EFRAG
European Financial Reporting Advisory Group

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

1049 Brussels

DRAFT FOR COMMENTS BY 24 May 2004

XY 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 The reasons for IASB issuing this standard was to reduce existing options established in superseded IAS 22 *Business Combinations* (IAS 22) and under national accounting regimes and to seek international convergence on the accounting for business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 many 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 impairment test for goodwill introduces elements of judgment, e.g. the estimation of future cash flows, which could reduce the reliability of the outcome of the measurement process. 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*. This does not enhance the relevance and reliability of the information provided in this particular respect when accounting for business combinations. 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, the related Basis for Conclusions and the consequential changes to other standards. Our evaluation is based on input from standard setters and market participants in accordance with EFRAG's due process.

EFRAG believes that the improvements introduced by IFRS 3 compared to IAS 22 outweigh the concern raised in this letter and therefore, on balance, EFRAG is supportive of IFRS 3 and has concluded that it 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.

Nevertheless, we urge 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.

<u>Dissenting opinions regarding the adoption of IFRS 3 *Business Combinations*:</u>

Dissent of Mr. Dominique 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.
Dominique 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 Dominique 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, Dominique 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.

Dissent of Mr. Hans 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 to or 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.

However, the majority of EFRAG members believe that it is in the European interest to adopt IFRS 3 and, accordingly, we recommend its adoption.

We 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

European Financial Reporting Advisory Group

Dr. Alexander Schaub
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DRAFT FOR COMMENTS BY 18 May 2004

XY June 2004

Dear Dr. Schaub,

Re: Adoption of IFRS 4 *Insurance Contracts*

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 4 *Insurance Contracts* (IFRS 4) as published by the IASB on 31 March 2004.

IFRS 4 requires entities to make limited improvements in accounting for insurance contracts and provides certain exceptions to the general hierarchy of international accounting standards pending completion of a definitive standard on accounting for insurance contracts (Phase II). It also requires disclosure of information about insurance contracts issued by the entity.

We acknowledge that this is the first international accounting standard issued by IASB providing guidance on accounting for insurance contracts and we are aware that IFRS 4 is neither a rigorous nor a comprehensive standard. The urgent need to provide guidance on the accounting for insurance contracts before 2005 did not allow IASB to address broader conceptual issues. We therefore regard IFRS 4 as a stepping stone towards improvement of the widely varying insurance accounting practices in Europe and worldwide.

IFRS 4 introduces improvements to recognition and measurement principles and disclosures, without requiring extensive changes that might have to be reversed in the light of the outcome of Phase II of the project. Although IFRS 4 permits continuation of various accounting practices presently adopted in national accounting regimes which may not comply with the hierarchy normally applied in international accounting standards, we regard it as conducive to the overall aim of establishing robust accounting standards that facilitate greater confidence in the financial reporting of insurance companies, which we see as a necessary ingredient in a strong European financial market.

It is recognised, however, that concerns raised by the industry, users of financial statements, auditors, standard setters and EFRAG within IASB's due process have not been fully satisfied in the final standard. The most critical areas are:

(i) the two different measurement principles for insurance assets (fair value concept) and liabilities (amortised cost concept based on regulatory requirements), which is often referred to as the "mismatch" problem and

(ii) the deposit floor limitation for investment contracts with a demand feature, created by IASB's assumption that the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (IAS 39 paragraph 49).

The "mismatch" issue

The mismatch issue arises from reporting assets on a fair value basis whilst liabilities are based on historical cost. This may result in volatility in equity not purely as a result of volatility in economic conditions but also because market conditions are reflected for assets but not for liabilities. EFRAG acknowledges that this volatility in equity represents a distortion to some degree. A number of solutions to this "mismatch" issue have been discussed with the IASB but none has achieved general acceptance. One of the solutions applicable under IFRS 4 is the possibility to remeasure designated insurance liabilities to reflect current market interest rates.

However, it is important to recognise that the mismatch issue is an economic as well as an accounting phenomenon. If an insurer invests premiums received in assets whose values do not respond to the same economic influences as the liabilities to policyholders, either over the course of the insurance contract or even in some cases by the end of the contract, a mismatch arises which should be reflected in the financial statements as economic reality.

Until now insurance accounting has not recognised the economic mismatch partly because conventions were used that adjust neither assets nor liabilities for changes in market prices and partly because gains and losses were reported only when assets were realised. With the adoption of IFRS 4, we expect that management will report on the effects of the mismatch and will provide useful information in order to enhance transparency and understandability of financial statements.

The “deposit floor” issue
It is EFRAG’s view that IASB’s assumption of a deposit floor for demand deposits (IAS 39 paragraph 49) does not reflect the real economic situation that European financial institutions have experienced in collecting long term savings as a result of policyholders’ behaviour in such circumstances. EFRAG believes that investment contracts, particularly those issued by insurance companies, are not primarily sold to serve as demand deposits but rather as long-term savings, e.g. related to pension plans. They are not regarded as savings accounts for the purpose of early withdrawals or for immediate access to cash. When we commented on ED 5 *Insurance Contracts*, we raised the concern that this assumption does not reflect real customer behaviour. We believe this issue should be reconsidered in the context of the underlying portfolio approach of the insurance business.

IFRS 4 becomes effective for annual periods beginning on or after 1 January 2005, with earlier application encouraged. The standard provides an exemption from some requirements for comparative figures for 2004 in parallel with the exemptions in IAS 32 and 39.

EFRAG has evaluated IFRS 4 and the related Basis for Conclusions. Our evaluation is based on input from standard setters and market participants in accordance with our due process.

We acknowledge that IFRS 4 has not been developed as a long term standard, but, rather, has to be seen as a stepping stone towards a more comprehensive and conceptually sound standard dealing with the accounting for insurance contracts that meets the needs of all stakeholders. We believe that the standard will serve the interest of Europe because it will improve existing accounting practices for insurance contracts.
We therefore recommend its adoption according to Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards.
Notwithstanding our adoption advice, we urge IASB, in consultation with the main stakeholders, to start developing immediately as Phase II of this project, a conceptually sound, long-term solution to improve the accounting for insurance contracts significantly, particularly in the areas we described and the general treatment of discretionary participation features.

We 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

Dr. Alexander Schaub
Director General
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XY June 2004 DRAFT FOR COMMENTS BY 18 May 2004

Dear Dr. Schaub,

Re: Adoption of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

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 5 *Non-current Assets Held for Sale and Discontinued Operations* as published by the IASB on 31 March 2004.

IFRS 5 arises from the IASB's consideration of the American standard FASB Statement No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* with the objective of reducing differences between IFRS and US GAAP that are capable of resolution in a relatively short time.

The standard adopts the classification "held for sale" and introduces the concept of a "disposal group", being a group of assets to be disposed of, by sales or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. IFRS 5 requires that assets or disposal groups that are classified as held for sale are:

(i) carried at the lower of carrying amount and fair value less costs to sell – which means that the related assets cease to be depreciated – and;

(ii) presented separately on the face of the balance sheet.

While IFRS 5 supersedes IAS 35 *Discontinuing Operations*, the actual amendments are limited to:

- The introduction of the term "a component of an entity", which is defined as a cash generating unit or a group of cash generating units;
- A change in the timing of the classification of an operation as discontinued. IAS 35 classified an operation as discontinuing at the earlier of (i) the entity entering into a binding sales agreement and (ii) the board of directors approving and announcing a formal disposal plan. Under the new standard, an operation shall be classified as discontinued at the date the operation meets the criteria to be classified as held for sale or when the entity has disposed of the operation;
- A requirement to show the results of discontinued operations separately on the face of the income statement, which is optional under IAS 35;
- A prohibition of retroactive classification of an operation as discontinued when the criteria for that classification are not met until after the balance sheet date but before the financial statements are authorised for issuance.

IFRS 5 becomes effective for annual periods beginning on or after 1 January 2005, with earlier application encouraged provided the valuations and other information needed to apply the standard were obtained at the time that the IFRS 5 criteria were originally met.

EFRAG has evaluated IFRS 5 including its Basis for Conclusions and the consequential amendments to other IFRSs. Our evaluation is based on input from standard setters and market participants in accordance with EFRAG's due process.

EFRAG supports the IASB/FASB convergence initiative to the extent that it leads to high quality accounting solutions, as commented in detail in our letter to the IASB, dated 27 October 2003, on the related exposure draft. We welcome the improvement of current standards to require a separate classification in the balance sheet of non-current assets (or a disposal group) held for sale as well as a separate presentation of the results of discontinued operations on the face of the income statement. EFRAG is also pleased that, in departure from the initial proposals, the IASB has not adopted the SFAS 144 criteria on how to determine a discontinued operation, because we do not believe this would lead to better financial reporting.

EFRAG still believes that depreciation should only cease when an asset is retired from active use and is concerned that the new standard could lead to inappropriate accounting especially when an entity decides to dispose of a division. However, we also acknowledge that the new measurement requirements will often not involve a significant change from the requirements of recently revised IFRS. Further, we believe that the Board made the right decision not to retain its initial proposals regarding the allocation of an impairment loss across the long-lived assets of the group, although this implies a deviation from SFAS 144, but to maintain the approach of the revised IAS 36, which allocates the loss initially to any goodwill within the component of the entity that is discontinued. In this context, we believe that the IASB's standard on impairment (IAS 36 *Impairment of Assets*) is superior to the US GAAP requirements.

As indicated in our October 2003 comment letter to the IASB, we find the introduction of the notion "component of an entity" not necessary because of the existing defined concept of "cash generating unit" though we accept that this matter does not change the substance of the accounting requirements. In general, EFRAG supports simply worded standards that are easy to understand.

Finally, we are concerned from a practical point of view about the removal of the limited IAS 27 *Consolidated and Separate Financial Statements* exemption from consolidation for subsidiaries acquired and held exclusively with a view to resale, despite the Board's efforts to accommodate our concerns by exempting companies from certain disclosure requirements and proposing the use of computational short cuts.

Having considered IFRS 5 and the above mentioned points EFRAG is on balance supportive of the new standard and has concluded that it 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:

iii. 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
iv. 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.

For the reasons given above, we believe that it is in the European interest to adopt IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and, accordingly, we recommend its adoption.

We 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

Dr. Alexander Schaub
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1049 Brussels

4 June 2004

Dear Dr. Schaub,

Re: Adoption of amended IAS 36 *Impairment of Assets* and amended IAS 38 *Intangible Assets*

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 the amended IAS 36 *Impairment of Assets* (IAS 36) and the amended IAS 38 *Intangible Assets* (IAS 38).

The amendments to IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets* have been issued by IASB together with IFRS 3 *Business Combinations*, which 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 reason for IASB to issue amendments to IAS 36 and IAS 38 was to reflect particularly those changes related to its decisions in the Business Combinations project but not to reconsider all the existing requirements of IAS 36 and IAS 38. Therefore, the changes made in IAS 36 are mainly concerned with the impairment test for goodwill; the changes made in IAS 38 are concerned with clarifying the notion of “identifiability” with regards to intangible assets and the accounting for in-process research and development projects acquired in a business combination.

The introductions to the revised standards (IAS 36 IN5 to IN18 and IAS 38 IN5 to IN13) summarise the main changes from the previous versions of IAS 36 and IAS 38, on which we provided a positive endorsement advice as part of our 19 June 2002 “en bloc” endorsement letter.

Although the complexity of the impairment test for goodwill in IAS 36 has been reduced, as proposed by EFRAG, by eliminating the second of the two steps proposed in the Exposure Draft of amendments to IAS 36, it is recognised that the implementation of the test in practice is very difficult compared to the well known application of the amortisation approach. The main criticism with regard to the impairment test for goodwill is that it does not distinguish between acquired and pre-existing internally generated goodwill of the acquirer nor between acquired goodwill and goodwill internally generated after the business combination. Thus losses in acquired goodwill can be masked by gains in pre-existing or internally generated goodwill. We acknowledge that there is no alternative to avoid the potential subsequent replacement of acquired goodwill by internally generated goodwill but we urge the Board to continue research work on separately identifying internally generated goodwill that existed at the date of acquisition.

We welcome the strengthening of the requirements regarding the projection of future cash flows as well as the extended disclosure requirements regarding the underlying assumptions, which will increase the robustness of the impairment test for goodwill compared to the proposal in the Exposure Draft.

In IAS 38 we welcome the change from the Exposure Draft regarding the measurement of intangible assets acquired in a business combination. The Board replaced its presumption that sufficient information should always exist to measure reliably the fair value of such an asset by a rebuttable presumption that it is “normally” possible to measure it with sufficient reliability to qualify for recognition separately from goodwill. This change, which resulted from comments received during the field tests, acknowledges that it is very difficult in some cases to measure the fair values of individual intangible assets. We are pleased to note the effectiveness of the field tests in this and other areas and we encourage the Board to continue to use this medium of consultation in appropriate cases.

Despite the change to the measurement presumption, the Board retained its proposed approach to recognition of intangible assets acquired in a business combination. It is still required, for example, to recognise in-process research and development projects separately from goodwill if they meet the identifiability criterion and can be measured reliably. Moreover, also in a separate acquisition of an intangible asset, IAS 38 considers the probability criterion to be satisfied and it would not be necessary to pass the recognition test established in the Framework.
IASB acknowledges in paragraph 18 of the Basis for Conclusions that there is an inconsistency between the recognition criteria in the Framework (based on probability of occurrence and reliability of measurement of expected future cash flows) and the approach to measuring fair values in, for example, a business combination. We believe that this inconsistency should be addressed at an early date in the context of a review of the general recognition principles in the Framework.

IAS 36 and IAS 38 should be applied on acquisition to goodwill and intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004 and, to all other assets, for annual periods beginning on or after 31 March 2004. Earlier application is encouraged.

EFRAG has evaluated the amended IAS 36 and IAS 38 and the related Basis for Conclusions. Our evaluation is based on input from standard setters and market participants in accordance with EFRAG’s due process.

EFRAG conclusion

We consider the improvements in the amended IAS 36 and IAS 38 to outweigh the concerns raised in this letter and concluded that the amended IAS 36 and IAS 38 meet 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:

v. they are 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

vi. they meet 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 the amended IAS 36 and IAS 38. It therefore recommends endorsement of amended IAS 36 *Impairment of Assets* and amended IAS 38 *Intangible Assets*.

Dissenting view

Mr. Thouvenin dissents from the above endorsement recommendation regarding the adoption of amended IAS 38 *Intangible Assets* for reasons explained hereafter.

<u>Dissenting view of Mr. Dominique Thouvenin</u>
Paragraph 25 of IAS 38 (Revised March 2004) *Intangible Assets* states that the probability criteria in paragraph 21 (a) are always considered to be satisfied for separately acquired intangible assets. The reason given for this (BC27) is that the price paid by an entity to acquire separately an intangible asset normally reflects expectations about the probability that the future benefits associated with the intangible asset will flow to the entity.
Paragraph 33 states the probability recognition criteria in paragraph 21 (a) are always considered to be satisfied for intangible assets acquired in business combinations.
The reason given for this (BC17 and BC18) is that fair value is the required measurement for acquisition of an intangible asset as part of a business combination, and fair value incorporates probability assessment.
Mr. Thouvenin believes that the Framework requires a prior recognition test based on probability, even when measurement reflects the effect of probability. This inconsistency between the recognition criteria in the Framework and IAS 38 revised is acknowledged in paragraph BC18. For Mr. Thouvenin this inconsistency should be resolved as part of an in depth review of the Framework, before changing the recognition criteria for intangible assets acquired separately or in a business combination. He therefore concluded that the revised version of IAS 38 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 it is in the European interest to adopt IAS 38 in its amended version.

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