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30 April 2012

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By email: commentletter@efrag.org

Dear Mme Flores

Accounting for Business Combinations under Common Control

ICAEW is pleased to respond to your request for comments on *Accounting for Business Combinations under Common Control*.

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

ACCOUNTING FOR BUSINESS COMBINATIONS UNDER COMMON CONTROL

Memorandum of comment submitted in April 2012 by ICAEW, in response to EFRAG discussion paper *Accounting for Business Combinations under Common Control* published in October 2011.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper, *Accounting for Business Combinations under Common Control*, published by EFRAG on 21 October 2012.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working 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 138,000 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 EFRAG's research work in this area

5. We acknowledge EFRAG's efforts in tackling this important topic. Although it is not currently an agenda priority for the IASB this area has been under consideration for a number of years and we agree it is useful to conduct research to develop the debate further. Indeed in our recent response to the IASB's agenda consultation (ICAEW REP 114/11) we suggested that research of this type was an ideal method of investigating ways of improving practice without committing the IASB to a particular course of action. EFRAG has a valuable role to play in this process and we therefore welcome the current paper. We are also supportive of EFRAG's wider proactive programme. In particular, we feel that the project *Use of Financial Statements* might provide a valuable opportunity to augment additional research on the use made of financial statements containing business combinations under common control (BCUCC). The accounting treatment of BCUCC is a complex area and part of the reason for it not having yet being appropriately addressed may lie in the difficulty of devising an adequately versatile standard-based solution. Thus, although EFRAG's paper offers a useful opportunity for further debate, we do not believe that the evidence presented is sufficiently well developed to allow a workable solution to be drawn out. In the paragraphs that follow we explore some specific considerations that we believe should be addressed before the ideas outlined in the discussion paper are taken any further and suggest some areas where, in our opinion, further development is necessary.

Apparent diversity in practice is not necessarily undesirable

6. The discussion paper is predicated on concerns about 'inconsistent accounting for BCUCC'. We agree that there is indeed diversity in this area, but do not accept that this is necessarily undesirable. Quite rightly, different facts and circumstances, for example differing legal and tax regimes, lead to different accounting consequences. The situations in which these transactions occur are many and various and therefore it may often be appropriate that differences arise in the accounting used for reporting them. As such we disagree with the approach taken in the paper and particularly with the conclusion it then reaches that there are three potential

solutions to this assumed problem of ‘inconsistency’. We suggest that if the paper had instead started from an acceptance that BCUCC are driven by a variety of different circumstances it would have reached different conclusions.

7. The approach taken leads us to question the source of these concerns about diversity in practice. It may be that such concerns have been voiced by market regulators rather than by participants in such transactions or by users of related information. We appreciate that some regulatory authorities have a desire to enforce conformity in accounting for BCUCC within their jurisdiction. However, accounting standards have to cater for a broad range of entities, listed and unlisted, and need to result in financial information that meets the needs of market participants (investors), not least by being filtered to include only items relevant for this purpose. Ultimately, regulators can always require additional information through other channels if they feel this is necessary. Specific regulatory needs therefore should not drive general financial reporting requirements and if regulators believe a certain approach is preferable in certain circumstances, it may be better for them to address this directly rather than refer such matters to the IASB.

A ‘one size fits all’ solution is undesirable

8. We are concerned that in attempting to reach a solution, inappropriate conclusions could be drawn if the project is not widely scoped and based upon sound evidence as to user needs. It would be better for no action to be taken at all than to impose an unduly restrictive approach which narrowed viable accounting alternatives. Such an approach could reduce the usefulness of information for users.
9. As explained above we do not agree with the assumptions used to reach the three conclusions in section 5. We do not agree that IFRS 3 should either be mandated or prohibited and therefore we disagree with both views 1 and 2. View 3 *the analogy to IFRS 3 may apply* is the most conditional of the three and therefore accords to some degree with our concerns expressed above, but this selection is largely because view 3 does not lead to a specific recommendation. Overall we believe that further work and evidence gathering is necessary before an appropriate conclusion can be reached.

User needs should drive the accounting for business combinations under common control

10. We believe that the accounting in this area should be driven by user needs. Just as the situations in which BCUCC occur are many and various so too are the needs of users of financial information relating to these transactions. It is important that any solution proposed accommodates these differing needs and because of this it is likely that the accounting will differ depending upon the user, the purpose for which the information will be used and the situation. This is particularly relevant in considering who the users are of consolidated and individual entity accounts in the context of BCUCC, whether these users are different and whether their needs differ. In considering the needs of users, the cost of each alternative and the benefits offered will also be relevant.
11. Furthermore, we do not agree that the starting point for this exercise should be IAS 8 *Accounting policies, changes in accounting estimates and errors*, which would try to fit the accounting into existing standards where it may not naturally sit. If a project is to be pursued to research options in this area it must start from first principles, guided by the conceptual framework. The fact that there is currently a gap in IFRS literature is indicative of the complexities faced here and the likelihood that innovation may be necessary to accommodate these transactions within IFRS. We therefore urge EFRAG in taking any research forward to move away from an assumption that IAS 8 is an appropriate starting point.

The scope of the discussion paper is too narrow

- 12.** In further developing the project we believe that the scope of the paper needs to be broadened. The paper currently scopes out the accounting for BCUCC in the separate and individual accounts of the transferee. In the majority of cases, particularly for group reconstructions, consolidated financial statements are not required (often because intermediate holding companies are exempt from producing consolidated accounts either under the law or IFRS); in other cases transfers of businesses occur rather than transfers of investments. Therefore any project needs to consider the complete picture, including the cost of investment which is being eliminated on consolidation and, if the transaction involves a business rather than an investment, the accounting in the individual accounts. Other areas that should be considered are the accounting in the transferring company, any non-controlling interests, and what is meant by 'cost'. A key consideration in this regard is deciding which entity's book values to use; for example, the book values in the individual accounts of the transferred entity may differ from those used by the group for consolidation purposes. In addition, further consideration should be given to the form of net income information that would be most useful in different circumstances. It may be possible to develop indicators that can be combined with cost/benefit considerations to provide guidance as to the more appropriate method of accounting in given circumstances, and to then do some more detailed testing on the operation of these. Without a consideration of these situations the paper is incomplete and further development of the research is therefore necessary.

RESPONSES TO SPECIFIC QUESTIONS

Question 1.1 – Concerns about BCUCC transactions

Do you think that the concerns have been accurately described in relation to the issues arising from accounting for BCUCC transactions? If not, please could you suggest other significant concerns that have not been addressed?

- 13.** No. We do not believe that the objective of the paper is clearly enough articulated. As we explain in paragraphs 6 and 7 above, we do not agree that diversity in practice is necessarily inappropriate. We also feel that in order to properly evaluate the issues raised the scope of the analysis should be extended (see paragraph 12).

Question 1.2 – The approaches in practice

In your experience, what approaches are typically applied by preparers in practice for BCUCC transactions and what justification is provided to support their application of these approaches?

- 14.** Rather than focussing on a justification by preparers of the approach taken, in our opinion the focus ought to be on users. A question posed in terms of what approaches users typically demand and why, would be more useful in understanding whether there is indeed an issue that needs addressing. It would also help focus field testing in any further research conducted.

Question 2.1 – The scope of the project

Are there any issues not included in the scope of the DP that, in your view, need to be addressed in developing an approach to accounting for BCUCC in the consolidated financial statements of the transferee?

- 15.** Yes. In paragraph 12 above we suggest that the scope of the paper should be extended. Specifically it would be useful to include:
- separate financial statements;
 - the accounts of transferors;
 - non-controlling interests;
 - hive-ups; and
 - the creation of new companies as part of a common control transaction.

It should also investigate:

- what is meant by cost (eg which entity's book values should be used); and
- what constitutes meaningful net income information in different circumstances.

Question 2.2 – Separate and individual financial statements of the transferee

Do you believe that there are any specific issues to be addressed in the initial recognition and measurement of BCUCC in the separate and individual financial statements? If so, please explain what those issues are and how they should be addressed?

- 16.** Yes. It is not practicable to explore all of these potential issues in this response, but if the scope of the exercise could be extended to encompass individual financial statements then a full evaluation could be performed. For example, the transfer of a business is an individual accounts issue. The consideration of separate and individual financial statement issues can inform the discussion on treatment in the consolidated financial statements and vice-versa. Ultimately however, we believe that these discussions should be guided by user needs.

Question 2.3 – Disclosures

Are there any specific issues you think need to be addressed when considering what information about a BCUCC should be disclosed in the notes to the financial statements of the transferee?

- 17.** In deciding what to include in the transferee's financial statements it may be useful to start from a consideration of what is relevant for the primary financial statements and then to determine what additional information in the transferee's financial statements might help users. Net income and trend analyses are examples of disclosures that could be useful, but care should be taken around requiring excessive disclosure and cluttering up the financial statements. We would not support the introduction of an extensive list of additional disclosures, unless the need for such disclosures and their benefits could be clearly demonstrated.

Question 3.1 – Addressing the information needs of primary users

Do you agree that an important step is to understand the information needs of users in the financial reporting of a BCUCC transaction? If not, how else would you set out an approach that satisfies the objective of financial reporting?

- 18.** Yes, we strongly agree that as a first step the information needs of users should be evaluated. It is important to note that the users of this particular type of financial information may be a quite specific sub-group and therefore it is important that they are correctly identified. For some group reconstructions, the primary user might be the parent of wholly owned subsidiaries, in other situations a new listed company could be created. User needs may also vary in relation to individual accounts and consolidated accounts. For individual entities, some may argue that one of the primary purposes of the financial statements is to demonstrate stewardship. The variety of different situations, information needs and costs/benefits should be considered.

Question 3.2 – The transferee is a reporting entity

It is noted above that the analysis in this DP is taken from the perspective of the transferee (entity perspective) as opposed to the perspective of the owners (proprietary perspective). Do you agree that, to be consistent with existing IFRS, the entity perspective should be dominant when considering BCUCC? If not, why not?

- 19.** EFRAG identifies in paragraph 8 that these two perspectives are currently neither well developed nor even precisely defined; we agree with this assessment and recognise the appeal of defaulting to the entity perspective given that it is apparently favoured within IFRS. However, again we feel that in this area the answer will be driven by user needs. BCUCC take many forms and there is a corresponding diversity in users and their needs. If the primary user of the reports is the owner then it may well be that the proprietary perspective is most appropriate. Presenting information in a way that best meets the needs of users should take precedence over consistency with existing IFRS.

Question 3.3 – Applying the logic of the IAS 8 hierarchy to help develop an approach on how to account for BCUCC

Do you agree with applying the logic of the IAS 8 hierarchy in developing an approach to accounting for BCUCC transactions? If not, what alternative would you propose and how would you reconcile that approach with existing IFRS?

- 20.** No, we do not believe that the IAS 8 hierarchy should be applied. If a solution is to be developed in this area it is preferable for it to be approached from first principles based upon the conceptual framework. Paragraph 11 above explores this area in more detail.

Questions 3.4 and 3.5 – Initial recognition and measurement

Do you agree that if and when an analogy to IFRS 3 is considered to apply, it is appropriate to assume that fair value at initial recognition provides information that is more decision-useful than values based on previously recognised amounts or any other measurement attribute? If not, please explain why?

- 21.** This is something of a circular question. It is unlikely that an analogy to IFRS 3 would have been drawn had fair value not provided more decision useful information at initial recognition.

Do you agree that if the analogy to IFRS 3 does not apply, defining an appropriate measurement attribute should be guided by an analysis of the information needs of users? If not, why not?

- 22.** We believe this question should be reversed. The information needs of users should be considered first in determining the reports to be provided; based upon this analysis an analogy to IFRS 3 may or may not then be drawn.

Questions 4.1 and 4.2 – The unique features of a BCUCC transaction

Do you agree with the main features of a BCUCC identified above? If not, what other features would you highlight?

It is noted above that BCUCC can be substantially different in nature from business combinations between unrelated parties. Do you agree that a BCUCC can be different to a business combination under IFRS 3? If so, describe examples you have encountered in practice that verifies this. If not, please explain why?

- 23.** We conceptually disagree with the methodology adopted in this section in attempting to identify the distinguishing factors of a BCUCC transaction. It appears to us that the rationale behind this exercise is to attempt to isolate a sufficiently homogeneous set of transactions on the basis that once this has been achieved a universal accounting approach can then be identified. We do not agree with this approach; common control transactions are in fact heterogeneous in nature and a 'one size fits all' approach is unlikely to give an appropriate answer. If the purpose of this section is to enable BCUCCs to be identified then we would note that a suitable definition is already provided in IFRS 3. This question suffers from the scope of the paper being too narrow. There are a lot of different types of common control transactions and in our view a key purpose of the paper should be in determining what it is that makes a common control transaction specifically a BCUCC. Rather than focussing on IFRS 3, further research should be done to determine the wide variety of situations where investments or businesses are transferred.

Question 4.3 – Understanding the information needs of users about BCUCC transactions

Do you agree with the analysis that has been performed in relation to the information needs of users? If not, why not?

- 24.** We consider that the scope of research should be broadened before any conclusions are drawn.

Questions 4.4 and 4.5 – Identification of an acquirer

Do you think that with BCUCC it may be difficult in some circumstances to identify an acquirer (View A) or do you believe that an acquirer can always be identified (View B)?

If you believe that an acquirer can always be identified in a BCUCC, do you think that an analogy to IFRS 3 is not valid because the ultimate parent entity can direct the identification of an acquirer so that the accounting outcome is not a faithful representation of the underlying BCUCC transaction?

- 25.** IFRS 3 operates from the premise that an acquirer can always be identified, and that the acquirer is the entity that obtains control. Such a premise may also be possible for BCUCC but it is more tenuous because all of the parties are, by definition, under common control, during and after the transactions. Such transactions are often directed from the top of a group and we do not believe that it would be appropriate to always conclude that the cash payer is the acquirer. Similarly, the ultimate controlling party may effectively be able to choose the acquirer and therefore the application of IFRS 3 could be misleading. If the IASB concluded that an approach based on IFRS 3 should be applied to BCUCC, it would be necessary to consider whether additional guidance should be issued to help determine which entity obtains control in a common control environment. We note that this decision may require significant judgment.

Question 4.6 – Obtaining control over one or more businesses

Do you agree with the analysis above that under IFRS 10 control' should be assessed from the perspective of the reporting entity and not from that of the ultimate parent entity? If not, why not?

- 26.** Yes. In the case of a BCUCC it may be necessary to suspend disbelief and pretend that the ultimate parent has directed the transaction so that control is assessed from the reporting entity's own perspective.

Question 4.7 – Acquisition of a business

Do you agree that the definition of a business' in IFRS 3 raises no particular issues for BCUCC? If not, why not?

- 27.** We agree. The concept of a 'business' is defined in IFRS 3 and we do not believe that common control transactions raise any unique issues in this area.

Questions 4.8 and 4.9 – Applying the 'mechanics' of IFRS 3 – the recognition and measurement principle

Do you think the absence of a market-based transaction can have consequences when applying the recognition principle in IFRS 3 because of a lack of measurement reliability? If so, do you agree with the analysis? If not, why not?

- 28.** We disagree. The lack of a market-based transaction does have consequences, mainly that the process of assessing fair value is more complex and potentially costly. It will normally be possible to reach a reliable measurement, but we question whether the cost of doing so is justified by the limited benefits to be gained in some situations. Again, analysing user needs is key in relation to assessing benefit.

Do you think it is appropriate to apply the measurement principle in IFRS 3 to BCUCC when the analogy to IFRS 3 is valid? If not, why not?

- 29.** Yes. If the analogy to IFRS 3 is valid then the measurement principle in that standard should be applied.

Questions 5.1, 5.2 and 5.3 – View one: IFRS 3 can always be applied by analogy

Do you believe that the transaction price should be referenced against the fair value of the business acquired and bifurcated (when the transaction price exceeds the fair value of the business acquired) if the transaction price does not reflect a proxy for fair value? This ensures the BCUCC transaction reflects two transactions: a) a contribution from (distribution to) the ultimate parent entity, and b) a business combination.

Do you believe that goodwill and/or identifiable intangible assets should not be recognised in the balance sheet of the acquirer on the basis that they cannot be reliably measured?

Do you believe that where the consideration transferred is lower than the fair value of the net assets acquired, the difference should reflect a contribution from the ultimate parent entity or recognised as income?

30. We disagree with view one. It is not always appropriate to analogise to IFRS 3. It may be more helpful to concentrate on the more common types of transaction that arise rather than rare circumstances. We agree that, in a common control transaction, there may be a contribution from or a distribution to a parent. We do not believe that the paper, as currently presented, explores all of the situations in which such transactions may arise or all of the ways in which they may be recorded and we believe that this is one of the areas that an expanded paper should consider. However, we generally agree that that a 'gain' or 'loss' arising from an off-market transaction with a shareholder acting in their capacity as an owner should be recorded in equity rather than the income statement.

Questions 5.4 and 5.5 – View two: It is not appropriate to apply IFRS 3 by analogy

Do you think that the BCUCC should be viewed as a 'transfer' of a business rather than an acquisition of a business when the analogy to IFRS 3 can never be applied?

Do you believe that all the arguments and views presented are valid when it is not appropriate to apply an analogy to IFRS 3?

31. We disagree with view two. In some cases it may be appropriate to analogise to IFRS 3.

Questions 5.6, 5.7 and 5.8 – View three: The analogy to IFRS 3 may apply

Do you agree that the approaches outlined in Appendix 3 are unlikely to result in decision-useful information? If not, why not?

Do you believe that the diversity in the information needs of users when compared to a business combination and the cost constraint in financial reporting provide justification to consider whether or not the recognition and measurement principle in IFRS 3 are appropriate when accounting for BCUCC?

Do you believe that all the arguments presented in relation to view three are valid or are there others that you would consider?

32. Of the three perspectives view 3 most closely accords with our own views. Paragraphs 8 & 9 above explores this issue in more detail. An expansion of scope and further research would be needed to take this project any further, but ultimately it may be possible to develop criteria for when one type of accounting is more appropriate than others.

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