Hill House
1 Little New Street
London EC4A 3TR
United Kingdom

Tel: National +44 20 7936 3000
Direct Telephone: +44 20 7007 0907
Direct Fax: +44 20 7007 0158
www.deloitte.com
www.iasplus.com

Deloitte Touche Tohmatsu

16 July 2004

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David,

Exposure Draft of Proposed Amendments to IFRS 3 Business Combinations

Deloitte Touche Tohmatsu is pleased to comment on the International Accounting Standards Board's (the Board's or IASB's) Exposure Draft— *Amendments to IFRS 3 Business Combinations – Combinations by Contract Alone or Involving Mutual Entities* (referred to as the proposed amendments or the Exposure Draft). Our responses to the questions raised in the Exposure Draft and comments on specific matters of concern are set out in the Appendix to this letter.

We strongly disagree with the proposed amendments and the issuance of any standard arising from this Exposure Draft. The proposed amendments create an additional form of purchase accounting with different rules than those for other business combinations. We believe the proposals constitute an unsuitable short-term solution and believe it would be more appropriate to leave the standard unchanged until such time as adequate research into, and resolution of, the accounting issues created by such transactions is completed.

We urge the Board to proceed with its project on 'fresh start accounting' as we consider exploration of this possibility may assist in the identification of conceptually robust solutions to this issue.

We do not believe the late introduction of a new requirement should form part of the so-called 'stable platform'. If the Board proceeds with this project, we suggest any final standard be effective in 2006.

If you have any questions concerning our comments, please contact Ken Wild in London at (020) 7007 0907.

Sincerely,

Deloitte Touche Tohmatsu

Appendix
Comments of Deloitte Touche Tohmatsu on
Amendments to Business Combinations

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 interests*

(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 the 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 an interim solution to the accounting for the identified transactions is necessary. In addition, given the nature of certain of the transactions identified (i.e., transactions that do not involve consideration given), we do not believe that an appropriate accounting solution can be resolved without additional research. We note, however, that certain transactions involving control by contract, such as those involving dual holding companies, may involve consideration and, therefore, should be appropriately within the scope of IFRS 3.

In addition, we question the scope of the entities potentially impacted by the Exposure Draft and believe the Board should continue to focus on its project on 'fresh start accounting'. We have been unable to identify at this time an accounting methodology that would represent an appropriate short-term fix that resolves the issues of accounting for certain of the transactions identified. Accordingly, we believe such transactions should continue to be excluded from the scope of IFRS 3.

The more specific nature of our concerns is noted below.

Appendix
Comments of Deloitte Touche Tohmatsu on
Amendments to Business Combinations

Economics

While we believe that transactions are generally entered into for the mutual benefit of the parties involved, we do not believe that those benefits are necessarily enjoyed by the owners of the pre-existing entities in proportion to the historic cost of the acquirer and the fair value of the acquiree. The proposed method of accounting effectively presumes that the benefits are enjoyed in such proportions, by assuming that the fair value of the equity interest the acquiree is considered to obtain in the combined entity is equal to the fair value of the assets, liabilities and contingent liabilities they forfeit in joining the combined entity. In fact, having fair valued the acquiree, but not the acquirer, it is possible that the equity instruments in the combined entity attributable to the acquiree's interest may be likely to appear to be greater than those of the acquirer (which would simply be the historic cost of the acquirer's equity).

Additional Method of Purchase Accounting

The proposed measurement of the cost of combination does not represent the cost to the acquirer of entering into the transaction, it represents the cost to the acquiree of entering into the transaction. While we accept the rationale that the IAS 22 method of purchase accounting is different from that required by IFRS 3, we believe the Board have failed to acknowledge that the proposed method is also different in that it fails to take account of the costs of acquisition incurred by the acquirer. Such directly attributable costs do represent part of the cost to the acquirer of entering into the transaction. We believe more research is needed to determine the appropriate accounting for transactions that do not involve consideration given.

We believe the creation of an additional and new purchase method is misleading, in that it would encourage users in the belief that the transaction had been accounted for similarly to other transactions accounted for under IFRS 3 when in fact the converse is true.

Identification of Acquirer

We believe that the identification of the acquirer in transactions that do not involve consideration given may be difficult. We believe that the IASB should further research this issue and field test any proposals before proceeding with a final standard.

Credit side of entry

The Exposure Draft provides no guidance as to what the credit side of the entry should be in such an acquisition. To illustrate this issue numerically, if the acquiree has assets of 100 and liabilities of 20 and no contingent liabilities, the existing owners of the acquiree are considered to acquire equity of 80 in the acquirer. Because the assets and liabilities of the acquiree have been fair valued, and those of the acquirer retained at cost, it is possible that the equity section would show a higher value of equity attributable to the acquiree than is attributable to the acquirer, which does not reflect the substance of the transaction, nor the likely future profit distributions agreed in the business combination agreement.

Existing goodwill in the acquiree

We are also concerned that the proposals deny the combined entity any opportunity to recognise acquired goodwill existing in the books of the acquiree at the date of the acquisition. Under IFRS 3, the application of the purchase method effectively ensures that the value of any goodwill existing in the acquiree is recognised in goodwill on acquisition. Under the proposals, existing goodwill cannot be recognised, as the purchase consideration measurement would not include the existing goodwill.

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) – 6(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?

Further to the comments in our cover letter, we also believe the issuance of the Exposure Draft so soon after the release of IFRS 3 suggests this issue may not have been thoroughly considered and may undermine the credibility of the IASB. Given that the IASB was unable to resolve this issue as part of its Business Combinations Phase I project, the Board should have held consideration of this issue over to the next Phase of the project, rather than attempting to resolve this issue immediately after the issuance of IFRS 3.