EFRAG
European Financial Reporting Advisory Group

23 July 2004

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

Dear David,

Re: Exposure Draft of Proposed Amendments to IFRS 3 Business Combinations:
Combinations by Contract Alone or Involving Mutual Entities

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of proposed Amendments to IFRS 3 *Business Combinations: Combinations by Contract Alone or Involving Mutual Entities* ("ED Proposed Amendments to IFRS 3"). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

ED Proposed Amendments to IFRS 3 deals with combinations involving two or more mutual entities and combinations in which separate entities are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest. We understand that the objective of the exposure draft is to avoid the continued application to such combinations of either the pooling of interest method or the purchase method as defined by superseded IAS 22 *Business Combinations* until further guidance on applying the purchase method to such transactions is developed.

On balance we agree with the abolition of the pooling method and the fact that combinations by contract alone and involving mutual entities are within the scope of IFRS 3 *Business Combinations*. We believe that the general requirements of IFRS 3 should be applicable in principle to all acquisitions and only in cases where it is impractical to determine the cost of the acquisition should the modified purchase method as proposed by the ED Proposed Amendments to IFRS 3 be applied.

We have some concerns, however, with regard to the application of the “modified purchase method” and the transitional requirements, to which we refer in our response to the questions raised in the exposure draft as set out in the appendix.

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely,

Stig Enevoldsen,
EFRAG Chairman

EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IFRS 3 BUSINESS COMBINATIONS:
COMBINATIONS BY CONTRACT ALONE OR INVOLVING MUTUAL ENTITIES

Question 1

The Exposure Draft proposes:

(a) to remove from IFRS 3 the scope exclusions for business combinations involving two or more mutual entities and business combinations in which separate entities are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.

(b) to require the acquirer to measure the cost of a business combination as:

(i) the aggregate of the following amounts when the combination is one in which the acquirer and acquiree are both mutual entities:

• the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities; and

• the fair value, at the date of exchange, of any assets given, liabilities incurred or assumed, or equity instruments issued by the acquirer in exchange for control of the acquiree.

Therefore, goodwill would be recognised in the accounting for such transactions only to the extent of any consideration given by the acquirer in exchange for control of the acquiree.

(ii) the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities when the combination is one in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest. Therefore, no goodwill would arise in the accounting for such transactions.

Is this an appropriate solution to the accounting for such transactions until the Board develops guidance on applying the purchase method to such transactions as part of a subsequent phase of its Business Combinations project? If not, what other approach would you recommend as an interim solution to the accounting for such transactions, and why?

EFRAG response:

ED Proposed Amendments to IFRS 3 is an extension of the scope of the only recently issued IFRS 3 *Business Combinations*. We understand that the Board was not fully satisfied with the lack of solutions in IFRS 3 (as published on 31 March 2004) for the two types of combinations subject to this exposure draft. This would have resulted in the continuing application of the pooling method and the existence of two different purchase methods until further guidance on the application of the purchase method has been developed. We therefore agree with the objective of this exposure draft to scope such transactions into IFRS 3 until such time as additional guidance is developed.

We are concerned, however, that the way the Board has chosen to deal with this problem is effectively to invent another version of the purchase method, involving no – or only minimal – goodwill, and prohibiting the capitalisation of costs directly attributable to the combination. We believe that the Board would do better to integrate its proposals more closely with the existing IFRS 3 requirements. It is clear that the existing text of paragraph

24 of IFRS 3 does not provide a basis for calculating the cost of a combination in which no cash or other assets are given and no liabilities assumed or shares issued by the acquirer. That does not mean, however, that no value can be attributed to the consideration in a combination of two entities by contract alone. For example, if – as is often the case – the combined enterprise is a quoted company, a value for the consideration could be calculated by reference to the value of the portion of the combined enterprise allocated under the contract to the former shareholders of the company deemed to have been acquired. For such cases the cost capitalisation rule of paragraph 24 should be applicable.

As a consequence we believe that the purchase method as required by IFRS 3 should be applicable in all cases. Only if it is impracticable to measure the cost of the acquisition reliably the modified purchase method as described in the ED *Proposed Amendments to IFRS 3* should be applied, which requires the total of the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities and any reliably measurable consideration given in exchange for control of the acquiree to be treated as the deemed cost of the combination.

For these cases we recommend the Board to amend the new paragraph 31B, which states that costs directly attributable to the combination (e.g. professional fees paid to accountants or other consultants) shall be recognised as an expense in profit or loss in the period in which they are incurred, and allow the general cost capitalisation rule of IFRS 3 paragraph 24 and require any costs directly attributable to the business combination to be included in the deemed cost of the business combination

Although we agree with the abolition of pooling in general, we repeat our concern expressed when we finally commented on IFRS 3, that in our view there are merger situations where it is difficult to justify the purchase method. Particularly in cases where mutual or co-operative entities are involved in a combination it is arbitrary to identify an acquirer since most combinations are rather mergers than acquisitions. In such combinations it is mainly the case that entities are brought together without one entity obtaining control over the other entities. The objective of such combinations is the uniting of interests rather than a take over and therefore the application of the (modified) purchase method and the need to identify an acquirer is not appropriate and would not result in improved information. We again urge the Board to consider an alternative accounting method for business combinations where the purchase method is not the most suitable method.

Question 2

The Exposure Draft proposes that no amendments be made to the transitional and effective date requirements in IFRS 3. This would have the effects set out in paragraph 6(a)-(c) above on the accounting for business combinations in which the acquirer and acquiree are both mutual entities or in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.

Is this appropriate? If not, what transitional and effective date arrangements would you recommend for such business combinations, and why?

EFRAG response:

ED Proposed Amendments to IFRS 3 proposes the same transitional and effective date requirements as IFRS 3. We appreciate that IASB's intention was to avoid the application of different accounting methods for business combinations of such types, which could be the case if the exposure draft had a later effective date than IFRS 3.

However, we have serious reservations with the approach of introducing new standards or amendments to existing standards which have an effective date even before the date of publication of the relevant exposure draft. This is in contrast to the legislative process in most European jurisdictions, where prospective application is the basic principle.

We are therefore seriously concerned that entities could be faced with a situation where decisions made under certain assumptions based on current accounting requirements would have been made differently if the change of accounting requirements – having a retrospective application date – would have been available at that date. In order to make sure that entities are able to have a stable set of standards and interpretations at the moment when decisions, e.g. with regard to a business combination, have to be made, we strongly urge the Board not to backdate the application date of standards as a principle.