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HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

By air-mail and e-mail <CommentLetters@iasb.org.uk>

Our. Ref.: C/FASC 4 April 2003

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Exposure Draft
ED 3 *Business Combinations*

The Hong Kong Society of Accountants (HKSA) welcomes the opportunity to provide you with our comments on the Exposure Draft ED 3 Business Combinations.

We set out in the attachment our response to the questions raised in your Invitation to Comment. We would wish to highlight for the Board's consideration our responses to questions 1(a) and 8. In our response to question 1, we would encourage the Board to address business combinations and reorganisations involving entities under common control as part of Phase 2. We would also recommend that the proposed IFRS resulting from Phases 1 and 2 have the same application date.

In our response to question 8, we express our reservations about the proposed approach with regard to the non-amortisation of goodwill in certain circumstances. We believe that the Board has not adequately addressed the conceptual rationale for such an approach, especially as it concerns the gradual replacement of purchased goodwill with internally-generated goodwill which we believe occurs even when it is deemed that the goodwill purchased might have an indefinite life. We also draw your attention to our comment under question 8 as to whether the non-amortisation approach proposed for goodwill and intangible assets can be extended to apply to tangible fixed assets.

The HKSA has a policy of converging its Statements of Standard Accounting Practice with the International Accounting Standards Board's Standards. The standard setting due process applied in Hong Kong (details of which are available on the HKSA's website) acts to support this policy. The HKSA's Financial Accounting Standards Committee (FASC) issued an Invitation to Comment on the exposure draft with a comment period concurrent with that set by the IASB. Accordingly, the accompanying comments may reflect the views not only of members of the FASC but also of constituents in Hong Kong who provided comments to the HKSA.

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If you have any questions on our comments, please contact our Deputy Director - Accounting, Mr. Simon Riley, in the first instance.

Yours faithfully

WINNIE C.W. CHEUNG
SENIOR DIRECTOR
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HONG KONG SOCIETY OF ACCOUNTANTS

WCC/SR/al

Hong Kong Society of Accountants' comments on the Exposure Draft ED 3 Business Combinations

Question 1 – Scope

The Exposure Draft proposes:

(a) to exclude from the scope of the IFRS business combinations in which separate entities or operations of entities are brought together to form a joint venture, and business combinations involving entities under common control (see proposed paragraphs 2 and 3 and paragraphs BC9-BC11 of the Basis for Conclusions).

Are these scope exclusions appropriate? If not, why not?

Ideally, all issues relevant to the business combinations project would be dealt with at the same time. However, we agree that it is appropriate for Phase 1 to exclude business combinations that result in the formation of a joint venture from the scope of the proposed IFRS because certain issues may need to be delayed until Phase 2 so that Phase 1 can move forward quickly. But we believe that the accounting for the formation of a joint venture should be considered in Phase 2. We suggest that the Board consider at the same time all transactions or combinations that result in the formation of a new entity rather than an acquisition. These include rare business combinations where an acquirer cannot be identified, entities brought together by contract, the combination of mutual entities, the combination of more than two entities and the transfer of state owned assets to private ownership.

We encourage the Board to publish an exposure draft for phase 2 at the soonest possible time. Phase 2 should address combinations and reorganisations involving entities under common control. The proposed standards that result from both Phase 1 and Phase 2 of the business combinations project should have the same mandatory application date. This will reduce the burden of multiple accounting changes. Both proposed standards should allow for early application.

(b) to include in the IFRS a definition of business combinations involving entities under common control, and additional guidance on identifying such transactions (see proposed paragraphs 9-12 and Appendix A, and paragraphs BC12-BC15 of the Basis for Conclusions).

Are the definition and additional guidance helpful in identifying transactions within the scope exclusion? If not, what additional guidance would you suggest, and why?

We generally agree that the guidance provided is helpful for the purpose of identifying which transactions are excluded from phase 1.

Question 2 – Method of accounting for business combinations

The Exposure Draft proposes to eliminate the use of the pooling of interests method and require all business combinations within its scope to be accounted for by applying the purchase method (see proposed paragraphs 13-15 and paragraphs BC18-BC 35 of the Basis for Conclusions).

Is this appropriate? If not, why not? If you believe the pooling of interests method should be applied to a particular class of transactions, what criteria should be used to distinguish those transactions from other business combinations, and why?

We agree that an acquirer can be identified in virtually all business combinations not involving entities under common control, and therefore we believe the proposition in question 2 is appropriate.

The inability to identify an acquirer may mean that the substance of the transaction is the creation of a new entity rather than a continuation of the combining entities or the dominance of the combining entities by a single entity. We suggest that the Board considers these types of transactions in Phase 2 along with business combinations and other reorganisations between entities under common control.

We believe the pooling of interests method would be inappropriate in the extremely rare circumstances in which an acquirer cannot be identified. The pooling of interests method should only be used for transactions where the ultimate shareholder remains the same and there is no change in the relative rights or interests of any shareholder or minority. Fresh start accounting may be a viable alternative. In any case, we believe that true mergers of equals are so rare that it should not be necessary for the proposed IFRS to provide for such situations.

Question 3 – Reverse acquisitions

Under IAS 22 Business Combinations, a business combination is accounted for as a reverse acquisition when an entity (the legal parent) obtains ownership of the equity of another entity (the legal subsidiary) but, as part of the exchange transaction, issues enough voting equity as consideration for control of the combined entity to pass to the owners of the legal subsidiary. In such circumstances, the legal subsidiary is deemed to be the acquirer. The Exposure Draft:

(a) proposes to modify the circumstances in which a business combination could be regarded as a reverse acquisition by clarifying that for all business combinations effected through an exchange of equity interests, the acquirer is the combining entity that has the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. As a result, a reverse acquisition occurs when the legal subsidiary has the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities (see proposed paragraph 21 and paragraphs BC37-BC41 of the Basis for Conclusions).

Is this an appropriate description of the circumstances in which a business combination should be accounted for as a reverse acquisition? If not, under what circumstances, if any, should a business combination be accounted for as a reverse acquisition?

Yes. The acquirer should be identified as the party that has obtained the power to govern the financial and operating policies of the combined entity at the date of the business combination. This is frequently the entity whose shareholders own more than half the voting rights after the combination, but this is not always the case and the proposed standard should be clear that all relevant facts and circumstances should be considered.

(b) proposes additional guidance on the accounting for reverse acquisitions (see proposed paragraphs B1-B14 of Appendix B).

Is this additional guidance appropriate? If not, why not? Should any additional guidance be included? If so, what specific guidance should be added?

We agree this guidance is generally appropriate.

Question 4 – Identifying the acquirer when a new entity is formed to effect a business combination

The Exposure Draft proposes that when a new entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination should be adjudged the acquirer on the evidence available (see proposed paragraph 22 and paragraphs BC42-BC46 of the Basis for Conclusions).

Is this appropriate? If not, why not?

Consistent with our response to question 2, we agree that the proposition in question 4 is appropriate. The accounting treatment should reflect the substance of the business combination and not be driven by the legal form of a particular transaction.

We believe that the accounting treatment for an acquisition should be neutral irrespective of whether a new entity is formed. On occasions, a business combination may be underway before the new entity legally exists. In such situations, the business combination or reorganisation may be achieved in stages, possibly over the course of more than one financial year, because control cannot pass to the newly formed legal entity before that entity exists.

The proposed standard does not explain how to account for the transaction between the new entity and the entity identified as the acquirer. This is merely a reorganisation of the interests of the acquirer and purchase accounting should not be applied. This principle should be made clear in the proposed IFRS.

Question 5 – Provisions for terminating or reducing the activities of the acquiree

Under IAS 22, an acquirer must recognise as part of allocating the cost of a business combination a provision for terminating or reducing the activities of the acquiree (a 'restructuring provision') that was not a liability of the acquiree at the acquisition date, provided the acquirer has satisfied specified criteria. The Exposure Draft proposes that an acquirer should recognise a restructuring provision as part of allocating the cost of a business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets (see proposed paragraph 40 and paragraphs BC55-BC66 of the Basis for Conclusions).

Is this appropriate? If not, what criteria should an acquirer be required to satisfy to recognise a restructuring provision that was not a liability of the acquiree as part of allocating the cost of a combination, and why?

We agree that a provision for the costs of terminating or reducing the activities of the acquired entity should be recognised in the purchase price allocation only when the acquired entity has an existing liability recognised in accordance with IAS 37. Because of the potential for abuse of the IFRS depending on whether a takeover is friendly or not, we suggest that the proposed standard require that the acquired entity's restructuring plan was in existence before the commencement of negotiations for the business combination and that management of the acquirer is demonstrably committed to executing the restructuring plan. We also suggest that liabilities where settlement becomes probable as a result of the change in control of the acquired entity are included in the purchase price allocation only if the contingent liability existed before the commencement of negotiations for the business combination.

Paragraph 40 of the proposed standard should be revised to be clear that a restructuring plan that was conditional on the occurrence of the transaction should not be recognised in the purchase price allocation. Recognition should be permitted only if the acquired entity is unconditionally committed to the plan prior to the date of acquisition. We also believe that the costs of a restructuring plan should be excluded specifically from the payments covered by paragraph 41 of the proposed standard.

Question 6 – Contingent liabilities

The Exposure Draft proposes that an acquirer should recognise separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably (see proposed paragraphs 36 and 45 and paragraphs BC80-BC85 of the Basis for Conclusions).

Is this appropriate? If not, why not?

In principle, we agree with the proposition in question 6.

A bona fide contingent liability (that is, one that fails IAS 37 recognition criteria as a 'full' liability) should have the effect of reducing the purchase consideration relative to the acquirer's share of the fair value of the net assets – the extent to which the purchase consideration is reduced should theoretically reflect that risk assumed by the acquirer in the contingent liability crystallising – appropriate to effectively offset the reduced purchase premium against the good will that would have otherwise arisen rather than recognise a liability at an estimated weight-average valuation. We do have a practical concern with the proposition in question 6 as regards the extent to which a risk-weighted measurement of the contingent liability may be reliable.

If the Board proceeds with the proposition in question 6, we would also believe that contingent assets should be recognised in a business combination provided their fair values can be measured reliably. The proposed standard should also include guidance on accounting for such contingent assets until they meet the criteria for recognition as an asset or are de-recognised.

Question 7 – Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

IAS 22 includes a benchmark and an allowed alternative 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. The Exposure Draft proposes requiring the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost to be measured initially by the acquirer at their fair values at the acquisition date. Therefore, any minority interest in the acquiree will be stated at the minority's proportion of the net fair values of those items. This proposal is consistent with the allowed alternative treatment in IAS 22 (see proposed paragraphs 35 and 39 and paragraphs BC88-BC95 of the Basis for Conclusions).

Is this appropriate? If not, how should the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of a business combination be measured when there is a minority interest in the acquiree, and why?

Yes. We agree with the proposal that the minority's interest in the assets and liabilities of the acquired entity should be stated at fair value.

Question 8 – Goodwill

The Exposure Draft proposes that goodwill acquired in a business combination should be recognised as an asset and should not be amortised. Instead, it should be accounted for after initial recognition at cost less any accumulated impairment losses (see proposed paragraphs 50-54 and paragraphs BC96-BC108 of the Basis for Conclusions).

Do you agree that goodwill acquired in a business combination should be recognised as an asset? If not, how should it be accounted for initially, and why? Should goodwill be accounted for after initial recognition at cost less any accumulated impairment losses? If not, how should it be accounted for after initial recognition, and why?

We express our strong reservations with the proposition in question 8.

The appropriate accounting treatment for goodwill is an issue on which the achievement of a long-standing conceptually sound global consensus may yet be some way off. The proposals in ED 3 represent the third major shift in goodwill accounting in the IAS/IFRS literature in little more than a decade.

We are concerned that the approach in ED 3 is a rule-based solution that lacks strong conceptual support, and which is designed to accommodate those who may well have a case for arguing that the current IAS 22 treatment for the amortisation of goodwill through the income statement gives rise to an arbitrary drag on reported earnings.

The concept that an intangible asset should be left on the balance sheet unamortised and subject only to impairment is a substantial shift away from the current conceptual framework published by the IASB. If the IASB were making a case for treating goodwill in such a manner, we would question why the same approach could not also be applied to tangible non-current assets.

The approach proposed in ED 3 is also conceptually inconsistent with the prohibition on recognising internally generated goodwill and we find the IASB's Basis of Conclusion paragraph BC.107 weak in justifying why such internally generated goodwill should remain on the balance sheet, especially as it takes a 'nature of the goodwill' approach (BC.96).

After a while, purchased goodwill is replaced by internally generated goodwill (through one's own management of an enterprise, advertising, etc). To subject purchased goodwill to an impairment test obscures the fact that the goodwill increasingly becomes generated internally – the acquirer manages to maintain the goodwill within an enterprise and no income statement expense arises although the source of the goodwill appearing on the balance sheet has changed from purchased to internally generated over time.

We would like to propose the following alternative approach:

1. Goodwill should be amortised over a prudent estimate of the period for which it has value. In determining this period, the rate at which purchased goodwill is replaced by internally generated goodwill should be estimated and taken into account. A guide to this might be a reasonable expectation of the cost of future activities the business will undertake in order to preserve the (original) value of the purchased goodwill;

2. The net book value of goodwill after amortisation should be subject to an impairment test on the basis proposed in the ED.

Question 9 – Excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities

In some business combinations, the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of the combination exceeds that cost. The Exposure Draft proposes that when such an excess exists, the acquirer should:

(a) reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and

(b) recognise immediately in profit or loss any excess remaining after that reassessment.

(See proposed paragraphs 55 and 56 and paragraphs BC109-BC120 of the Basis for Conclusions.)

Is this treatment appropriate? If not, how should any such excess be accounted for, and why?

We disagree with the proposition in question 9.

We express our concern about the proposed recognition of all negative goodwill immediately through the income statement. This would give rise to imprudent accounting, for example, in cases where an entity has acquired an illiquid asset such as land as part of a bargain purchase upon which an ostensibly distributable profit would be recognised.

We believe that the "excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities", which will become colloquially known as "negative goodwill", should be either allocated across the fair values of the assets acquired or dealt with in accordance with the stratified approach presently applying in IAS 22. If an asset has a supposed fair value of 15 and yet is acquired even in an arms' length bargain purchase scenario for 10, we believe that the 10 is a more reliable indicator of fair value at the time of acquisition than the 15. While we agree in the most part with Basis of Conclusion paragraph BC.110, we would not necessarily share the Board's view that such an excess is rare.

Question 10 – Completing the initial accounting for a business combination and subsequent adjustments to that accounting

The Exposure Draft proposes that:

(a) **if the initial accounting for a business combination can be determined provisionally by the end of the reporting period in which the combination occurs because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of combination can be determined only provisionally, the acquirer should account for the combination using those provisional values. Any adjustment to those values as a result of completing the initial accounting is to recognised within twelve months of the acquisition date (see proposed paragraphs 60 and 61 and paragraphs BC123-BC126 of the Basis Conclusions).**

Is twelve months from the acquisition date sufficient time for completing accounting for a business combination? If not, what period would be sufficient, and why?

Yes. We agree that this is reasonable period to complete the purchase price allocation.

(b) **with some exceptions carried forward as an interim measure from IAS 22, adjustments to the initial accounting for a business combination after that accounting is complete should be recognised only to correct an error (see proposed paragraphs 62 and 63 and paragraphs BC127-BC132 of Basis for Conclusions).**

Is this appropriate? If not, under what other circumstances should the initial accounting be amended after it is complete, and why?

Yes, in general. We agree with the general principle that adjustments to the initial accounting should be recognised only to correct an error, but we suggest that a change in accounting policy should also result in a change to the initial accounting that should be recognised retrospectively.

We do not agree that the initial accounting should be adjusted when deferred tax assets not recognised at the date of acquisition are recognised subsequently. The subsequent recognition of such assets is no different to the revision of any other estimate, so we believe there is no need for a special requirement. Should paragraph 64 be retained in the proposed standard, the text should be clear that the guidance applies only to assets recognised after the end of the hindsight period and that that reduction in the carrying amount of goodwill is not a tax expense.