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28 July 2004

Dear Ms Kimmit

Proposed amendments to IFRS 3 Business combinations: Combinations by contract alone or involving mutual entities

1. With a membership of in excess of 37,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies that form the Institute of Chartered Accountants in England & Wales. London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to issuing bodies such as yourselves.

2. We are pleased to have the opportunity to comment on the IASB's proposals in relation to IFRS 3.

Overall comments

3. Whilst we support the removal of the scope exclusion, we do not support the Board's proposed method of accounting when the transactions are brought within the scope of IFRS 3. In particular, we are not convinced that the solution proposed provides an improvement on the practice that would probably result from retaining the current

scope exclusion and believe that the exclusion should not be removed if the proposed accounting method is not amended.

4. We propose that the scope exclusion is removed and that goodwill is calculated based on the difference between the fair value of the acquired entity and the fair value of its identifiable assets, liabilities and contingent liabilities.

5. As a general comment, it is difficult to fully assess the Board's proposals in the exposure draft since there is a lack of explanation and reasoning. The Board has not justified or explained its proposals as to how the combinations to be brought within the scope of IFRS 3 should be accounted for.

Detailed comments

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 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?

6. IFRS 3, in paragraph three, states that the combinations referred to are outside its scope. It does not state how such combinations should be accounted for. The basis of conclusions of ED 3 (paragraph BC 146) stated that IAS 22 should continue to be applied to such combinations; this comment was not, however, carried over to the basis of conclusions in IFRS 3 itself.

7. In the absence of a particular standard dealing with an issue, users of IFRS are directed towards paragraphs 10-12 of IAS 8, 'Accounting policies, changes in accounting estimates and errors'. Paragraph 10 of IAS 8 requires management to use judgement in developing an accounting policy that is relevant and reliable. In considering this management should first consider the "requirements and guidance in Standards and Interpretations dealing with similar and related issues".

8. Since IAS 22 has been superseded and replaced by IFRS 3, one view is that management's application of IAS 8 will most likely lead to an accounting treatment that is based on the principles of IFRS 3. Others, however, appear to believe that IAS 22 continues to be relevant (particularly since the combinations in question are scoped out from IFRS 3). It is therefore likely that some confusion will arise in this area if combinations by contract alone or involving mutual entities continue to be excluded from the scope of IFRS 3.

9. We support the principles of IFRS 3 and believe that, pending a fuller review of accounting for combinations involving mutual entities and those by contract alone, these principles should be applied. If the exposure draft were to propose a removal of the scope exemption and an accounting treatment that is close to IFRS 3 then we would support it. The objective of IFRS 3 is that all business combinations should be accounted for using the purchase method. This involves recognising assets, liabilities and contingent liabilities at fair value and recognising goodwill.

10. The proposed accounting treatment in the exposure draft goes some way to achieving this objective. It ensures that all identifiable assets and liabilities, including intangible assets, and contingent liabilities are measured at fair value in accordance with IFRS 3. Where the exposure draft is in our view deficient, however, is that in the case of combinations by contract alone it does not measure goodwill at all and in the case of contracts involving mutual entities the goodwill is a somewhat arbitrary

number. The goodwill is the amount of consideration paid, regardless of the fair value of the net assets acquired (see further paragraph 16).

11. Assuming that business combinations are undertaken by willing, knowledgeable parties at arm's length, then it may be assumed that, in general, the fair value of what has been given is equal to the fair value of what has been received. In principle, the consideration for a business combination should be fair valued and the difference between this and the fair value of the identifiable assets, liabilities and contingent liabilities is goodwill. If the fair value of the consideration cannot be ascertained then it may be argued that the fair value of what is being acquired is a proxy. In this way, if IFRS 3 cannot be applied in full then the treatment proposed by the IASB should be that the acquired business is fair valued (as a proxy for the consideration) and the difference between this amount and the fair value of the identifiable assets, liabilities and contingent liabilities is goodwill. Some might argue that there are difficulties involved in valuing mutual entities. This may well be the case but there are no scope exemptions or different treatments when non-mutuals acquire mutual entities. And even though it might be argued that, in such circumstances, the consideration paid can be valued directly, nevertheless the acquirer must have had some basis for the amount it decided to pay. Presumably, therefore, acquirers are capable of valuing mutuals in such circumstances.

12. We note that there is some precedent for such an approach: IFRS 2, 'Share-based Payment' requires that the fair value of employee services paid for with share-based payment is calculated using an indirect method, that is, fair valuing the equity instruments granted. This method would appear to work equally well for combinations by contract alone or combinations involving two or more mutual entities.

13. Regarding the latter, we are not convinced that the method of attributing goodwill is at all satisfactory. In the first place, the party making a payment will not necessarily be the acquirer; the IASB does not appear to have considered this and what the result would be. Furthermore, it seems that this is not an appropriate method of calculating goodwill. The amount of goodwill will be based on a combination of the cash consideration and any other consideration, perhaps involving fair valuing both businesses. The exposure draft has not justified the method selected and it seems to us that it is partial and may even be misleading.

14. It may be that the IASB has considered alternative approaches (including that suggested in paragraph 13 above) and rejected them, and that it can also conceptually justify the approaches proposed. However, as noted in paragraph 3, there is no explanation or justification for the approach chosen. It is difficult, therefore, to consider fully what has been proposed. Nevertheless, absent practical issues, our proposal is that if the exemption from the scope of IFRS 3 is removed, goodwill is calculated based on the method set out in paragraph 13. Additionally, we recommend that the final standard gives guidance as to where any credit entry

resulting from combinations by contract alone or involving mutual entities should be recorded. We presume that it will be in equity but this should be stated.

15. If, however, the Board is of the view that our proposed method cannot be used then we would not recommend that the exemption from the scope of IFRS 3 is removed. This is because we believe that removal of the exemption combined with the exposure draft's proposals leads to a solution that is not superior to what might be used by combining entities applying IAS 8. In other words, we only support the removal of the exemption if the IASB produces a method of accounting that is closer to the principles of IFRS 3 than that proposed. However, given the potential for confusion and for the application of different treatments noted in paragraph nine of this response a statement should be added to IFRS 3 stating that although the combinations are excluded from the scope of IFRS 3, users should have regard to the principles of IFRS 3 when formulating accounting policies in relation to such combinations.

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?

16. No, we do not believe that this is appropriate. Our view is that if accounting standards are applied prospectively then it is for a good reason: that the cost of applying retrospectively would be prohibitive or there would be too much use of hindsight. The IASB set a precedent that is against this principle when it introduced IFRS 3: for first-time adopters the standard applies to combinations effected up to three months prior to the issue of the standard. This would be compounded if the proposed amendments to IFRS 3 were applied from the same point. Entities would be forced to apply a method of accounting to combinations that took place up to nine or ten months prior to the issue of the standard. We believe that this is not acceptable and that the amendment, if it is implemented, should apply only to combinations occurring after 1 January 2005. For those combinations occurring before then the transitional rules should make it clear that entities should have regard to paragraphs ten to twelve of IAS 8 (unless IFRS 3 is applied to combinations taking place from a particular date, in which case the amendments should also apply from this date). Provisions should also be made so that first-time adopters are not disadvantaged.

We hope that you have found our comments helpful. Should you wish to discuss them further please contact me at the address above or on 020 7466 2686.

Yours sincerely

Kathryn Cearns
Chairman
LSCA Technical Committee