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International Accounting Standards Board
30 Cannon Street
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United Kingdom

Comments on "ED3 BUSINESS COMBINATIONS," and AMENDMENTS to IAS 36, "IMPAIRMENT OF ASSETS," and IAS 38, "INTANGIBLE ASSETS"

Dear Sir or Madam;

We, the Japanese Institute of Certified Public Accountants, are pleased to comment on ED3 Business Combinations ("ED3"), an amendment to IAS 36 Impairment of Assets (the "Amendment to IAS 36") and an amendment to IAS 38 Intangible Assets (the "Amendment to IAS 38"). We support the proposed accounting standard for business combinations, which adopts the purchase method and eliminates the pooling of interests method, subject to a comment as described in paragraph, "Method of accounting." We also support the proposed recognition and measurement criteria for intangible assets and the impairment of assets other than goodwill.

Our comments below principally relate to three issues. First, we present our comments on the proposed ED3 standard which eliminates the amortization of goodwill resulting from a business combination. Secondly, we disagree with the proposed standard which requires the acquirer to measure the cost of a business combination at the fair value of equity instruments issued by the acquirer as of the date of the exchange. Thirdly, we comment on the fair value measurement of contingent liabilities assumed by the acquirer after their initial recognition.

Method of accounting

It is not appropriate to use the purchase method, which requires identifying one of the combining entities as the acquirer in the case of a true merger, since the purchase method does not reflect the substance of a true merger. In the case of a true merger, the new entity created as a result of the merger is clearly different from the combining entities, if one of the combining entities does not obtain control of the other combing entity or entities. In order to reflect a transaction such as a true merger, the "fresh start method" is considered to be one of the acceptable methods. However, the fresh start method is not currently adopted in accounting for business combinations. It is essential that all potential issues upon application be taken into consideration before accounting for a true merger is adopted. In this context, we agree that the Board has committed itself to exploring whether or not the fresh start method might be applied to some business combinations. We recommend that the Board accelerate deliberations on the fresh start method (or other alternatives, if any) to apply to such business combinations.

Goodwill

ED3 proposes that goodwill acquired in a business combination be recognized as an asset, but not amortized after acquisition. Instead, it proposes that, after initial recognition, goodwill be accounted for at cost less any accumulated impairment losses.

We recommend that acquired goodwill be subject to amortization. Certain types of goodwill apparently have specific useful lives. For example, the acquisition cost of an investment reflects a certain value representing the acquiree's list of customers which was created before the business combination and also representing business activities to maintain the quality of the relationship with these customers. If some of these customers were replaced by new customers, the turnover from the new customers could be reasonably estimated to determine the useful life of the goodwill. Even if the useful life cannot be reasonably estimated, the value of the goodwill acquired will decrease proportionally with the passage of time. Accordingly, it is necessary to amortize goodwill in order to reflect this decline in value. As ED3 states, if the goodwill presented in the assets on the balance sheet of the acquirer is not amortized it may be replaced by internally generated goodwill. The recognition of internally generated goodwill as an asset would not be consistent with the general prohibition against such recognition under current accounting practices.

The issue that the use of an arbitrary useful life or the recognition of amortization may provide the users of the financial statements with no significant value would be rectified, if the useful life and the amount of the amortization of goodwill were properly disclosed. We do not believe that the determination of a useful life based on management's judgment and the amortization of goodwill over that period could deteriorate the transparency and reliability of the financial statements. Rather, we believe that presentation in the financial statements of the amortization of goodwill acquired contributes valuable information to the users who can then make an appropriate evaluation of the return on any investment in the acquiree's business. Therefore, we suggest that the limit of the useful life of goodwill and its amortization as stipulated in IAS 22 be included in ED3.

Further, from a practical point of view, an impairment loss on unamortized goodwill should be tested at regular intervals (at least once a year) by the same method as that applied to other long-lived assets under the Amendment to IAS 36, rather than by the complicated two-step method which compares the carrying value of goodwill with the implied value.

The Amendment to IAS 36, as stated in Paragraph 85, proposes that a test of impairment of goodwill be made in two steps. The two-step method is proposed that given the nature of goodwill and the fact that its non-amortization increases the reliance that must be placed on impairment testing, a more rigorous impairment test is justified for goodwill than for other assets. On the other hand, if the first step does not indicate an impairment of the unit, the carrying amount of the goodwill would be regarded as unimpaired under the two-step method. If the second step is performed in these circumstances, the implied value of the goodwill might be lower than the carrying amount. As a result, the proposed method may not enable the acquirer to identify clearly an incidence of impairment of goodwill. We believe that cost involved in adopting such a complex method as the one proposed exceeds any achieved benefit.

In addition, the impairment test for goodwill is not consistent with that for other long-lived assets proposed by the Amendment to IAS 36. We believe that any impairment test for goodwill should be applied in a manner consistent with that applicable to other long-lived tangible and intangible assets.

Measurement date for the cost of a business combination

Paragraph 23 of ED3 proposes that the cost of a business combination be measured *at the fair values of assets given, liabilities incurred, and equity instruments issued at the date of exchange. (Italics added)*

We suggest that the cost of a business combination be measured at the market value as of a few days before the date on which the number of shares to be issued is agreed to, if the business is being acquired in exchange for marketable shares issued by the acquirer.

The determination of the cost of a business combination is made at the time when the number of shares to be issued as the consideration for the acquired business is agreed to, but not based on the fair value prevailing at the date of exchange of the shares issued by the acquirer. Price fluctuations in the acquirer's shares during the period from the date on which the number of shares to be issued has been determined to the date of exchange do not directly relate to a change in the fair value of the acquired business. Once the share exchange ratio has been fixed, the ratio of the share price of the acquirer to that of the acquiree begins to converge to the established fixed ratio as a result of arbitrage in the market. However, the resulting market value of the share prices of both the acquirer and the acquiree at the date of exchange does not represent the fair value of the acquired business upon acquisition.

Acquiree's contingent liabilities

Paragraph 46 of ED3 proposes that contingent liabilities recognized in accordance with Paragraph 35 be measured at fair value after their initial recognition.

Although we agree that the contingent liabilities assumed in a business combination should be recognized as liabilities and measured at fair value as of the date of their initial recognition, we suggest that the measurement after initial recognition be based on other IAS standards, or be determined by current accounting practices if a specific standard does not exist, rather than at the fair value, as measured, of all contingent liabilities assumed in exchange for the consideration received. The requirement to initially measure the contingent liabilities assumed at fair value is a completely different matter from carrying them at fair value on an ongoing basis, which goes beyond the scope of accounting for the business combination. We believe that the measurement of contingent liabilities after their initial recognition should be determined by current accounting standards or practices. In addition, it would be impracticable in some cases for fair value measurement after initial recognition to be required. For example, recognized tax exposure liabilities assumed in exchange for consideration received should not subsequently be remeasured at fair value. They should not be remeasured until the conditions to recognize the provision are met. In this case, the measurement of the contingent liabilities after their initial recognition that does not meet the conditions should not be subject to the application of IAS 37. Otherwise, even if contingent liabilities incurred in connection with a business combination were recognized and measured at fair value, these might immediately be reversed in accordance with IAS 37.

Other

Paragraph 36 of ED3

Paragraph 36 proposes that the acquiree's assets and liabilities be separately recognized if they satisfy the criteria shown from (a) through (d). Except for intangible assets as shown in (c) and contingent liabilities as shown in (d), the criteria (a) and (b) mean that only those items which satisfy the definition of assets or liabilities should be recognized as assets or liabilities.

We suggest that the Paragraph 36 be rewritten as follows:

"The acquirer shall recognize separately the acquiree's identifiable assets and liabilities at the acquisition date only if they satisfy the definition of assets or liabilities, or the criteria for recognition under the related standards, except for: (a) non-recognition of an intangible asset representing an assembled workforce (even if it meets the definition of an asset), and (b) recognition of a contingent liability whose fair value can be measured reliably (despite the related provisions of IAS 37).

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We would be pleased to discuss any aspect of this letter with the IASB or its staff at your convenience.

Very truly yours,

Michiyoshi Sakamoto
Chairman
Technical Committee for IASB