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Dear Sylvie

Combined Financial Statements

ICAEW is pleased to respond to your request for comments on *Combined Financial Statements*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

Combined Financial Statements

Memorandum of comment submitted in September 2011 by ICAEW, in response to FEE discussion paper *Combined Financial Statements* published in April 2011.

Contents	**Paragraph**

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper *Combined Financial Statements* published by the Fédération des Experts-comptables Européens (FEE) on 7 April 2011. A copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

We welcome FEE's work in this area

5. There is an established demand for the production of combined financial statements in certain transactional situations, and while individual countries within Europe may have their own regulations or guidance (for example in the UK the annexure to Standard for Investment Reporting 2000), it would be desirable if a particular approach were adopted consistently across different jurisdictions. We therefore welcome FEE's work in this area and are supportive of the project being taken forward to the production of a formal document.

6. As the major audience for formalised requirements in this area is likely to be comprised of capital market participants involved in specific transactions, we feel that the project would be best progressed through regulatory channels rather than as an accounting standard under the umbrella of the IASB. The final guidance may therefore sit best as a pan-European best practice statement, or similar, for capital market participants - although we would envisage any output being equally applicable to the preparation of combined financial statements by unlisted entities should the need arise. We suggest that perhaps the European Securities and Markets Authority (ESMA), whose predecessor CESR has already published recommendations for the consistent implementation of the European Commission's Regulation on Prospectuses, would be the most suited body to take the project to completion (with input from FEE and other interested parties).

Further debate desirable on key elements of the proposals

7. A number of interesting questions are raised by the proposals regarding the purpose and parameters of combined financial statements. There are mixed views on these topics. Some commentators, note that alternative approaches and innovation are essential when preparing bespoke financial information such as prospectuses and investment circulars. In this context the purpose of the potential best practice statement would be to facilitate these alternative forms of presentation and by establishing an under-pinning set of principles, bring some consistency to their preparation. As IFRS has not been produced to specifically address such situations, adherence to IFRS requirements is not necessarily the most important attribute of this type of information. Others however, suggest that the purpose of the potential best practice guidance should be the differentiation of combined from pro-forma financial information by, as far as possible, adhering to the principles of IFRS in combined financial statements. We urge FEE to give further consideration to this area. Were there to be support for FEE to favour the latter option, we have set out below in paragraphs 8 to 11 some further factors that could be considered in establishing these parameters, while also noting some alternative views. We use below the phrase 'IFRS consistent' to describe financial information that is prepared as closely as possible in accordance with IFRS principles.

Defining combined financial statements

8. We believe it is important that a clear definition is established to differentiate combined from consolidated or pro-forma financial statements. As set out in paragraph 7 above, there are different views on the factors to include in this definition. To some commentators the proximity to IFRS is a key defining factor for this type of information. In some cases combined financial statements may be sufficiently close to IFRS[1] consolidated accounts to be able to show a true and fair view. In some other cases, combined financial statements may not show a true and fair view, perhaps because of allocation assumptions made in their preparation, but it may still be possible to conclude that they are properly prepared on a largely IFRS compliant basis. Pro-forma financial information conversely may be distinguished from combined financial statements by its inclusion of hypothetical 'what if' assumptions. By excluding such hypothetical information and otherwise conforming as far as possible to the principles of IFRS, combined financial statements may have the capacity to carry a higher level of assurance than pro-forma information.

Should common control be a pre-condition to the preparation of combined financial statements?

9. Following on from this point, it could therefore be asserted that the purpose of the best practice guidance should be to define a model for combined financial statements that remains sufficiently close to the requirements of IFRS for the resultant reports to be able to have at least the capacity to be described as properly prepared largely in accordance with the principles of IFRS. Establishing common control as a pre-condition ties the concept to IAS 27 *Consolidated and Separate Financial Statements*, which similarly uses control as the basis for consolidation. Conversely, common management or common business may not form an appropriate basis for preparation of 'IFRS consistent' combined financial statements. However, while some may think it essential for any potential combination group to share common control others, preferring greater flexibility and room for innovation, would be comfortable describing commonality more widely. Consideration could also be given to whether future common control could be a sufficient justification.

The objective of the combination exercise needs to be clearly defined

10. As well as by a form of commonality the parameters of the combination group could also be determined by a second requirement – that the objective of the combination exercise be defined from the outset. By establishing the purpose of the exercise the boundary of the reporting entity / group should then become clear, rather than the preparer having a free-hand in deciding which entities to include or exclude. Were it possible to freely choose the mix of entities then selection could be biased towards achieving a certain outcome – for example by selecting only profitable entities. A biased selection in this way is unlikely to result in 'IFRS consistent' financial information. In this context therefore we would suggest that the parameters of the combination group be limited by the objective of the exercise. To take a simple example; if the report is being prepared in response to a potential transaction involving

[1] In an EU capital markets context the relevant GAAP is likely to be IFRS and therefore the term IFRS is used throughout this response although other preparation bases may be relevant in some situations.

entities C, E, F & G then all of these entities, and no others, should be combined in this particular exercise.

Allocation of consolidated balances should remain as close as possible to IFRS principles

11. Certain balances present in the consolidated accounts may need to be segregated for the purposes of the combined financial statements. In a framework designed to produce 'IFRS consistent' information it would be preferable that this segregation be done by properly attributing underlying actual historical balances between the two groups rather than by estimation or allocation. In some cases, notably taxation and assets used commonly across various entities without fair-value based recharging, a degree of estimation may be necessary and it is important in these cases that such estimations are consistent with IFRS. Ultimately where an estimation cannot be supported or where hypothetical factors are used to make the division, it may be that the resultant accounts are unable to show a true and fair view or that they even move away from being combined to become pro-forma financial statements.

RESPONSES TO SPECIFIC QUESTIONS

Section 3: Types of financial information for the past

Q1.1: Do you agree with the distinction of combined financial statements, consolidated financial statements and pro forma financial information as described and the characterisation of combined financial statements as historical financial information?

12. We largely agree with the three-part classification. As depicted, combined financial statements appropriately occupy a middle position between the consolidated results and pro-forma financial information. Combined and pro-forma financial statements are both forms of information that exist outside the context of the statutory financial statements. As we suggest in paragraph 7, we believe that further debate on the purpose of combined financial statements would be useful. Some commentators believe that a key distinguishing feature of combined financial statements is that by deviating as little as possible from IFRS they may have the capacity to show a true and fair view, or at least be seen as properly prepared on a largely IFRS compliant basis. The purpose of pro-forma financial information is to demonstrate the effect of certain sets of assumptions. Although useful for this purpose, those assumptions may not be consistent with the principles of IFRS and as a result it generally will not be possible to conclude that they show a true and fair view. In this context the capacity to show an 'IFRS consistent' view allows a conceptual boundary to be drawn between combined and pro-forma financial information, it also provides a clear indication of the end result the potential best practice guidance is setting out to achieve.

13. Paragraph 3.7 suggests that combined may be distinguished from consolidated financial statements as the former relate to a 'circumscribed area of economic activity'. We agree that the entities for combination should form a 'circumscribed area', but we question whether the consolidated group could not also be described in these terms, as is proposed in IASB's Exposure Draft on the Reporting Entity. A better distinction may perhaps be that in the case of a consolidation the boundary of circumscription is pre-defined, for example by statute or in accounting standards. For combined financial statements the circumscribed area would need to be expressly defined by the commissioner or preparer for the purposes of the exercise, albeit within certain parameters.

Q1.2: Do you agree with the proposed definition of combined financial statements?

14. The proposed definition is a good starting point for the current project. In particular, identifying a 'circumscribed area of economic activities' is crucial to the exercise and we agree that it should form a central part of the definition. It may be beneficial however to give further thought to the way in which the purpose of the combination exercise is described. Ultimately, unlike consolidated financial statements where the purpose is clearly established in IFRS, the purpose of the combination exercise is determined by the commissioning or preparing party and therefore although it may in practice follow a familiar theme, the purpose could differ from one exercise to another. It may be better if the definition were to acknowledge this potential variability rather than stating a single, if rather generic, purpose.

Section 4: Principal approaches underlying the preparation of Combined Financial Statements

Q2.1: Do you agree that the common control approach referred to is appropriate for preparing combined financial statements? Please give the reasons.

15. As we set out in paragraph 7 above, we believe that further debate is necessary on whether the parameters of the combination exercise should be restricted. However we agree that care needs to be taken in determining what can and cannot be combined. If the objective of the best practice statement were the production of 'IFRS consistent' information then it is likely that common control would be a pre-requisite. For those preferring a more flexible approach other forms of commonality may also be acceptable. In both cases some kind of effective 'glue', some shared attribute, is likely to be essential to bind the entities in the combination together. Without this shared attribute the combination could appear arbitrary.

16. It would also be beneficial for the objective of the combination exercise to be pre-defined. Within a group of common control entities there may be many possible ways of combination and it could be possible to deliberately choose a certain structure to achieve a desired outcome, for example by only selecting profitable entities that have been under common management (within the umbrella of common control) and are to be spun off, and excluding unprofitable ones. This could obscure the 'true' picture of the management team's track record. To avoid this situation we believe that each combination should be supported by a specific objective. To take a very simplistic example; if the exercise has been commissioned in response to a proposed transaction specifically involving entities A, B, D & H, then the objective of the exercise would be the combination of their results. In this situation a combination of say, D & H alone is unlikely to be appropriate. Therefore as well as sharing a form of commonality, the combination group should also be supported by a specified objective establishing its parameters.

Q2.2: Is the common control approach acceptable in your legal or market environment? If not, please state the reasons.

17. Yes. Their preparation is not precluded and combined financial statements are not specifically addressed by either UK company law or mainstream accounting standards, although for the specific purposes of investment circulars their preparation would normally be in line with the annexure to Standard for Investment Reporting (SIR) 2000. SIR 2000 would then be followed by the auditor in providing assurance on the circular.

Q2.3: With respect to the described scenario 2, do you agree that there are circumstances where it is acceptable to prepare combined financial statements for the remaining group?

18. As we suggest in paragraph 16 above, if the purpose of the exercise is 'IFRS consistent' financial information then each set of combined financial statements should be supported by an objective defining the purpose of the combination. Where such an objective is in place for the combination of A, B, D & H, it would be a natural extension to then model a second combination for the remaining group. However, it would be undesirable to extend this principle to any further sub-sets of the residual group as these are unlikely to be supported by the original objective.

19. It would also be very important that such a situation be described in the best practice guidance in such a way that there could be no grounds for confusion between these and the IFRS consolidated financial statements. And in these cases it should generally be expected that the information should be capable of being presented within the overall framework of the group's IFRS financial statements (eg, by the application of IFRS 5 *Non-current assets held for sale* or through additional disclosure).

Q3.1: Do you agree that the common management approach referred to is appropriate for preparing combined financial statements? Please give the reasons.

20. If the objective is the presentation of 'IFRS consistent' financial information then common management alone would need to be approached with care. In most cases where there is common management, common control would also be present and therefore it would be largely unnecessary to identify this as a separate approach. In situations where there is no common control then careful consideration would need to be given to the exact situation and the expectations for the resultant financial statements. Common management could be influenced or directed differently by different owners, and it may be difficult to derive an underlying objective although in the more flexible approach the absence of common control should not be a barrier.

Q3.2: If you consider the common management approach appropriate, what circumstance(s) do you consider necessary to assume common management?

21. See paragraph 20 above.

Q3.3: Is the common management approach acceptable in your legal or market environment? If not, please state the reasons.

22. There is no explicit restriction on their preparation although in the UK we don't commonly in practice encounter common management in isolation without common control.

Q4.1: Do you agree that the common business approach referred to is appropriate for preparing combined financial statements? Please give the reasons.

23. The answer depends on the circumstances of the situation. If common business is a 'glue' for a previously unified entity that has merely shifted its legal identity then that is likely to be acceptable, indeed in the annexure to SIR 2000 such situations are recognised. Care would however still be necessary as where the only 'glue' between the entities is a common business it is likely that the combined group would be divergent from the principles of IAS 27 *Consolidated and separate financial statements* and therefore that the resultant financial statements would not be 'IFRS consistent'.

24. It should however be noted that as drafted paragraph 4.16 of the consultation paper does not seem to suggest the limited situation where an entity has shifted its legal identity but rather a wider situation where entities may only be connected as obliquely as through their operation in the same industry. This is unlikely to be a sufficient degree of commonality.

Q4.2: Is the common business approach acceptable in your legal or market environment? If not, please state the reasons.

25. Financial statements prepared on this basis could still be compliant with SIR 2000 and therefore could form part of an investment circular in the UK.

Section 5: Identifying the area of economic activities

Q5: Do you agree with the proposed definition of economic activities? If not, please state the reasons.

26. In principle we agree with the definition of economic activities. We welcome the inclusion in paragraph 5.2 of the proposed conceptual framework definition of economic activities which we believe clearly articulates principles for drawing an appropriate boundary. However, in paragraph 5.9 (2) the discussion paper does appear to tighten this boundary by adding the term 'integrated', which seems to imply that the activities have already been brought together. Both this definition and the proposed conceptual framework recognise that it is only the *potential* for the activities to be brought together that is necessary and therefore it may be desirable to remove the term 'integrated' from the definition.

Section 6: Key building blocks (major critical accounting issues)

Q6: Are there any additional key building blocks, other than the six identified?

27. No, we do not have any additional suggestions for building blocks.

Q6.1: Do you agree that the principles of consolidation accounting under IFRS are to be applied when preparing combined financial statements? Why/why not?

28. It depends upon the purposes of the exercise. In some cases it may be desirable that as far as possible the *principles* of IAS 27 are followed.

Q6.2: Which of the described accounting policy choices do you find most relevant when preparing combined financial statements? Why?

29. In our opinion it is not possible to answer this question at the conceptual level. The choice of accounting policies will depend upon the individual circumstances and the purpose of the combination in question. In some cases the choice of accounting policy may determine whether the resultant financial statements can be seen as true and fair, properly prepared or pro-forma and therefore the purpose of the exercise may circumscribe the accounting policies which may be chosen.

Q6.3: Do you agree with the principles of allocation as described?

30. Again, we believe that the allocation basis may vary depending upon the purpose for which the combination is performed. Therefore, we do not believe that a single generic set of allocation guidelines can effectively be established in advance. Ultimately it may well be necessary to apply a degree of allocation in a combination exercise. However, it is important to recognise that allocation is likely to result in assets or liabilities being recognised that would not be supportable under the principles of IFRS and as a result that the financial statements would not show a true and fair view. Nevertheless an important element of the potential best practice guidance could be to restrict allocation and estimation to methods in attempting to remain as close as possible to the principles of IFRS.

Q6.4: In terms of dealing with subsequent events, which of the presented three possibilities do you consider most relevant for the preparation of combined financial statements?

31. IAS 10 *Events after the reporting period* sets out the criteria for the recognition of post balance sheet events and for the current year the principles of IAS 10 should be followed and the results adjusted as appropriate. Previous years however should not be ‘re-opened’, this information should remain as stated at the approval date.

Q6.5: Which of the presented two approaches to account for transactions between different economic activities do you consider most relevant? Do you agree that whatever the approach adopted full disclosure of the approach taken and respective transactions should be made?

32. It may not be appropriate to fair-value cross-group transactions for the purposes of the combined financial statements. Where estimation occurs, particularly if based upon hypothetical factors, it becomes increasingly unlikely that the resultant financial statements will reflect a true and fair view

Q6.6: Do you agree with the presented specific disclosure requirements? Do you believe there should be other specific disclosure requirements? Please specify.

33. We agree that adequate disclosure of the basis of combination is essential and we agree with all of the specific disclosure suggestions in paragraph 6.6.

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