EFRAG

European Financial Reporting Advisory Group

Dr. Alexander Schaub
Director General
European Commission
Directorate General for the Internal Market

1049 Brussels

4 June 2004

Dear Dr. Schaub,

Re: Adoption of IFRS 3 *Business Combinations*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of IFRS 3 *Business Combinations* (IFRS 3) as published by the IASB on 31 March 2004.

IFRS 3 is part of the first phase of a project which has the objective to improve the quality of the accounting for business combinations, for goodwill and intangible assets. The reasons for IASB issuing this standard was to reduce existing options established in superseded IAS 22 *Business Combinations* (IAS 22) and under national accounting regimes and to seek international convergence on the accounting for business combinations.

The main features of IFRS 3 are:

- to prohibit the use of the pooling of interests method and to require all business combinations within the scope of IFRS 3 to be accounted for using the purchase method,
- to have goodwill and intangible assets with indefinite useful lives to be tested for impairment on an annual basis instead of being amortised,
- to have restructuring costs treated as expenses, unless they are pre-existing liabilities of the acquired entity,
- to require intangible items acquired to be recognised as assets separately from goodwill if they meet certain criteria, and
- to measure initially at fair value identifiable assets acquired, liabilities and contingent liabilities incurred or assumed.

We regard it to be an improvement compared to IAS 22 *Business Combinations* that IFRS 3 eliminates the use of the pooling of interests method, which has been applied in the past to business combinations that were in many cases acquisitions to avoid goodwill amortisation costs and the restatement of assets and liabilities at fair values. Although we believe that there is a need for a specific accounting method other than purchase accounting in cases of real mergers, we also believe that such cases are rare and that IFRS 3 improves the general quality of information provided for business combinations. Further it improves comparability of financial statements in Europe and globally by converging international accounting policies.

In our comments on ED 3 *Business Combinations* we raised a concern that the required accounting for goodwill, the impairment-only method, does not recognise that in certain cases the useful life of acquired goodwill is definite and therefore amortisation over its useful life would be an appropriate and well established accounting principle. Further, the focus on an impairment test for goodwill emphasizes the need for judgment, e.g. the estimation of future cash flows. However, based on the amendments to the design of the impairment test (IAS 36 *Impairment of Assets*) EFRAG believes that the robustness of the test has been increased compared to the proposals in the Exposure Draft and therefore is supportive of the impairment-only approach for goodwill.
Nevertheless, we have one serious concern expressed in our comments on ED 3 *Business Combinations* which has not been alleviated by the final standard – the recognition requirements for certain assets and liabilities.

IFRS 3 establishes requirements which result in recognition of certain assets and liabilities in cases of business combinations, which would not be permitted to be recognised in any other circumstances, because they have to meet the probability requirement that the future benefits will flow to or from the acquirer, as established in the Framework. For example the requirement to recognise contingent liabilities and certain in-process research and development projects in business combinations is inconsistent (IFRS 3 Basis for Conclusion paragraphs BC96 and BC112) with the recognition criteria for assets and liabilities laid down in the Framework and, in the case of contingent liabilities, inconsistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. We believe that changes to general concepts and inconsistencies with existing standards should not be introduced in advance of a full review of recognition criteria in the Framework.

IFRS 3 will be effective for business combinations for which the agreement date is on or after 31 March 2004.

EFRAG has evaluated IFRS 3 including its Basis for Conclusions and the consequential amendments to other IFRSs. The evaluation is based on input from standard setters and market participants in accordance with EFRAG’s due process.

EFRAG conclusion

EFRAG believes that the improvements introduced by IFRS 3 compared to IAS 22 outweigh the concern raised in this letter and concluded that IFRS 3 meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards that:

i. it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
ii. it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

Based on the above considerations EFRAG, on balance, believes that it is in the European interest to adopt IFRS 3. It therefore recommends endorsement of IFRS 3 *Business Combinations*.

Nevertheless, EFRAG urges the IASB to work on (i) the adaptation of the Framework and (ii) the completion of the subsequent phases of this project in order to have a comprehensive and consistent standard on the accounting for business combinations in place as soon as possible.

Dissenting views

Mr. Leeuwerik and Mr. Thouvenin dissent from the above endorsement recommendation for reasons explained hereafter.

Dissenting view of Mr. Leeuwerik:
Mr. Leeuwerik dissents from the recognition criteria in IFRS 3 *Business Combinations* paragraph 37 insofar as they exempt contingent liabilities included in a business combination from the requirement that related benefits probably flow from the acquirer.
BC112 of IFRS 3 – as explained in the letter- is inconsistent with the Framework and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Mr. Leeuwerik believes that this inconsistency is not outweighed by the improvements introduced by IFRS 3 and therefore he does not believe that is in the European interest to adopt IFRS 3 in its present form.

Dissenting view of Mr. Thouvenin:
The recognition criteria in paragraph 37 of IFRS 3 *Business Combinations* exempt intangible assets acquired and contingent liabilities assumed in a business combination from the requirement, clearly stated in the Framework, that the inflows or outflows of benefits will probably flow to or from the acquirer. The reason given for this (BC96 and BC111) is that the measurement at fair value of intangible assets or contingent liabilities reflects such probability.
Mr. Thouvenin believes that the Framework requires recognition based on probability, even when measurement at fair value reflects such probability. Moreover, the application of probability is currently different for recognition purposes: for example, the "more likely

than not" criterion is used for recognition in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* when the "expected value" approach is used for the measurement of fair value.

The Board acknowledges the inconsistency between these recognition criteria in the Framework and fair values in paragraph BC96 and BC112. For Mr. Thouvenin such inconsistency should be resolved as part of an in-depth review of the Framework before changing the recognition criteria for intangible assets acquired and contingent liabilities assumed in a business combination.

For these reasons, Mr. Thouvenin believes that IFRS 3 does not meet the criteria of relevance and comparability required of financial information and, as this is a major issue, he does not believe that is in the European interest to adopt IFRS 3 in its present form.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman