EFRAG
European Financial Reporting Advisory Group

Organismo Italiano di Contabilità

EUROPEAN OUTREACH ON EFRAG PROACTIVE DISCUSSION PAPER ON BUSINESS COMBINATIONS UNDER COMMON CONTROL

SUMMARY OF THE FEEDBACK RECEIVED

JULY 2012

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DISCLAIMER

Executive summary

Objective

EFRAG's Discussion Paper issued within its proactive projects

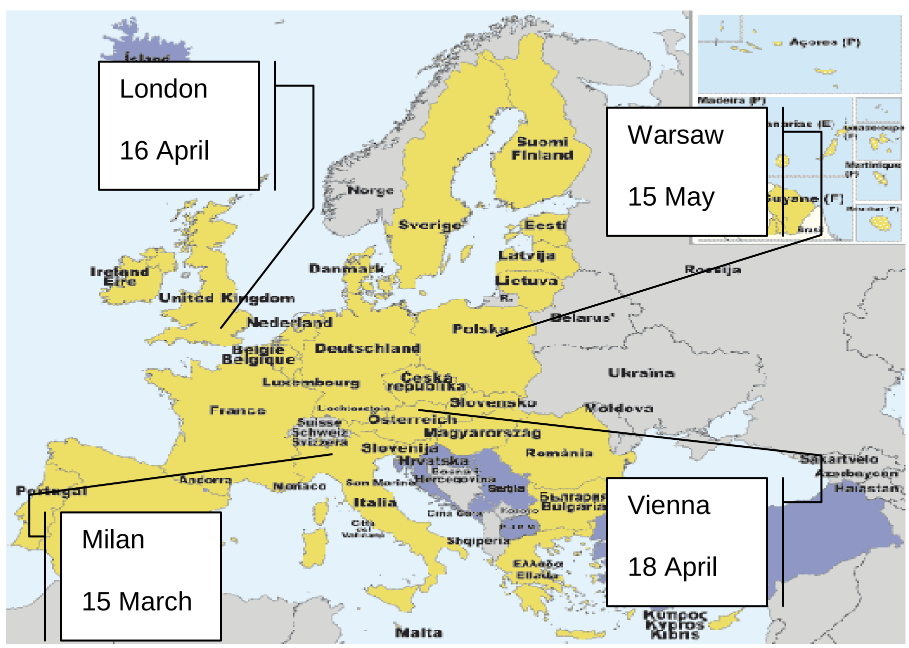
In October 2011 EFRAG issued the Discussion Paper 'Accounting for Business Combination under Common Control' (the DP) together with the Italian standard setter - Organismo Italiano di Contabilita' (OIC).

The accounting for Business Combination under Common Control

The DP represents a first step in responding to the diversity that exists in practice. It principally aims to set out the arguments and provide analysis to stimulate discussion and debate and it therefore includes a comprehensive analysis of the issues. In addition, it notes that there is no ´ideal´ accounting approach, but draws out three different views or ways of looking at the problem highlighting some of the strengths and weaknesses of each view.

EFRAG and the OIC were willing to gather European constituents' views

EFRAG and the OIC were keen to gather views from constituents and obtain input from them in order to understand what practitioners and others thought about the topics considered in the DP. Accordingly, they organised, together with National standard setters, meetings in four European cities. The chart below shows the places where the outreach events were held:



The inputs received at the events will benefit EFRAG, the National Standard Setters involved, and the future work of the IASB.

EFRAG is in the process of analysing the comments received from constituents on its DP.

This consolidated feedback statement summarises views of the European constituents. It should be read together with EFRAG's DP, which details the arguments discussed at the outreach events.

Next Steps

EFRAG deliberately did not take a position in the DP. Given its objective, EFRAG attempted to provide a comprehensive analysis of the issues and the clear intention was for constituents to consider the arguments set out and provide their views. The nature of the comments received, including those gathered in the outreach events, will form the basis for EFRAG's re-deliberation of the issues that fall within the scope of this project. At that stage, a decision will be made about what further steps to take before putting forward views to the IASB.

EFRAG's proactive work

It is important to see the DP within the broader context of EFRAG's Proactive Work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. This proactive work is done in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at European level. There are four strategic aims that underpin proactive work:

- Engaging with European constituents to ensure we understand their issues and how financial reporting affects them.
- Influencing the development of global financial reporting standards.
- Providing thought leadership in developing the principles and practices that underpin financial reporting.
- Promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about proactive work and current projects is available on EFRAG's website (www.efrag.org).

Methodology

The outreach events were conducted by presenting the main topics analysed within the DP to the audience made up of preparers, users, academics and regulators.

Participants were requested to express their views in response to the questions included in the DP.

In addition to this summarised feedback statement, EFRAG has issued detailed feedback reports on each outreach event for the convenience of the European constituents - available on EFRAG's website.

Level of participation

Overall, over 200 constituents participated in the meetings. Representatives of EFRAG, the OIC and the National Standard Setters involved participated at all meetings.

The tables below show the total number of participants by nature and by industry:

Participants by nature:	
User	104
Preparer	78
National Standard Setter	30
	212

Participants by industry:	
Accountants	68
Automotive	1
Banking and Insurance	31
Government	2
Services	19
Telecommunications	10
Utilities	12
University	20
Others	49
	212

Overall feedback received from constituents in Europe

This section outlines the overall feedback received from constituents in Europe and is based solely on that and *does not* include views expressed by representatives of EFRAG and the OIC.

General feedback

Participants considered the DP a valuable attempt to stimulate the debate but (…)

The issuance of the DP was welcomed by participants, who considered it as a valuable attempt to stimulate the debate in order to remove existing divergence in practice on accounting for Business Combinations under Common Control ('BCUCC').

Participants at the events expressed a general support for the debate promoted by the DP.

Participants also provided feedback on how to improve the analysis.

(…) its scope should be wider in order to consider:

Some believed that the way the IASB has modified the definition of control within IFRS 10 *Consolidated Financial Statements,* could represent an additional area to investigate especially in circumstances when the ultimate parent is neither the listed company nor the reporting entity.

what is current practice, andhow current legislations affect the accounting treatment

Others believed that it should be further investigated how such transactions are currently accounted for on a country by country basis. They noticed that in some jurisdictions local law, such as taxation law, might have a significant influence on the preferred method of accounting. Others argued, on the other hand, that in some jurisdictions it could be difficult to apply – for instance – the concept of bifurcating the contribution/distribution component within the consideration transferred.

Some believed that the working group should consult with research organizations such as the Financial Reporting Lab in the UK in order to understand the current practice.

The DP's scope should encompass all transactions between related parties

EFRAG staff noted that many participants at the events would have welcomed a broader analysis in order to encompass the whole set of transactions with related parties to which BCUCC belong; however, they were aware that the IASB has not considered such topic as part of its agenda consultation.

The analysis should cover all different possible objects of such transactions

At the events many participants believed that it would be useful to define an accounting treatment irrespective of the object of the transaction (e.g. asset, business, subsidiary).

Some participants believed that the analysis carried out in the DP should be more focused on the impact of such transactions on minorities and the corresponding accounting should be influenced by the purpose of the transaction (i.e. acquisition, restructuring or enhancing synergies).

Accounting for BCUCC in the separate financial statements should not be scoped out from the DP

Participants at the events generally would have welcomed a broader scope in which also the accounting for BCUCC in the separate financial statements would have been covered.

Finally, some questioned whether the reporting entity for the purposes of the analysis was the legal entity directly involved in the BCUCC, or whether it was the ultimate parent company. They believed the analysis should have considered all local regulatory and civil requirements along with accompanying complications given the existence of country by country issues which could have affected the analysis.

Some participants noticed that in a specific country it might happen that the listed entity was not the ultimate parent company (or investor) and therefore the relevance of BCUCC was high; while in other jurisdictions it might be difficult to identify who the users of such sub-consolidated financial statements were.

The three views

Three views have emerged over the course of developing the DP and they consider that there are circumstances when the analogy to IFRS 3 is appropriate and others when it is not. Where the analogy to IFRS 3 is appropriate the unique characteristics of BCUCC can play different roles in shaping the accounting outcome when applying the recognition and measurement principles of IFRS 3. This is because they have an effect on determining what makes information useful for users of the financial statements of the transferee/acquirer. Also, to some extent, the diversity in information needs of the users challenges whether or not the recognition and measurement principle should apply at all.

On the contrary, when the analogy to IFRS 3 is not appropriate because the transaction is under common control, the use of ‘fresh start’ or a predecessor basis of accounting may be appropriate, depending on the specific facts and circumstances and the analysis of user needs.

View 1

IFRS 3 can always be applied by analogy. Three different variants have been identified within this view depending on the extent to which the recognition and measurement principles in IFRS 3 are deemed to be applicable.

Under View 1 the definition of a business combination equally applies to BCUCC; however, the unique features of a BCUCC can affect the mechanics of IFRS 3. Accordingly three different variants have been presented in the DP:

- Variant 1: the recognition and measurement principles in IFRS 3 should equally apply to BCUCC;
- Variant 2: goodwill should not be recognised in the balance sheet of transferee; and
- Variant 3: goodwill and intangible assets should not be recognised in the balance sheet of transferee.

Participants supporting View 1 were fairly split on which of the three variants could best depict the economics and the substance of the transaction, because BCUCC are transactions not subject to the market forces. They therefore believed that fair values could not be reliably measured in all circumstances.

Participants were not comfortable in recognising goodwill and intangible assets in applying View 1

Most participants believed that – among the three variants included in the DP - variants two and three could be at least further investigated. In particular, those participants did not believe that the recognition principle for intangibles or goodwill should be applied as part of the acquisition accounting. Those participants unanimously believed that fair values could be reliably measured only for tangible fixed assets through an independent appraisal evaluation made by third parties.

The way transaction prices could be defined affects the application of View 1

Those against the application of the acquisition accounting noted also that in some jurisdictions the price could have been set even at a nominal unit amount.

Others believed that the inexistence of market based values would represent a difficulty in bifurcating the value of the business transferred and the distribution/contribution made by the parent company.

Those not supporting the recognition of goodwill in a BCUCC believed that such transactions are only aimed at unwinding all the economic and financial benefits which the group has acquired in a preceding business combination occurred with third parties; therefore, no additional cash flows would have been forecasted in order to justify the recognition of additional goodwill.

On the other hand, many preparers at the events favoured the application of IFRS 3 in accounting for BCUCC as they believe that the acquisition accounting provides the most relevant and useful information to users of financial statements.

In some circumstances, participants presented also fact patterns where restructuring within a group had substantially modified the expected future cash flows and the acquisition accounting would therefore best represent the economic substance of the outcome of such BCUCC.

View 2

Applying an analogy to IFRS 3 may not be appropriate because there could be difficulty in identifying an acquirer or the accounting outcome may not represent a faithful representation of the BCUCC transaction where the ultimate parent entity directs the selection of the accounting acquirer. Therefore, two accounting treatments could be applied under these unique circumstances: 'fresh start' accounting and a predecessor basis of accounting. The selection of an accounting treatment is dependent upon who the users are and what their information needs entail. That is 'fresh start accounting' could apply where users deem that the assessment of the prospects of future net cash inflows is best reflected through fair value measurement. A predecessor basis of accounting could be applied when the information needs of users are best served through a historical trend analysis of the income and cash flow statements and the statement of financial position.

Within View 2, predecessor accounting was the preferred approach in circumstances when:

- there is no change in the controlling structure and therefore the goal of the transaction is not to create additional synergies;
- assets and liabilities continue to be managed on the basis of the transferor's carrying value; and the
- transfer price is not a market-based price, as the transferee and transferor are related parties.

BCUCC represents a mere reallocation of existing resources between entities within a group

Participants noted that when applying View 2 the excess of the transfer price over the carrying value of net assets transferred could represent, from an entity's perspective, a reallocation of resources by the ultimate parent between different legal entities.

Applying acquisition accounting would lead to having several

Other participants noted that the acquisition accounting method would lead (in the absence of economic reasons) to high operational difficulties since companies would need to keep different sets of accounting data for reporting purposes. In their view, the cost of this would not be outweighed by the benefit of applying IFRS 3.

sets of accounting books

Those not in favour of applying the predecessor basis of accounting in View 2 mainly noticed that actually there are several existing ways of applying it. The methods that are used in practice include push down accounting, values in the books of the transferor and original historical cost. Therefore by choosing such view the inconsistency in practice in accounting for BCUCC would not be removed.

There is not a unique way of applying the predecessor basis of accounting

In addition, participants not supporting View 2 believed that in circumstances where the BCUCC had an impact on forecasted cash flows the predecessor basis of accounting was not the best way to depict the economics of the transactions. Someone noticed that - usually when litigation is filed - the claims are made on fair values rather than on book values.

BCUCC may affects future cash flows and thus fair value accounting should be applied

Some academics supported the fresh start accounting method without recognising any goodwill and believed that in some circumstances the combined entity represents something different than the mere sum of the entities making up the BCUCC. However, they represented a minority as others participants at the events expressed their support for other methods presented in the DP.

Only few academics sympathised with the fresh start accounting

View 3

> *The analogy to IFRS 3 may apply in specific circumstances like a change to previous economic decisions taken in relation to the users of the consolidated financial statements of the transferee. Such an approach is consistent with the objective of financial reporting which is to provide "information that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit."*

View 3 requires evaluating all facts and circumstances to understand which of View 1 and View 2 best depicts the economics of the particular transaction and provides relevant information. Participants at the event believed that View 3 would have allowed them to identify the best accounting treatment depending on the economics of the BCUCC transaction.

EFRAG staff perceived that View 3 was the one which had, on balance, gained the most support of participants at all the outreach events.

View 3 was the alternative view which gained major support at the events

Participants mentioned that a similar guidance has been already developed at a local level in different countries. The discriminating factor in implementing that guidance was the evaluation of the

Current practice in several

jurisdictions seems to be coherent with View 3

economic substance of the underlying transaction which would have influenced the corresponding accounting treatment to adopt.

Some of the relevant indicators mentioned at the events are:

Even if Participants would welcome further analysis on how different indicators affect BCUCC transactions (…)

- purpose of the transaction;
- impact on the cash flows before and after the transaction;
- modification of the control structure and impact on minorities;
- change in risk profiles for creditors; and
- the substance over form criterion.

If View 3 was the one perceived as the most favoured approach, two different and opposite views arose from its application:

(…) the majority seemed to believe that it was not possible to define a bright set of indicators to choose theoretically the accounting treatment

1. Some participants believed that within View 3 the acquisition accounting should have been the first approach to consider in order to define the accounting treatment for BCUCC and, only in case the BCUCC would have met some specific and bright criteria (e.g. relevant indicators) the predecessor basis of accounting could have been used instead; and
2. Other participants believed that it was not possible to define a bright line and a clear set of indicators in order to choose the appropriate method. The current diverse legal requirements and regimes together with multiple reasons for carrying out BCUCC transactions imply it is impossible to identify a single preferred accounting treatment based on some strict rules.

Participants - in presenting such views - were strongly influenced by existing practice which depends on analysing all facts and circumstances.