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Ms Annette Kimmit
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London
EC4 M6XH

Dear Ms Kimmit

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

The global organisation of Ernst & Young is pleased to comment on the above Exposure Draft.

Unfortunately, for the reasons set out below, we are not able to support the proposed changes to IFRS 3.

Although we understand the objective of the Exposure Draft ('ED') is to avoid applying the superseded IAS 22 'Business Combinations' to combinations by contract alone and to combinations involving mutual entities, it is extremely unfortunate that an ED amending IFRS 3 'Business Combinations' was issued so soon – a mere 29 days after the publication of IFRS 3. Although we recognise the particular challenges posed by the need to put in place a comprehensive platform of standards in time for 2005, new standards should not be amended so soon after their issue unless absolutely essential. In this case, a new form of purchase accounting is proposed that raises issues of principle which are not discussed in the ED and considering the limited number of transactions concerned in this case, we do not regard the proposed amendments as essential we also question the appropriateness of the ED. We hope that in future new standards will not be issued until all known relevant issues have been properly addressed.

We are concerned that the following additional issues have not been appropriately considered:

- The difficulties in identifying the acquirer in the combinations proposed to be included within the scope of the ED.
- Business combinations involving both mutual entities and non-mutual entities.
- Where an acquirer can be identified in a combination involving a mutual entity, why a 'modified purchase method' is more appropriate than the current purchase accounting model.

We also believe that, pending the development of a new accounting method for such transactions, the pooling of interests method may seem preferable to purchase accounting in such circumstances. Without the amendment present in this ED, it would be possible to utilise the pooling method available through US GAAP by application of the hierarchy present in IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'. In this particular case, we would be supportive of changes to IFRS that are effected in tandem with the Financial Accounting Standards Board ('FASB') including, for example, the proposals present in the current FASB project on mutual entities.

Our responses to your detailed questions are included in the Appendix to this letter.

We would be pleased to discuss our views with the Board or staff at its convenience.

Please contact David Lindsell at 0207 980 0106.

Yours faithfully

Ernst & Young

Ernst & Young Global comments on ED of proposed amendments to IFRS 3 Business Combinations. Combinations by Contract Alone or Involving Mutual Entities.

Appendix: Responses to specific questions:

QUESTION 1

The Expose 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 transaction until the Board develops guidance on applying the purchase method to such transaction as part of subsequent phase of its Business Combinations projects? If not, what other approach would you recommend as interim solution to the accounting for such transactions, and why?

Purchase accounting as embodied in IFRS 3 is based on measurement of the cost of the acquisition to the acquirer. This basis does not exist in the case of certain combinations by contract alone or combinations involving mutual entities. The ED introduces a new form of purchase accounting for such combinations without explaining the rationale for the approach other than a decision to prohibit the pooling of interests method. It appears to us that the so-called 'modified purchase method' is in fact based on measuring what the acquiree is giving up in order to merge with the acquirer. This is fundamentally different from the rationale for purchase accounting. Furthermore, it is not clear why the measurement of the economic benefits given up by the acquiree should exclude goodwill.

In our comments letter to ED 3, 'Business Combinations' we indicated that we generally supported the Board's proposal to eliminate the use of the pooling of interests method of accounting for uniting of interests as an acquirer can be identified in almost all business combinations. However, we also indicated that we believed that there are indeed certain cases where either an acquirer cannot be identified or, by the very nature of the transaction, there is no acquirer. Such instances include combinations in which separate entities are brought together by contract alone without the obtaining of an ownership interest (for example, dual-listed corporations). The proposed "modified purchase method" will not help identify the acquirer. In the absence of guidance on the identification of the acquirer, the application of the ED will require arbitrary decisions that may lead to fundamentally different effects on the financial statements.

We do not believe that IFRS 3 should be amended to include a modified purchase method approach. When an acquirer cannot be identified in the aforementioned types of business combination the entities forming the structure will be directed to the IAS 8 hierarchy leading to the US GAAP accounting approach of the pooling of interests method which may be acceptable in particular circumstances. We understand that the FASB is currently undertaking a project addressing the accounting for mutual entities on a similar 'modified purchase accounting basis'. We may support future proposed changes for mutual entities when these are undertaken in tandem with the FASB incorporating similar effective dates etc. Removal of these entities from the scope of IFRS 3, effectively removes the possibility of entities applying the IAS 8 hierarchy. We agree with the Board that it is not possible and impracticable to return to accounting for these types of structures under IAS 22, as two methods of purchase accounting will emerge. However we also consider the modified purchase accounting method to be wholly inappropriate particularly for dual listed entities. Thus in the absence of a superior approach the status quo should be maintained allowing entities to use the pooling of interests method under the hierarchy until a more suitable accounting approach is developed in Business Combinations Phase 2.

Additionally, we believe the Board has been too swift in assuming that in all combinations by contract alone or all those involving mutual entities an acquirer cannot be identified. There is likely to exist some situations where purchase accounting is a reasonable approach to apply in such situations. Furthermore, we do not believe that the Board has considered the scenario of a non-mutual entity acquiring a mutual entity and vice versa and the resulting accounting treatment in these circumstances.

We have noted that no explanation is given for the requirement in paragraph 31b to expense the directly attributable acquisition costs. We do not understand why such a modification is required if such combinations are deemed to be acquisitions. We therefore do not support the proposal in this paragraph, the requirements of which appear inconsistent with IFRS 3, as we believe that the accounting for acquisition costs should be identical for all acquisitions.

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?

We note that the ED proposes the same transitional and effective date requirements as IFRS 3, which means that the revised Standard would be applicable from an earlier date than the point of time at which the ED was issued. Conceptually, the introduction of amendments with a retrospective effective date does not seem acceptable for quality standard setting. From a practical point of view, we are seriously concerned that, because of such retrospective application, entities presently engaged in combination negotiations cannot be certain which rules apply to the accounting of their contemplated transaction. We therefore strongly recommend that the Board not backdate the application of the amended Standard.