Ordine dei Dottori Commercialisti e degli Esperti Contabili di Roma

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Discussion Paper on the Accounting for Business Combination Under Common Control – Comment Letter

I am writing on behalf of the Commissione per i Principi Contabili of the Ordine dei Dottori Commercialisti e degli Esperti Contabili di Roma (Italy) to express our views on te above-mentioned discussion paper.

The issue of Accounting for Business Combinations Under Common Control (BCUCC) represents an important issue for Italy, because it regards extraordinary operations as mergers, demergers, contribution in kind, sale of businesses, which are all transactions with other entities in the same group. These transactions represents in Italy the most cases. Therefore we consider useful to undertake research and analysis on this area.

The analysis, in our view, is well developed and of considerable interest; but it refer to consolidated financial statements while the principal issues in this area regard, in Italy, separate and individual financial statements.

Our detailed comments at questions of DP are in the files enclosed.

We think that the different features among the BCUCC and the ordinary business combinations of the IFRS 3 make very difficult applying analogy of the IFRS 3 and the acquisition accounting based on fair value. We prefer the accounting treatment based on the predecessor basis, especially when the combination involves wholly owned entities.

Yours sincerely

Matteo Caratozzolo

Chairman

Matteo Caratozzolo

ORDINE DEI DOTTORI COMMERCIALISTI E DEGLI ESPERTI CONTABILI DI ROMA
Commissione per i Principi Contabili Nazionali ed Internazionali

EFRAG-OIC- DISCUSSION PAPER
"ACCOUNTING FOR BUSINESS COMBINATIONS UNDER COMMON CONTROL"
(the DP)

Detailed Answers to Questions

CHAPTER ONE: INTRODUCTION

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?"

Answer

We believe that the DP properly describes the main issues arising from accounting for BCUCC transactions and correctly describes the directions taken by the European Institutions, the Regulators at European level and companies on the matter.

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?"

Answer

In our professional experience, in the absence of a mandatory rule, companies have largely acted according to their tax opportunities, applying the predecessor basis of accounting approach or the acquisition accounting provided by IFRS 3, the latter applied mainly for business combinations between not wholly owned entities (entities with minorities).

The guidelines provided by OPI 1 and OPI 2, documents issued by Assirevi (the Italian association among audit firms), have been applied to BCUCC of listed or large companies. OPI 1 and OPI 2 suggest to select the accounting treatment based on the presence or not of the 'commercial substance', a notion similar to that one described by IAS 16 and IAS 38 for exchange transactions (assets acquired in exchange of non-monetary assets): the transaction has commercial substance by considering the extent to which the future cash flows are expected to change significantly as a result of the transaction. When the BCUCC has 'commercial substance' the acquisition method should be elected.

We do not know about cases where fresh start accounting was applied.

CHAPTER TWO: SCOPE OF THE DP

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?"

Answer

Since the scope of the DP is exclusively the initial recognition and measurement of assets and liabilities in the consolidated financial statement of the transferee, we believe the issues described are quite complete. At a later stage, however, it should be dealt with all the other issues which also affect recognition, measurement and disclosure in the consolidated financial statements of subsequent periods.

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?"

Answer

In Italy, the issues of major interest are those concerning the accounting treatment of BCUCC in separate and individual financial statements, which involve the solution of statutory as well as accounting issues, particularly with regard to the criteria applicable to the "reverse acquisitions".

Even if these issues should be addressed country by country, given the existing differences in company law rules on business combinations. However, at least for Countries that adopted the European Directives on contribution in kinds, mergers and demergers, we believe it is possible and useful to provide guidelines and general criteria about the BCUCC accounting treatment; guidelines to be implemented in the single country according to the specific internal company law rules.

CHAPTER THREE: ASSUMPTIONS AND GUIDING PRINCIPLES

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?"

Answer

We agree; the first important step is to address the issue of the information needs of the primary users of financial statements (existing and potential investors, lenders and other creditors).

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?"

Answer

We agree; the analysis on the recognition and measurement criteria of assets and liabilities in the consolidated financial statement should be provided according to the 'entity perspective' and not to the 'proprietary perspective'.

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?"

Answer

We agree with applying the hierarchy of sources of rules provided by IAS 8 in paragraphs 10-12. Compliance with this hierarchy seems to be mandatory in Europe, since the IAS-IFRS adopted in the European Union are European legal rules and no more merely accounting standards.

Questions 3.4 and 3.5 – Initial recognition and measurement

3.4 *"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?"*

3.5 *"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?"*

Answers

3.4 If all the needed features to apply IFRS 3 by analogy exist, then the fair value measurement should to be applied, because it seems the most proper measurement rule in this case (except some specific exceptions).

3.5 On the contrary, whether the analogy to IFRS 3 does not apply, the most suitable measurement approach should be based on the analysis users' needs.

CHAPTER FOUR: DEFINING THE PROBLEM

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

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

4.2 *"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?"*

Answers

We agree; we believe that the main features of a BCUCC are:

- the purpose of the transaction,

- the absence of the market conditions: because the BCUCC is a related party transaction, the lack of market condition challenges the assumption that the transaction price is deemed to represent fair value,
- the nature of the consideration: also the nature of consideration can be affected by the lack of market conditions.

The DP has properly considered the specific features of BCUCC as related party transaction. We believe that the main feature is that the transaction is designed and implemented according to the parent company decisions, with terms, conditions and a consideration that, as a general assumption, are established by the parent company itself, while the transferor and the transferee may have little or no influence on them. We think this is the main feature of BCUCC compared to business combinations between third parties negotiated at market conditions.

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?"

Answer

We agree with the analysis of information needs of users of financial statements of the transferee made in paragraphs 27 to 68. In particular, we appreciate the analysis: *a)* of information needs based on whether the controlling shareholder has or has not the need to obtain the information needed for its investment decisions from financial statements, *b)* of information needs of non-controlling shareholders and of the lenders of the entity, more interested in separate and individual financial statements compared to consolidated financial statements.

The analysis demonstrates that there are significant differences with respect to information available from the transferee's financial statements in a business combination that is an acquisition according to IFRS 3. The differences are well summarized in paragraph 67 with regards to forecasts of future net cash flows and to the assessment of management's efficiency in carrying out the business (Management Stewardship).

Assessing whether the definition of a business combination and the key principle of IFRS 3 are relevant

Questions 4.4 and 4.5 – Identification of an acquirer

4.4 *"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)?"*

4.5 *"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?"*

Answers

4.4 We believe that, notwithstanding it is a BCUCC, an acquirer can always be identified analysing all the relevant facts and circumstances, as provided by paragraph 15 of IFRS 3. In any case, it is a *sui generis* acquirer, other than an acquirer acting in a market transaction, because, as well explained on the DP, the parent company decides how the transaction has to be designed and who should appear as the acquirer.

4.5 As a consequence, the accounting treatment of the transaction presents some differences with respect to a business combination in an arm's length transaction.

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?"

Answer

Paragraphs 90 and 91 of the DP are not clear; above all the conclusion of paragraph 91 is not acceptable, because the real control remains in the hands of the ultimate parent, even after the operation. Under this perspective the difference is substantial compared to business combinations under IFRS 3

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?"

Answer

We agree.

Questions 4.8 – Applying the 'mechanics' of IFRS 3 – the recognition 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"

Answer

We agree; the lack of market conditions and, above all, of a market price, leads to some consequences. So that, we believe that goodwill and identifiable intangibles assets, other than intangibile assets protected by property/patent rights established by law or contract, could not be reliable measured and recognised. Therefore, we share the conclusions in paragraphs 107 a)(i), b) and c)(i).

Questions 4.9 – the measurement principle

"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?"

Answer

The features of BCUCC, that make them different form the 'ordinary' business combinations, do not allow to always apply the fair value measurement principle, even if there would be analogy to IFRS 3.

The DP does not give the right importance to the change in the percentage of control, well considered by the UK GAAP FRS 6 dealing with 'Group Reconstructions'.

Another particular feature to be considered is the absence of minorities (i.e. the entity is wholly owned by the parent company). In this case, we question the applicability of the fair value principle and the recognition of goodwill, since the transaction is not a market transaction and its accounting treatment in the consolidated financial statement of the transferee does not provide useful information to the existing equity investors (the parent only), that obtain financial information not through the transferee's consolidated financial statement but from the group and from the parent company's consolidated financial statement.

CHAPTER FIVE: CONSIDERATION OF POTENTIAL WAYS TO ACCOUNT FOR BCUCC AT INITIAL RECOGNITION AND MEASUREMENT

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

5.1 *"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"*

5.2 *"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?"*

5.3 *"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?"*

Answers

5.1 Applying IFRS 3 by analogy requires a business combination measured at fair value, where the consideration can be assumed to be a market value. When the consideration is significantly different from the fair value of the acquired business, the difference should be allocated to another kind of transaction (a distribution to/contribution from the ultimate parent entity).

5..2 We agree.

5.3 We believe that when the consideration transferred is lower than the fair value of the net assets acquired, the difference should be presented as an equity contribution from the ultimate parent entity (not an income).

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

5.4 *"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?"*

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

Answer

When the analogy to IFRS 3 can not be applied, the BCUCC is properly viewed as a 'transfer' rather than an acquisition; so that the predecessor basis of accounting seems to be the most appropriate accounting treatment. Furthermore, when predecessor basis of accounting is not suitable according to users needs, we prefer the acquisition accounting rather than the fresh start accounting, which can be misused (abused) in some circumstances.

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

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

5.7 *"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?"*

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

Answers

5.6 No, we do not agree. We consider important and find reasonable the third approach listed in the Appendix 3 on the 'commercial substance' of the transaction, as provided by the Canadian GAAP related party standard (Section 3840 of CICA Handbook of Canadian GAAP), with the exceptions provided in a) and b).

5.7 We agree.

5.8 We believe that the analysis is accurate and appreciable.