



The South African Institute of Chartered Accountants

31 July 2004

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Dear Ms Kimmit

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

In response to your request for comments on the exposure draft of *Proposed Amendments to IFRS 3 Business Combinations – Combinations by Contract Alone or Involving Mutual Entities*, attached please find the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but is also secretariat for the Accounting Practices Board, the official accounting standard setting body in South Africa.

We thank you for the opportunity to provide comments on this document. We have, in addition to our response to the questions raised, also included general comments on aspects not specifically dealt with in the questions.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Yusuf Hassan
Project Director: Members advice and Research

cc: Doug Brooking (Chairman of the Accounting Practices Board)
Prof. Geoff Everingham (Chairman of the Accounting Practices Committee)

SAICA COMMENT ON PROPOSED AMENDMENTS TO IFRS 3 BUSINESS COMBINATIONS – COMBINATIONS BY CONTRACT ALONE OR INVOLVING MUTUAL ENTITIES

GENERAL COMMENTS

1. As you are aware, South Africa has adopted IFRS, and SAICA has issued IFRS 3 - *Business Combinations* as a South African Statement of Generally Accepted Accounting Practice (GAAP), with the standard affecting business combinations where the agreement date is on or after 31 March 2004. The proposals in the exposure draft that amends IFRS 3 will thus impact South Africa, as an IFRS-adopter, in so far as these transactions are encountered in our environment. The proposals, if approved in the current form, would be applicable with immediate effect and would require application as of the effective date. This may cause problems for companies in that it would effectively be a retrospective application of the requirements.
2. As far as we are aware, business combinations by contract alone or involving mutual entities, are very rarely encountered in South Africa. As a result, this exposure draft is expected to have limited impact in the South African context. In contrast, common control transactions are very prevalent and, if anything, this is where we believe the IASB should be focussing their urgent attention.
3. In presenting our views, we have approached the comments to the exposure draft and its related questions based on the principles established in IFRS 3.
4. We agree that combinations by contract alone or involving mutual entities should be within the scope of IFRS 3. However, we disagree with the proposed amendments to IFRS 3, for the following reasons:
 - 4.1 We are concerned that the proposed amendment occurs so soon after the issuance of the standard and proposes a less-than-perfect interim solution, which will possibly be changed when the Board redeliberates on this issue in phase II of business combinations.
 - 4.2 The proposals do not provide comprehensive guidance on implementation issues. The proposals do not dispel uncertainties as to the identification of the acquirer in these types of combinations and also do not deal with the practical accounting issues of the combination.
 - 4.3 The proposals in the exposure draft could enable entities to structure future business acquisition transactions as that of a contract alone, to avoid the recognition of goodwill. This may cause confusion amongst users who may not be able to distinguish between combinations by contract alone as opposed to the typical parent-subsidiary combination.

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4.4 The proposed effective date may force companies to retrospectively apply the provisions, which may be:

- impracticable,
- costly to obtain information, or
- or costly to adapt accounting systems to account for the changes.

4.5 Since the FASB also intends to address this issue as part of the phase II of their business combinations project, we believe that the proposals of this exposure will introduce a difference between IFRS and US GAAP. This raises concerns that decisions are being taken by the Board, in connection with these types of transactions, unilaterally and at a different time to the FASB. In our view, the amended guidance should be concurrently issued by both Boards.

5. Although we principally disagree with the interim measure, we agree that a short-term solution would prevent the identified transactions not being dealt with in IFRS, and thus address the treatment of the identified transactions, albeit only as a temporary measure. We also appreciate that the prescription of the modified purchase method proposed in the exposure draft would prevent further use of the pooling of interest method, of which the Board disapproves.
6. We strongly recommend that more urgent consideration be given to addressing issues of business combinations involving common control.

In summary, we agree that combinations by contract alone or involving mutual entities should be within the scope of IFRS 3. However, we disagree with the proposals of the exposure draft. The interim solution would result in far more ramifications for implementation than it is intended to address. The effective date of March 2004 may have serious implications for existing IFRS - adopters in particular. The Board should rather consider revisiting this issue as part of Phase II.

SPECIFIC COMMENTS ON QUESTIONS RAISED

Question 1 – Scope exclusion

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:*

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- (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 interim 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?

We do not believe that the interim solution is appropriate. The exposure draft gives the impression that this amendment is intended to be temporary only, until the Board reconsiders the treatment for these types of business combinations in phase II of the project. It would be inappropriate to require companies to change their accounting treatment in the short-term, when changes to that treatment would be forthcoming in the short to medium term. It is further noted that the Board did not prescribe an interim measure for the insurance and extractive industries.

Our concerns over the interim measures are as follows:

- ***No clear guidance on identifying the acquirer*** – There is no clear guidance on identification of the acquirer for these specific transactions. IFRS 3 provides limited guidance for identifying an acquirer, but this would not dispel the uncertainty of who the acquirer actually is when combinations occur by contract alone or between mutual entities.
- ***Different measurement bases for acquirer and acquiree*** – The proposal assumes that benefits by the combining entities are shared in proportion of the historic cost of the net assets of the acquirer to the fair value of the net assets of the acquiree. There is a potential miss-match in the combined entity where the acquirer is measured at historical cost against the fair-value measured acquiree. Due to this, the acquirer's assets may be smaller than that of the acquiree, with the result that there is difficulty for the user to identify who the acquirer actually is.

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- ***Inconsistent treatment of goodwill*** – The treatment of the cost of the combination and the resultant goodwill is also not consistent with IFRS 3 as firstly it deems a value for the cost of the combination and, with mutual entities, permits the recognition of goodwill while with combinations where entities are brought together by contract alone, does not require the measurement of goodwill. The inconsistent recognition of goodwill may be confusing to users.
- ***Inconsistent treatment of costs*** – The treatment of acquisition costs also significantly differs from IFRS 3, which permits the capitalisation of such costs while the amendment requires the expensing thereof. We understand however that the proposed treatment of acquisition costs is driven by the requirement to avoid goodwill recognition.
- ***Treatment of existing goodwill*** – The recognition of previously acquired goodwill in the acquiree's balance sheet is not catered for by the exposure draft. Existing goodwill that was acquired as part of another business combination would not qualify as identifiable assets and would therefore not be included, either in the cost of the acquirer or fair value of the acquiree, in all subsequent combinations of this nature.
- ***Practical application*** – The proposals do not provide guidance on how the accounting for such transactions would work in practice. The treatment of the credit entry on the combination for the transaction is not specified, and one would assume that the credit be taken to equity, but no guidance is provided hereon.

Despite our views, it may be considered that the adoption of this interim measure will create a degree of uniformity where such uniformity did not previously exist. However, should the proposals in the exposure draft be adopted, we recommend the following:

- Detailed guidance and examples should be provided on the identification of the acquirer.
- Implementation guidance should be provided that details the appropriate accounting treatments for these types of combinations, which should include a post-combination set of financial statements of the combined entity.
- Guidance should be provided to address the subsequent reconstruction of a group established by contract alone in contrast to the typical parent/subsidiary combination.

Question 2 – Transition and effective dates of IFRS 3

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?

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The use of the IFRS 3 effective date for this amendment may create practical problems as combinations involving mutual entities and by contract alone combinations may have already been entered into since the effective date, and it could be difficult to apply the provisions of this proposal retrospectively. Those entities who are already IFRS adopters may encounter further practical problems in the transition to the requirements of the exposure draft.

In terms of due process limited amendments to standards, such as the one proposed in this exposure draft, should be better timed in future, due to the enormity of the tasks of retrospective application.

Should the proposals be approved, we recommend that either:

- the effective date be postponed to a date later than 31 March 2004; or
- that concessions be made for existing IFRS - adopters.

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