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EFRAG and OIC Discussion Paper: Accounting for Business Combinations under Common Control

Introduction

Grant Thornton International Ltd (Grant Thornton International) is pleased to comment on the European Financial Reporting Advisory Group's (EFRAG) Discussion Paper: *Accounting for Business Combinations Under Common Control* (the Paper).

We welcome the Paper as an important contribution to the debate on this issue and a stimulus for future standard-setting activity. We have not responded to all the questions in the Paper. Instead, this letter sets out our comments on the Paper's approach and our thoughts on possible next steps.

Need for additional guidance

As noted in the Paper, business combinations under common control (BCUCC) are widespread, occur in many forms and are currently subject to diverse accounting practices. The lack of authoritative guidance in International Financial Reporting Standards (IFRS) is well explained in the Paper and is clearly a primary cause of diversity. However, we suggest other factors have also contributed to diversity. These include guidance issued by national standard-setters, positions taken by local enforcement bodies, and the challenges of applying the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8).

For these reasons, we believe this issue requires attention by the International Accounting Standards Board (IASB). We have also expressed this view in our response to the IASB's recent Agenda Consultation.

Comments on the Paper

We believe the Paper provides a thorough analysis of the issues and challenges in developing authoritative guidance on accounting for BCUCC transactions. These include the wide variety of structures and reasons for entering into such transactions, and the fact that BCUCC are related party transactions that are frequently effected on non-arm's length terms.

The Paper approaches the challenge of developing accounting principles for BCUCC by applying the logic of the IAS 8 hierarchy. We find this an interesting exercise. However, we also question whether it will yield a clear conclusion. One of the challenges in applying the hierarchy is that BCUCC have both similarities and differences to combinations within the scope of IFRS 3 *Business Combinations* (IFRS 3). The nature and extent of these differences varies from one transaction to another. We also observe that reporting entities currently apply the hierarchy and evidently reach inconsistent conclusions.

The Paper also includes an extensive discussion of the information needs of users in relation to reporting BCUCC transactions. We agree that considering users' needs is central to the development of general purpose financial reporting standards. However, similar to our comments on the hierarchy, we question whether this line of reasoning will reveal clear and persuasive arguments for one accounting treatment over another. Users are a diverse group, and not all users have the same needs. Research on 'decision-usefulness' has tended to focus on the financial statements as a whole rather than specific accounting rules for particular types of transaction and, as noted, the circumstances and structure of BCUCC vary widely.

We are not arguing against a user-focused approach or being informed by the hierarchy. We do however suggest that users would be well-served by practical improvements to the consistency, understandability and transparency of reporting BCUCC. The Paper notes that there is no 'ideal solution'. A quest for clarity on user needs at a detailed level may yield no clear outcome and might delay the development of practical improvements.

We note the Paper identifies three broad accounting approaches for BCUCC as follows:

- applying IFRS 3's acquisition method by analogy (acquisition accounting)
- a predecessor accounting method (predecessor accounting)
- fresh start accounting.

We agree with the Paper's assertion that the first two approaches are far more widespread in practice. We believe that fresh start accounting is used only rarely.

We strongly endorse the Paper's comments to the effect that the application of 'predecessor accounting' has several variants in practice. We suggest that this diversity of application is unsatisfactory and should be addressed by the IASB. We also acknowledge the difficulties of applying acquisition accounting to some BCUCC, including identifying the acquirer.

Practical improvements

Given that the approaches most commonly seen in practice are acquisition accounting and predecessor accounting, we agree with the direction of the Paper that a practical solution should focus on those approaches. We suggest two main issues for further analysis by EFRAG and the IASB:

- the basis for selecting between the two methods, for example whether both should be permitted as a 'free' accounting policy choice or, alternatively, whether entities should be required to apply one or the other in particular circumstances
- practical issues on the application of each of the two methods.

We comment further below.

Selection of method

We suggest the critical issue in this context is whether selection of the method to be used should be a 'free choice' (which, as a practical matter, is probably the case at present) or addressed by authoritative guidance. Under the second scenario, future guidance could require one or other method depending on the facts and circumstances of the BCUCC in question. Other variants could also be envisaged such as a presumption in favour of one method along with circumstances in which that presumption could be rebutted.

An assessment of, and research into, user needs for different categories of BCUCC might provide insights into how to proceed on this question. For example, one line of thought is that acquisition accounting does not serve user needs well if existing owners have simply reorganised their existing ownership interests (to achieve tax advantages or other synergies for example). In these cases some view a fair value 'step-up' as an irrelevance at best and, at worst, an obstruction to transparency. A predecessor accounting method might then seem more appropriate.

By contrast, acquisition accounting may provide more useful information if ownership interests have changed – for example new owners have been brought in, proportionate interests in the combining entities have changed or non-controlling interest is affected.

Should an assessment of user needs yield no clear insights, however, one possible approach would be to leave the basis of selection as an explicit accounting policy choice. The aim of future project work would then be to address the key practice issues and inconsistencies currently encountered in the application of the two methods. We expand on this below.

Addressing practice issues

We suggest that improving consistency in the application of acquisition accounting and, in particular, of predecessor accounting to BCUCC is a worthwhile and practical aim. We believe this is perhaps a higher priority than developing definitive guidance on which method should be applied.

As regards predecessor accounting, issues include:

- comparative figures - whether these are restated and, if so, whether for all comparative periods or only as far back as the date common control first existed (if a shorter period)
- if comparatives are restated, the treatment of any changes in non-controlling interests in the comparative period (from the perspective of the controlling party)
- whether the 'predecessor values' used are those in the combining entities' standalone financial statements or, if different, the values in the controlling party's (eg the ultimate parent's) consolidated financial statements
- whether, under a controlling party perspective, goodwill recorded on a previous acquisition of the combining entities is recognised
- the basis for recognising certain items such as intangibles and contingent liabilities. For example, are such items recognised on the same basis as they would be under acquisition accounting or only to the extent that they are included in the combining entities' standalone financial statements (in accordance with applicable IFRS)?

Under acquisition accounting, we believe that some extra guidance might be useful on identification of the acquirer in a common control scenario. It might be useful to consider whether a modified form of acquisition accounting is more appropriate for BCUCC transactions eg in relation to the treatment of goodwill or a gain from a bargain purchase.

Other issues that may merit attention in a future project include clarification of:

- some aspects of IFRS 3's definition of common control - for example whether entities controlled by two or more close family members are regarded as under common control
- the meaning of 'transitory' in this context.

We hope that the IASB will in due course complete its project on a revised Conceptual Framework, which is currently suspended. This may provide relevant insights into a project on BCUCC transactions. For example, future framework components on measurement, the reporting entity and disclosure may all provide useful insights. That said, we believe that it should be possible to deliver practical improvements on the accounting for BCUCC transactions without waiting for the new Conceptual Framework.

Next steps

We assume that EFRAG will analyse the responses to the Paper. This may provide more insights into user needs or preferences. One possible output might be a list of indicators to help preparers and users decide whether these needs would be better addressed by using acquisition accounting or predecessor accounting.

In addition, we believe it would be useful if the various methods of predecessor accounting currently accepted by national standard-setters were assessed and recommendations made as to a preferred approach.

We encourage EFRAG to determine its next steps, and the scope of the next phase of this project if applicable, in cooperation with the IASB, with the long-term aim of incorporating the outcome into a future IASB pronouncement.

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If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@uk.gt.com or telephone + 44 207 391 9510).

Yours sincerely,

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