB and the IASB agreed to reconsider jointly their guidance for applying the purchase method of accounting, which the Exposure Draft calls the acquisition method, for business combinations. An objective of the joint effort is to develop a common and comprehensive standard for the accounting for business combinations that could be used for both domestic and cross-border financial reporting. Although the boards reached the same conclusions on the fundamental issues addressed in the Exposure Draft, they reached different conclusions on a few limited matters. Therefore, the IASB's version and the FASB's version of the Exposure Draft provide different guidance on those limited matters. A comparison, by paragraph, of the different guidance provided by each board accompanies the draft IFRS. Most of the differences arise because each board decided to provide business combinations guidance that is consistent with its other standards. Even though those differences are candidates for future convergence projects, the boards do not plan to eliminate those differences before final standards on business combinations are issued.

The joint Exposure Draft proposes to resolve a difference between IFRS 3 and SFAS 141 relating to the criteria for recognising an intangible asset separately from goodwill. Both boards concluded that an intangible asset must be identifiable (arising from contractual-legal rights or separable) to be recognised separately from goodwill. In its deliberations that led to SFAS 141, the FASB concluded that, when acquired in a business combination, all intangible assets (except for an assembled workforce) that are identifiable can be measured with sufficient reliability to warrant recognition separately from goodwill. In addition to the identifiability criterion, IFRS 3 and IAS 38 required that an intangible asset acquired in a business combination be reliably measurable to be recognised separately from goodwill. Paragraphs 35-41 of IAS 38 provide guidance for determining whether an intangible asset acquired in a business combination is reliably measurable. IAS 38 presumes that the fair value of an intangible asset with a finite useful life can be measured reliably. Therefore, a difference between IFRS 3 and SFAS 141 would arise only if the intangible asset has an indefinite life. The IASB decided to converge with the

FASB in the Exposure Draft by:

(a) eliminating the requirement that an intangible asset be reliably measurable to be recognised separately from goodwill; and

(b) precluding the recognition of an assembled workforce acquired in a business combination as an intangible asset separately from goodwill.

(See paragraphs 40 and BC100-BC102.)

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 are surprised the Exposure Draft omits the reliable measurement criterion for intangible assets. The Basis for Conclusions that accompanies IFRS 3 sets out in paragraphs BC97 to BC103 the reasons why the IASB decided to amend ED 3 and include the criterion in IFRS 3.

We note that the Basis for Conclusions to the Exposure Draft states the reason for amending the position in IFRS 3 is "*that an estimate of fair value and the separate recognition of intangible assets, rather than subsuming them in goodwill, provides better information to the users of financial statements, even though a significant degree of judgement could be involved in determining that fair value*". We accept that in the absence of amortisation of goodwill the separate recognition of intangible assets provides better information to users of financial statements. It is our concern that the requirement does not consider the practicable implications of measuring intangible assets.

We do not believe that you can reliably measure *all* intangible assets. In the absence of an active market, valuation will be based on estimated future cash flows. Whilst it might be possible to estimate the cash flows arising from the business combination, requiring these cash flows to be disaggregated to individual assets can only be done on an arbitrary basis.

An example of an intangible asset that arises from a legal or contractual right that cannot be sold and where the cash flows are inextricably linked with the cash flows that the business generates as a whole is a customer list which exists in a regulated market. The ability to sell the customer list is prohibited or rendered ineffective by prohibitions on cold calling.

17 Recognition of acquirer deferred tax benefits

For the joint Exposure Draft, the boards considered the provisions of IAS 12 *Income Taxes* and FASB Statement No. 109 *Accounting for Income Taxes*, relating to an acquirer's deferred tax benefits that become recognisable because of a business combination. IAS 12 requires the acquirer to recognise separately from the business combination accounting any changes in its deferred tax assets that become recognisable because of the business combination. Such changes are recognised in post-combination profit or loss, or equity. On the other hand, SFAS 109 requires any recognition of an acquirer's deferred tax benefits (through the reduction of the acquirer's valuation allowance) that results from a business combination to be accounted for as part of the business combination, generally as a reduction of goodwill. The FASB decided to amend SFAS 109 to require the recognition of any changes in the acquirer's deferred tax benefits (through a change in the acquirer's previously recognised valuation allowance) as a transaction separately from the business combination. As amended, SFAS 109 would require such changes in deferred tax benefits to be recognised either in income from continuing operations in the period of the combination or directly to contributed capital, depending on the circumstances. Both boards decided to require disclosure of the amount of such acquisition-date changes in the acquirer's deferred tax benefits in the notes to the financial statements. (See paragraphs D4 and BC119-BC129.)

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?*

We agree that 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.

18 Disclosure differences

The boards reconsidered disclosure requirements in IFRS 3 and SFAS 141 for the purposes of convergence. For some of the disclosures, the boards decided to converge. However, divergence continues to exist for some disclosures as described in the accompanying note *Differences between the Exposure Drafts published by the IASB and the FASB.* The boards concluded that some of this divergence stems from differences that are broader than the Business Combinations project.

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 consider the disclosure differences should be eliminated, unless the information is required by another Standard. We have considered the following disclosure differences:

Comparable prior period

Paragraph 74(b)(2) is not used by the IASB. We concur with the IASB decision and consider the FASB proforma requirements are suited to the requirements of investment circulars. We do not consider historical proforma information is of benefit to the users of financial statements.

Changes to amounts recognised in a business combination

Paragraph 76(d) appears to be an anti-abuse paragraph aimed at providing information about gains and losses relating to the measurement of identifiable assets acquired and liabilities assumed in a business combination. We believe it is fundamentally difficult to identify whether a gain or a loss arises from an unintended error in the measurement of an asset acquired or liability assumed or abuse of the fair value principle. As such we are not convinced that information in this disclosure will benefit users of financial statements.

Goodwill

The additional information that is required by the FASB provides the user with information about the amount of goodwill arising during the year by segment. We believe this information would benefit users of the financial statements.

19 Style of the Exposure Draft

The Exposure Draft was prepared in a style similar to the style used by the IASB in its standards in which paragraphs in **bold type** state the main principles. All paragraphs have equal authority.

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?*

The style and format of the Exposure Draft were debated when the Preface to International Financial Reporting Standards was issued in April 2002. We have supported the presentation of Standards in bold type and have not changed position since that time.

Section B: Exposure Draft of Proposed Amendments to IAS 27 Consolidated and Separate Financial Statements

1 Transactions with non-controlling interests

Draft paragraph 30A proposes that changes in the parent's ownership interest in a subsidiary after control is obtained that do not result in a loss of control should be accounted for as transactions with equity holders in their capacity as equity holders. As a result, no gain or loss on such changes would be recognised in profit or loss (see paragraph BC4 of the Basis for Conclusions).

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

The proposed treatment relies on the assumption that non-controlling interests are equity holders in the consolidated group. We consider that reporting transactions with non-controlling interests merely as transfers within equity fails to recognise the primary objective of financial reporting is to report to the shareholders of the parent entity the transactions management have undertaken in the reporting period.

In view of the above we do not agree that changes in the parent's ownership interest in a subsidiary after control is obtained that do not result in a loss of control should be accounted for as transactions with equity holders. In our view a decrease in ownership without loss of control should give rise to a gain or loss and be recorded in the profit and loss account. An increase in ownership after control is obtained should use the cost of the transaction and fair value information at the date of each exchange transaction to determine the additional amount of any goodwill associated with the acquirer's interest.

2 Measurement of non-controlling equity investments

Paragraph 30D proposes that on loss of control of a subsidiary any non-controlling equity investment remaining in the former subsidiary should be remeasured to its fair value in the consolidated financial statements at the date control is lost. Paragraph 30C proposes that the gain or loss on such remeasurement be included in the determination of the gain or loss arising on loss of control (see paragraph BC7 of the Basis for Conclusions).

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

Do you agree with the proposal to include any gain or loss resulting from such remeasurement in the calculation of the gain or loss arising on loss of control? If not, why not, and what alternative would you propose?

We set out in our response to question 10 of the Exposure Draft of proposed amendments to IFRS 3 that we do not consider the non-controlling equity investment is party to the acquisition transaction that gives rise to obtaining control. Similarly we are of the view that when control is lost the non-controlling element is not part of the transaction. We do not therefore consider the investment should be remeasured.

As stated in our response to question 10 we question why, if it is decided nonetheless that a gain should be recognised, that it should be recognised in the profit and loss account – any change in value is comparable to the revaluation of property, plant and equipment and in our opinion should be presented within equity.

3 Multiple arrangements

As explained in Question 1, the Exposure Draft proposes that changes in a parent's ownership interest in a subsidiary that do not result in a loss of control should be treated as transactions with equity holders in their capacity as equity holders. Therefore, no gain or loss would be recognised in profit or loss. However, a decrease in the parent's ownership interest resulting in the loss of control of a subsidiary would result in any gain or loss being recognised in profit or loss for the period. The Board is aware that differences in accounting that depend on whether a change in control occurs could create opportunities for entities to structure transactions to achieve a particular accounting result. To reduce this risk, the Exposure Draft proposes that if one or more of the indicators in paragraph 30F are present, it is presumed that two or more disposal transactions or arrangements that result in a loss of control should be accounted for as a single transaction or arrangement. This presumption can be overcome if the entity can demonstrate clearly that such accounting would be inappropriate (see paragraphs BC9-BC13 of the Basis for Conclusions).

Do you agree that it is appropriate to presume that multiple arrangements that result in a loss of control should be accounted for as a single arrangement when the indicators in paragraph 30F are present? Are the proposed factors suitable indicators? If not, what alternative indicators would you propose?

We agree that it is appropriate to presume that multiple arrangements that result in the loss of control should be treated as a single transaction.

4 Losses applicable to non-controlling interests

Paragraph 35 proposes that losses applicable to the non-controlling interest in a subsidiary should be allocated to the non-controlling interest even if such losses exceed the non-controlling interest in the subsidiary's equity. Non-controlling interests are part of the equity of the group and, therefore, participate proportionally in the risks and rewards of investment in the subsidiary.

Do you agree with the proposed loss allocation? Do you agree that any guarantees or other support arrangements from the controlling and non-controlling interests should be accounted for separately? If not, why not, and what alternative treatment would you propose?

We agree with the proposal that losses applicable to the non-controlling interest should be allocated to the non-controlling interest, even if such losses exceed the subsidiary's equity. We are however concerned that the amendments to the Standard will not specify that any guarantee or other support arrangements from the controlling and non-controlling interests should be accounted for separately.

5 Transitional arrangements

The transitional provisions in the Exposure Draft propose that all of its requirements should apply retrospectively, except in limited circumstances in which the Board believes that retrospective application is likely to be impracticable.

Do you agree that proposed paragraphs 30A, 30C and 30D should apply on a prospective basis in the cases set out in paragraph 43B? 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?

We agree with the transitional arrangements.

Section C: Exposure Draft of Proposed Amendments to IAS 37 Provisions, contingent liabilities and contingent assets

1 Scope of IAS 37 and terminology

The Exposure Draft proposes to clarify that IAS 37, except in specified cases, should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards (see paragraph 2). To emphasise this point, the Exposure Draft does not use 'provision' as a defined term to describe liabilities within its scope. Instead, it uses the term 'non-financial liability' (see paragraph 10). However, the Exposure Draft explains that an entity may describe some classes of non-financial liabilities as provisions in their financial statements (see paragraph 9).

(a) *Do you agree that IAS 37 should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards? If not, for which type of liabilities do you regard its requirements as inappropriate and why?*

(b) *Do you agree with not using 'provision' as a defined term? If not, why not*?

As outlined in our covering letter we are concerned as to the extent of the proposed amendments to IAS 37. The project appears to have suffered from "mission creep" such that the proposed amendments extend beyond convergence with SFAS 146 and the Business Combinations project.

In particular we are concerned that the extension in the scope of the draft Standard which, when combined with the amendments made to the measurement criteria, implies a principle that all non-financial liabilities should be measured at an exit value – with exceptions made only on pragmatic grounds.

We consider the amendments that arise from the Business Combinations project and the proposed extension to the scope of the Standard should be delayed until further analysis has been completed on the practical implications that arise from these proposals.

2 Contingent liabilities

The Exposure Draft proposes to eliminate the term 'contingent liability'.

The Basis for Conclusions on the proposals in the Exposure Draft explains that liabilities arise only from unconditional (or non-contingent) obligations (see paragraph BC11). Hence, it highlights that something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability (see paragraph BC30).

The Basis for Conclusions also explains that many items previously described as contingent liabilities satisfy the definition of a liability in the *Framework*. This is because the contingency does not relate to whether an unconditional obligation exists. Rather it relates to one or more uncertain future events that affect the amount that will be required to settle the unconditional obligation (see paragraph BC23).

The Basis for Conclusions highlights that many items previously described as contingent liabilities can be analysed into two obligations: an unconditional obligation and a conditional obligation. The unconditional obligation establishes the liability and the conditional obligation affects the amount that will be required to settle the liability (see paragraph BC24).

The Exposure Draft proposes that when the amount that will be required to settle a liability (unconditional obligation) is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events, the liability is recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur). Uncertainty about the future event(s) is reflected in the measurement of the liability recognised (see paragraph 23).

(a) Do you agree with eliminating the term 'contingent liability'? If not, why not?

(b) Do you agree that when the amount that will be required to settle a liability (unconditional obligation) is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability should be recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur)? If not, why not?

We agree conceptually that a liability should be recognised independently of the probability of an uncertain future event that effects the measurement of that liability. We are, however, concerned that the implications of these proposals give rise to serious practical difficulties. In particular:

(a) the absence of a threshold and the increased level of subjectivity means, for example, that a liability would have to be recognised if there was only a 10 per cent risk of an outflow. In practice it may be difficult, without a threshold, to ensure all liabilities have been recognised;

(b) arguably, the proposals also introduce a greater degree of subjectivity in measuring liabilities. Whilst the draft Standard requires that only liabilities that can be reliably measured are recognised, a significant degree of judgement will sometimes be required both as to whether that criterion is met and, if so, the appropriate amount at which the liability should be stated; and

(c) it is also possible that (despite the disclosure exemption in paragraph 71 of the draft Standard) the requirement to recognise a liability at an early stage of negotiation (for example in the case of litigation) could be prejudicial to the outcome.

The definition of a liability requires there to be an outflow of economic benefits. Moreover we are not persuaded that merely standing ready or being obligated to stand ready meets this requirement within the definition.

As regards whether a liability should be recognised independently of the probability of the uncertain future event please see our response to question 5.

3 Contingent assets

The Exposure Draft proposes to eliminate the term ‘contingent asset’.

As with contingent liabilities, the Basis for Conclusions explains that assets arise only from unconditional (or non-contingent) rights (see paragraph BC11). Hence, an asset (an unconditional right) cannot be contingent or conditional, and a right that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to an asset (see paragraph BC17).

The Basis for Conclusions also explains that many items previously described as contingent assets satisfy the definition of an asset in the *Framework*. This is because the contingency does not relate to whether an unconditional right exists. Rather, it relates to one or more uncertain future events that affect the amount of the future economic benefits embodied in the asset (see paragraph BC17).

The Exposure Draft proposes that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38 *Intangible Assets* rather than IAS 37 (except for rights to reimbursement, which remain within the scope of IAS 37). This is because such items are non-monetary assets without physical substance and, subject to meeting the identifiability criterion in IAS 38, are intangible assets (see paragraph A22 in the Appendix). The Exposure Draft does not propose any amendments to the recognition requirements of IAS 38.

(a) *Do you agree with eliminating the term 'contingent asset'? If not, why not?*

(b) *Do you agree that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38? If not, why not?*

As regards the amendments to IAS 38 we believe a greater degree of guidance is required in this area and further examples of unconditional intangible assets should be provided. In practice we believe that many items previously presented within "debtors" will now be presented as an intangible asset. For example, where an entity has paid for warranty services in advance, at present such items are presented within prepaid expenses. Under the new analysis it seems possible such items now meet the definition of an intangible asset. We consider that further guidance is required to explain the reclassification of these items.

4 Constructive obligations

The Exposure Draft proposes amending the definition of a constructive obligation to emphasise that an entity has a constructive obligation only if its actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform (see paragraph 10). The Exposure Draft also provides additional guidance for determining whether an entity has incurred a constructive obligation (see paragraph 15).

(a) *Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not? How would you define one and why?*

(b) *Is the additional guidance for determining whether an entity has incurred a constructive obligation appropriate and helpful? If not, why not? Is it sufficient? If not, what other guidance should be provided?*

We agree with the proposed amendments to the definition of a constructive obligation. We also consider that the guidance is sufficient.

5 Probability recognition criterion

The Exposure Draft proposes omitting the probability recognition criterion (currently in paragraph 14(b)) from the Standard because, in all cases, an unconditional obligation satisfies the criterion. Therefore, items that satisfy the definition of a liability are recognised unless they cannot be measured reliably.

The Basis for Conclusions emphasises that the probability recognition criterion is used in the *Framework* to determine whether it is probable that settlement of an item that has previously been determined to be a liability will require an outflow of economic benefits from the entity. In other words, the *Framework* requires an entity to determine whether a liability exists before considering whether that liability should be recognised. The Basis notes that in many cases, although there may be uncertainty about the amount and timing of the resources that will be required to settle a liability, there is little or no uncertainty that settlement will require *some* outflow of resources. An example is an entity that has an obligation to decommission plant or to restore previously contaminated land. The Basis also outlines the Board's conclusion that in cases previously described as contingent liabilities in which the entity has an unconditional obligation and a conditional obligation, the probability recognition criterion should be applied to the unconditional obligation (ie the liability) rather than the conditional obligation. So, for example, in the case of a product warranty, the question is not whether it is probable that the entity will be required to repair or replace the product. Rather, the question is whether the entity's *unconditional* obligation to provide warranty coverage for the duration of the warranty (ie to stand ready to honour warranty claims) will probably result in an outflow of economic benefits (see paragraphs BC37-BC41).

The Basis for Conclusions highlights that the *Framework* articulates the probability recognition criterion in terms of an outflow of economic benefits, not just direct cash flows. This includes the provision of services. An entity's unconditional obligation to stand ready to honour a conditional obligation if an uncertain future event occurs (or fails to occur) is a type of service obligation. Therefore, any liability that incorporates an unconditional obligation satisfies the probability recognition criterion. For example, the issuer of a product warranty has a certain (not just probable) outflow of economic benefits because it is providing a service for the duration of the contract, ie it is standing ready to honour warranty claims (see paragraphs BC42-BC47).

Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?

In our opinion the elimination of the probability criterion (ie the removal of the threshold) from the Standard results in the Standard not adequately addressing element uncertainty. In a business environment, uncertainty exists on a continuum, so that 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. The probability criterion in IAS 37 previously provided a pragmatic approach to recognition of contingent liabilities and provisions.

The elimination of the probability criterion, in our opinion, fails to leave adequate guidance as to the amount and quality of evidence required to recognise liabilities. Whilst accepting that sufficient evidence is a matter of judgement, it is unsatisfactory for the Standard to fail to provide any guidance; whilst we accept the proposed amendments provide greater guidance on meeting the definition of a liability, we believe this does not specifically address element uncertainty.

6 Measurement

The Exposure Draft proposes that an entity should measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date (see paragraph 29). The Exposure Draft explains that an expected cash flow approach is an appropriate basis for measuring a non-financial liability for both a class of similar obligations and a single obligation. It highlights that measuring a single obligation at the most likely outcome would not necessarily be consistent with the Standard's measurement objective (see paragraph 31).

Do you agree with the proposed amendments to the measurement requirements? If not, why not? What measurement would you propose and why?

As noted previously we are particularly concerned by the extension to the scope of the Standard and the implications that this has for the measurement of liabilities. Please refer to our response to question 1.

We do however support the application of the expected cash flow approach as an appropriate basis for measuring a non-financial liability.

7 Reimbursements

The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the economic benefits that will be required to settle a non-financial liability, it recognises the reimbursement right as an asset if the reimbursement right can be measured reliably (see paragraph 46).

Do you agree with the proposed amendment to the recognition requirements for reimbursements? If not, why not? What recognition requirements would you propose and why?

We agree with the proposed amendments to the recognition of reimbursement rights.

We note that the Exposure Draft specifies that the amount recognised for a reimbursement right shall not exceed the amount of the non-financial liability. In circumstances where reimbursement does exceed the amount of the non-financial liability then should an intangible asset be recognised? For example – an insurance claim for loss of profits following a fire is not accompanied by a liability – does such an item meet the definition of an intangible asset? We consider further guidance is required in the area of intangible assets.

8 Onerous contracts

The Exposure Draft proposes that if a contract will become onerous as a result of an entity's own action, the liability should not be recognised until the entity takes that action. Hence, in the case of a property held under an operating lease that becomes onerous as a result of the entity's actions (for example, as a result of a restructuring) the liability is recognised when the entity ceases to use the property (see paragraphs 55 and 57). In addition, the Exposure Draft proposes that, if the onerous contract is an operating lease, the unavoidable cost of the contract is the remaining lease commitment reduced by the estimated sublease rentals that the entity could reasonably obtain, regardless of whether the entity intends to enter into a sublease (see paragraph 58).

(a) Do you agree with the proposed amendment that a liability for a contract that becomes onerous as a result of the entity's own actions should be recognised only when the entity has taken that action? If not, when should it be recognised and why?

(b) Do you agree with the additional guidance for clarifying the measurement of a liability for an onerous operating lease? If not, why not? How would you measure the liability?

(c) If you do not agree, would you be prepared to accept the amendments to achieve convergence?

We agree with the proposed amendment that a liability for a contract that becomes onerous as a result of the entity's own actions should be recognised only when the entity has taken that action. We also agree with the additional measurement guidance.

9 Restructuring provisions

The Exposure Draft proposes that non-financial liabilities for costs associated with a restructuring should be recognised on the same basis as if they arose independently of a restructuring, namely when the entity has a liability for those costs (see paragraphs 61 and 62).

The Exposure Draft proposes guidance (or provides cross-references to other Standards) for applying this principle to two types of costs that are often associated with a restructuring: termination benefits and contract termination costs (see paragraphs 63 and 64).

(a) *Do you agree that a liability for each cost associated with a restructuring should be recognised when the entity has a liability for that cost, in contrast to the current approach of recognising at a specified point a single liability for all of the costs associated with the restructuring? If not, why not?*

(b) *Is the guidance for applying the Standard's principles to costs associated with a restructuring appropriate? If not, why not? Is it sufficient? If not, what other guidance should be added?*

We agree that a liability for each cost associated with a restructuring should be recognised when the entity has a liability for that cost. We consider that the additional guidance is sufficient.

Section D: Exposure Draft of Proposed Amendments to IAS 19 Employee Benefits

1 Definition of termination benefits

The Exposure Draft proposes amending the definition of termination benefits to clarify that benefits that are offered in exchange for an employee's decision to accept voluntary termination of employment are termination benefits only if they are offered for a short period (see paragraph 7). Other employee benefits that are offered to encourage employees to leave service before normal retirement date are post-employment benefits (see paragraph 135).

Do you agree with this amendment? If not, how would you characterise such benefits, and why?

We agree with the principle that termination benefits are only termination benefits if offered for a short period of time.

2 Recognition of termination benefits

The Exposure Draft proposes that voluntary termination benefits should be recognised when employees accept the entity's offer of those benefits (see paragraph 137). It also proposes that involuntary termination benefits, with the exception of those provided in exchange for employees' future services, should be recognised when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria (see paragraph 138).

Is recognition of a liability for voluntary and involuntary termination benefits at these points appropriate? If not, when should they be recognised and why?

In proposing that the liability for voluntary termination benefits should be recognised when the employee accepts the entity's offer of those termination benefits "acceptance" is considered to be the point that obligates the entity. An alternative view is that the "offer" of termination benefits to an employee obligates the entity when it is made, and so a constructive obligation arises at that time, rather than when acceptance of the offer is received. In our view the voluntary termination benefits should be recognised when the offer is made.

3 Recognition of involuntary termination benefits that relate to future service

The Exposure Draft proposes that if involuntary termination benefits are provided in exchange for employees' future services, the liability for those benefits should be recognised over the period of the future service (see paragraph 139). The Exposure Draft proposes three criteria for determining whether involuntary termination benefits are provided in exchange for future services (see paragraph 140).

Do you agree with the criteria for determining whether involuntary termination benefits are provided in exchange for future services? If not, why not and what criteria would you propose? In these cases, is recognition of a liability over the future service period appropriate? If not, when should it be recognised and why?

We agree with the three criteria specified in paragraph 140.