Swiss Re

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4 April 2003

Comments to Exposure Draft 3 Business Combinations

Dear Annette

It is our pleasure to accept your invitation to comment on the IASB's exposure draft on Business Combinations (phase I). Swiss Re Group's financial statements are published in accordance with Swiss GAAP (FER), but some of our subsidiaries, as well as a number of our clients use IAS as their reporting standards. Therefore, we along with the Swiss standard setters, place significant importance on achieving convergence to IAS.

Swiss Re, whose global operations are present in more than 30 different countries, is exposed to accounting regulations issued by many different national standard setters and regulatory authorities. We strongly support the harmonisation of national accounting frameworks and the elimination of options in existing accounting standards.

Our comments are as follows:

1. Provisions for terminating or reducing the activities of the acquiree

We do not agree that liabilities for terminating or reducing the activities of the acquiree should be recognised by the acquirer as part of allocating the cost of the business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 for the following reasons:

- We believe that financial statements excluding restructuring charges from the combined entity's earnings would be more relevant to, and therefore demanded by, most users. The recognition of provisions for restructuring in the earnings of the combined entity would perpetuate the practice of using non-IAS compliant pro-forma income statements.

- We perceive a similarity between the principles underlying the recognition of restructuring provisions as part of the cost of a business combination and the recognition of the effect of changes in accounting principles in retained earnings.

- An estimate of the acquiree's fair value prepared by the acquirer would include the impact of restructuring costs to be incurred as a result of the acquisition.

Therefore, we favour allowing the inclusion of restructuring provisions in the calculation of goodwill regardless of whether or not these costs were recognised by the acquiree at the acquisition date. However, we would suggest that restructuring provisions included in the cost of a business combination, as well as any subsequent changes to these provisions, be subjected to clear disclosure requirements.

2. Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

2.1 Calculation of Goodwill

IAS 22 includes a benchmark and an allowed treatment for the initial measurement of the identifiable net assets acquired in a business combination, and therefore for the initial measurement of any minority interests. We agree with the Board that permitting similar transactions to be accounted for in dissimilar ways impairs the usefulness of the information provided to users of financial statements. The benchmark treatment in IAS 22 effectively results in a proportionate approach to consolidation. Such an approach would not be consistent with the requirements of IAS 27. More precisely, under IAS 27, the consolidated financial statements of a group are intended to reflect the performance of that group and the resources under the control of the parent entity, irrespective of the extent of ownership interest held.

Therefore, we agree with the Board that, with the exception of goodwill, 100 percent of a subsidiary's assets and liabilities are included in the consolidated financial statements from the date on which the parent obtains control of that subsidiary, irrespective of the ownership interest held in the subsidiary.

We acknowledge that the requirement to recognise only the amount of goodwill acquired by the parent based on the parent's ownership interest, rather than the amount of goodwill controlled by the parent as a result of the business combination, represents an exception to the recognition requirements for all other assets and liabilities acquired. We also understand that the Board plans to reconsider the above requirement as part of the second phase of the Business Combinations project.

We would, however, prefer if the guidance on goodwill recognition were finalised in the current ED 3. We support the proposal to recognise only the amount of goodwill acquired by the parent based on the parent's ownership interest, and believe that recognising the entire amount of goodwill controlled by the parent is not a viable option for the following reasons:

- The calculation of the additional goodwill would require an assumption about the amount of the additional purchase consideration for 100% control of the acquiree. This assumption may lead to an unrealistic measurement of the additional goodwill. For example, the average price per share for acquiring 90% of the subsidiary's stock may be higher than the average price per share for acquiring 51% of the subsidiary's stock. This may be due to the value attached to the ability of minority shareholders to block certain actions of the controlling shareholder.

- A remeasurement issue would arise if the parent first acquired less than 100% of the voting rights and obtained full control in a subsequent accounting period.

2.2 Allocation of goodwill to cash-generating units

The proposed amendment to IAS 36 states that goodwill can only be allocated to a cash-generating unit (CGU) on a consistent basis when that CGU is the lowest level at which management monitors the return on investment on assets that include that goodwill (which must be at least segment level).

We strongly agree with the Board that there should be a link between the level at which impairment is tested and the level at which an entity manages its operations. By aligning the level at which impairment is tested with the level that management operates and measures its business, the Board will achieve its aim of goodwill being tested at the level to which goodwill is naturally associated. In addition, this will avoid an unnecessary increase in the reporting burden, where testing may have been required to be performed at a level lower than that used by management to steer business operations. We would however wish the Board to consider that the asset base on which management measures return may not include goodwill.

3. Identifying a business combination

Under paragraph 4 of ED 3, a business combination may involve the assumption of the liabilities of another entity. In our opinion, a transaction that solely involves the assumption of the liabilities of another entity should not be presumed to give rise to a business combination.

For example, the market for closed blocks of in-force insurance business has grown substantially over the past few years. Closed blocks of in-force insurance business can be facilitated through either an acquisition or reinsurance agreement. The purchase of a closed block of business does not ordinarily include the transfer of any of the seller's personnel or tangible assets. Thus, the portfolio of insurance policies transferred cannot "operate" independently from the business organisation of the seller or the purchaser in the transaction. Therefore, it cannot be considered a business.

We suggest that the Board revises the criteria for identifying a business combination to prevent the assumption of liabilities from being treated as a business combination.

4. Contingent consideration

The guidance on recognition of contingent consideration under ED 3 - Business Combinations is inconsistent with the principles underlying ED 2 - Share-based Payments. Under ED 2, a compensation expense must be recognised for the fair value of stock-based compensation at the date of grant. This contradicts the requirement under ED 3 to include the expected amount of contingent consideration in calculating goodwill only when the amounts are probable and can be reasonably estimated.

5. Consolidated insurance assets and liabilities at fair market value

The exposure draft proposes that, at inception, all assets acquired and liabilities assumed in a business combination should be recorded at their fair market values. However, in the absence of an IAS standard on insurance accounting, it would be difficult to determine the fair value of insurance liabilities.

Fair-valuing insurance liabilities on acquisition would also create an inconsistency with the subsidiary's stand-alone financial statements where insurance liabilities are not discounted.

We therefore suggest that the Board considers granting an exemption to preparers from valuing assets and liabilities at market value on acquisition if no current guidance on the measurement of those assets and liabilities exists.

6. Disclosure requirements

The ED of proposed amendments to IAS 36 and IAS 38 includes extensive additional disclosure relating to goodwill. The proposal includes disclosing the amount by which the recoverable amount exceeds the carrying amount, details of key assumptions and sensitivities of these assumptions. This disclosure significantly exceeds that required under US GAAP.

A stated aim of the Board is, where appropriate, to obtain convergence with US GAAP. Goodwill and related disclosure is once such area where we believe convergence of all international reporting would benefit users of financial statements. We believe the Board should move towards the level of US GAAP disclosure rather than require the additional disclosures contained within the exposure draft. Requiring equivalent disclosure will assist in the harmonisation of financial reporting, and provide users with comparable financial information across accounting jurisdictions.

We appreciate the Board's efforts in preparing the exposure drafts on Business Combinations and would like to thank you for giving us the opportunity to comment on the proposals. We would be happy to lend our support to any future discussions. We also would be pleased to discuss with you at your convenience any questions or issues that you may have concerning our letter (please contact Alexandre Hristov on +41 43 285 2547 or John Karvellas on +41 43 285 2234).

Best regards,

George Quinn
Chief Accounting Officer