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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Sirs,

Comments on ED 3 "Business Combinations" and Proposed amendments to IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets"

The Accounting Standards Board of Japan (ASBJ) is pleased to comment on ED 3 "Business Combinations" and Proposed amendments to IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets". The views expressed in this letter are those of International Issues Standing Committee of ASBJ.

On November 2, 2001, after the national standard setters meeting in September 2001, in the letter to IASB and liaison national standard setters, we expressed our opposition to the then tentative agreements at IASB, that is, unification of the accounting for business combinations to the purchase method, elimination of the pooling of interest method, and the non-amortisation of goodwill (impairment only approach for goodwill). We have reconsidered these matters with discretion, but we found no reason to change our position regarding to these matters.

Please note that in Japan, accounting for business combinations are now deliberated by the Business Accounting Council, which have been considering this matter before the establishment of ASBJ in July 2001.

We hope that our comments will contribute to the work of the IASB in arriving at its final decision.

Best Regards,

Ikuo Nishikawa

Chairman, International Issues Standing Committee
Vice Chairman, Accounting Standards Board of Japan

1. Accounting for business combinations (Question 2 and 3 in ED 3)

We do not agree with the unification of accounting method for business combinations to the purchase method and the elimination of the pooling of interest method, which are proposed in paragraph 13 of ED 3. We have already expressed this position in the letter to IASB and national standard setters in November 2001.

We agree with the view that most business combinations shall be accounted for by the purchase method. However, for marginal cases where it is quite difficult to identify an acquirer in the transaction, we do not agree with the proposed requirement to adopt the purchase method with compelling identification of the acquirer. If numbers of shares issued by or voting rights obtained by one of combining entity are similar to those of another, it will be easy to change an acquirer from one entity to another by structuring the condition of the transaction. While paragraph BC 28 of ED 3 states a concern that permitting more than one method of accounting for business combinations would create incentives for structuring transactions to achieve a desired accounting result, we have a similar concern that an arbitrary identification of acquirer would create a different accounting consequence under the single accounting method. In other words, an abuse in the application of the purchase method may undermine comparability of financial statements.

We believe that it is necessary to apply a method other than the purchase method for business combinations in which it is quite difficult to identify an acquirer. In such case, the pooling of interest method or the fresh-start method shall be candidates. However, we recognise that application of the fresh start accounting has not been fully discussed yet and defined clearly at the moment. Moreover, because the fresh start accounting is based on a fictitious assumption of liquidation of both entities that are not actually liquidated, its logical consequence could be that an entity would be allowed to revalue its assets and liabilities by repeating demerger and merger or even by being involved in business alliance or capital investment which has economic effect similar to a business combination. Since the purchase method is based on the view that a business combination is one of the forms of real investments made by a continuing entity, we believe the alternative method also should be based on the view that at least one of combining entities is regarded as a continuing entity, that is the pooling of interest method.

We also believe that more illustrative examples should be provided for the treatment of business combinations in which it is difficult to identify an acquirer, if the purchase method should be applied to all business combinations. Appendix A of ED 3 provides only an example of typical reverse acquisition but it is necessary to provide more guidance in the standard in order to determine which of the combining entities substantially obtains the control in more difficult cases.

2. Goodwill (Question 8 in ED 3 and 5 in the proposed amendments to IAS 36)

2-1. Non-amortisation of goodwill

We do not agree with the proposed subsequent accounting for goodwill in paragraph 54 of ED 3, that is, non-amortisation and impairment only approach for goodwill. We expressed this position in the letter to IASB and national standard setters in November 2001. We believe that goodwill should be amortised over a certain period and be subject to impairment when necessary.

We agree with the rejection of the immediate write-off of goodwill because goodwill includes some components which do not immediately diminish, such as the value of excess earning power of the acquired entity. However, we do not agree with non- amortization of goodwill, since the value of such power usually diminishes as the competition intensifies. Even where the value of excess earnings appears to be sustained, this occurs owing to complementarity by the additional investment or other efforts made by the acquirer after the business combination. Therefore, we believe that non-amortization of goodwill is virtually equal to capitalization of internally generated goodwill and inconsistent with the current accounting model, including the requirement in paragraph 40 of the proposed amendments to IAS 38 “Intangible Assets”.

Paragraph BC 107 of Basis for Conclusion of ED 3 states that the straight-line amortisation of goodwill over an arbitrary period fails to provide useful information because it is doubtful about the usefulness of an amortisation charge that reflects the consumption of acquired goodwill, whilst the internally generated goodwill replacing it is not recognised. However, we believe that the amortisation of acquired goodwill properly represents the diminishment of goodwill that is the reflection of value created by the acquired entity prior to the business combination. On the other hand, current expenses are the results of additional expenditure to maintain the excess earning power by the combining entity. Those are entirely different by nature and the usefulness of the information is not lost. If such expenses were considered as “doubling-up” and meaningless, the current accounting for property, plant and equipment would also need reconsideration, because depreciation costs and expenses for maintenance and repair would also be regarded as “doubling-up” as well.

Some also argue against the amortization of goodwill on the ground that users of accounting information, such as analysts, ignore or exclude goodwill amortisation expense in their analysis. However, in similar ways, users often exclude from their analysis some items such as restructuring costs, interest expenses, research and development costs and so on, for their respective purposes. We do not believe it can be a sufficient reason for exclusion from financial statements.

2-2. Impairment test for goodwill

We are of the view that the impairment test proposed in paragraphs 73-104 of the exposure draft of proposed amendments to IAS 36 fails in excluding the effect of the internally generated goodwill arisen subsequently after the business combination, and it is not rigorous enough to be clearly better than the existing impairment test of IAS 36. We believe it better to retain the existing impairment test of the IAS 36.

The proposed impairment test requires the calculation of the implied value of goodwill. However, it is only the difference between the value of the unit and that of identifiable net assets in the unit and therefore cannot be calculated independently of them. When an entity reorganise its reporting structure after the business combination, paragraph 82 of the proposed amendments to IAS 36 requires re-allocation of the goodwill to the units affected using a relative value approach, and then the proposed impairment test should be performed based on such relative value continuously. However, there is no guarantee that such reallocated value of goodwill has relevance to the implied value of goodwill as a difference of the new reorganised unit. Furthermore, under the proposed impairment test, there may arise a case that impairment loss would not be recognised even if the value of the unit declines lower than the carrying amounts of the unit, because of "cushion" by the effect of internally generated goodwill. Under the existing impairment test of IAS 36, although the difficulty relating to the reorganisation or the effect of internally generated goodwill cannot be avoided as well, the impairment loss of goodwill is at first recognised when the value of the unit declines.
Therefore, we believe that the proposed impairment test should not be adopted in the standard, because its benefit would never outweigh the cost and efforts involved by the complex calculation.

3. Negative goodwill, Restructuring provision and Contingent liabilities (Question 5, 6 and 9 in ED 3)

3-1. Negative goodwill

We do not agree with the accounting treatment proposed in paragraph 55 (b) of ED 3, that is, recognition of the remaining "negative goodwill" in profit or loss immediately. We believe that such remains should be allocated to the amount of the acquired non-monetary assets or recognised as a liability and allocated over a certain period. The excess of an acquirer's interest in the fair value of identifiable acquired net assets over the cost of combination usually occurs when future losses or expenses are expected to incur and deducted in advance from the consideration of combination paid by the acquirer. Therefore, it should be appropriately allocated over a certain expected period as a gain or a deduction of expense as corresponding expenses incurred.

3-2. Restructuring provision

We do not agree with the proposed prohibition (paragraph 40 of ED 3) against recognition of a restructuring provision on the business combination, which is allowed under the existing IAS 22. If the value corresponding to a restructuring provision is included in the determination of the consideration paid by an acquirer, it should be recognised as a liability at the initial accounting for the combination. If the excess of the acquirer's interest in fair value of identifiable acquired net assets over the cost of combination are recognised in profit or loss immediately, and the restructuring provision is prohibited as proposed in ED 3, it results in recognising a gain at the inception of business combination, while it corresponds to future losses incurred after the combination. We believe that such a consequence is obviously inappropriate and the recognition of a restructuring provision should be allowed when certain requirements as prescribed in the existing IAS 22 are met.

3-3. Contingent liabilities

Paragraph 36 (d) of ED 3 proposes that an acquirer shall recognise contingent liabilities at their fair values, if they can be measured reliably, at the inception of the combination, and paragraph 46 of ED 3 proposes that the acquirer shall measure them at their fair value with changes in fair value recognised in profit or loss. We agree with the recognition of contingent liabilities at their fair values but do not agree with the requirement for the re-measurement of them at their fair value subsequently when it cannot be reliably measured. In such case, we believe that they should be transferred to payables or gains when the underlying event occurs or diminishes.

4. Measurement date of equity instruments issued by an acquirer as the consideration of business combination (paragraph 23 of ED 3)

Paragraph 23 of ED 3 proposes that equity instruments issued by an acquirer as the consideration of combination should be measured at their fair values at the date of exchange of combination. However, in usual cases, a value of transaction is determined at the agreement date by willing parties and only at that date the transaction can be regarded as an exchange of equal values. On the other hand, if the date of exchange were the measurement date of equity instruments issued by the acquirer, it would result in the consequence that the cost of combination were affected by the fluctuation of its own share price between the agreement date and the date of exchange. When a business combination is made in the form of exchange of shares, as share prices of both combining entities move toward the announced exchange ratio at the date of exchange, such fluctuation distinctly affects the accounting for business combination. Thus, we believe that the agreement date should be the measurement date of the equity instruments issued by an acquirer as a consideration of the business combination.

5. Disclosures about estimates used for the impairment test for goodwill and other intangibles with indefinite useful lives (Question 7 in the proposed amendments to IAS 36)

We do not agree with the proposal about disclosures in paragraph 134 (d), (e) and (f) of the proposed amendments to IAS 36. These subparagraphs require disclosure about the description of calculation and sensitivity analysis of recoverable amounts of segments or cash generating units which includes goodwill or intangible assets with indefinite useful lives, even when there is no impairment loss recognised in those segments or units. The primary reason for our opposition is that forecast information such as proposed in paragraph 134, by nature, would not be appropriate for disclosure in financial statements, though they may be used for the purpose of the impairment test. Moreover, the sensitivity analysis required in the proposed paragraph 134 is subject to serious difficulty, because of interrelation between the parameters used in the calculation.

If such proposal is based on a concern about difficulty in the proper recognition of a decline of goodwill, we would rather recommend the regular amortisation with impairment approach for the accounting for goodwill to reduce the risk of overstatement.

6. Non-amortisation for intangible assets with indefinite useful lives (Question 3 and 5 in the proposed amendments to IAS 38)

The exposure draft, in paragraphs 85- 88 and 91- 104 of the proposed amendments to IAS 38, proposes to require the useful life of intangible assets to be regarded as indefinite when, based on an analysis of all of the relevant factors, there is no foreseeable limit on the period of time over which the asset is expected to generate net cash inflows for the entity, and proposes that intangible assets with indefinite useful lives should not be amortised.
We believe that most intangible assets should be amortised over their useful lives, except for extremely rare cases of assets which can be demonstrated as having an infinite useful life. Even when the value of an intangible asset appears to be sustained, its value is, in most cases, in fact replaced by internally generated goodwill and intangibles arising after the combination. We believe that the non-amortisation approach is inconsistent with paragraph 40 of the proposed amendments to IAS 38 “Intangible Assets”.