

European Financial Reporting Advisory Group
35 Square de Meeûs
B-1000 Brussels
Belgium

8 June 2012

Dear EFRAG members

Discussion Paper: Accounting for Business Combinations Under Common Control (BCUCC)

The global organisation of Ernst & Young is pleased to submit its comments on the above discussion paper (DP) issued by the European Financial Reporting Advisory Group (EFRAG) and the Italian standard-setter, the Organismo Italiano di Contabilità. Our responses to the specific questions in the DP, when not addressed in this letter, are set out in an Appendix to this letter.

Acknowledgement of the concerns regarding BCUCC

In general, we believe that the DP adequately addresses the concerns arising from the accounting for BCUCC. As highlighted in the DP, we believe that the lack of guidance in IFRS on how to account for BCUCC has led to the diversity in practice. We are also aware of diverging interpretive guidance issued by regulators on how to account for certain aspects of a BCUCC. This diversity has reduced the comparability of financial information between companies.

In practice, the two methods of accounting for BCUCC most commonly found are the predecessor basis of accounting (historical cost) and the acquisition method under IFRS 3 (fair value). Of these two methods, it is our experience that the predecessor basis of accounting is applied more frequently in practice. We are not aware of companies applying fresh start accounting to account for BCUCC.

Companies justify the use of the predecessor basis of accounting by applying the hierarchy in IAS 8 and referring to other bodies of GAAP such as US GAAP, which permits companies to account for a BCUCC in a manner similar to a pooling of interests. As further discussed in our responses to the specific questions, even when companies apply the predecessor basis of accounting, the application of this method is not necessarily uniform.

Companies justify the use of the acquisition method under IFRS 3 in situations in which they can demonstrate that the transaction has economic substance from the perspective of the reporting entity (transferee). If there is no economic substance to the transaction, then the predecessor basis of accounting is followed. As further discussed in our responses to the specific questions, even when companies apply the acquisition method, the application of this method is not necessarily uniform when the consideration transferred differs from the fair value of the business acquired.

Finally, there are also questions in practice about whether certain transactions qualify as a BCUCC. For example, consider an internal reorganisation within a group in which a Newco is inserted at the top of an existing group or between a parent company and a subsidiary. While we believe such transactions do not represent business combinations but rather reorganisations, others may not share this view. Therefore, we believe any project should consider the use of a Newco within a consolidated group and whether that transaction would be considered a business combination.

The Scope of the Project

As indicated in our response to Request for Views on the *Agenda Consultation 2011* issued by the International Accounting Standards Board (IASB), we believe that its project on *Business Combinations between entities under control* should be higher in priority in the upcoming three year agenda of the IASB. We therefore welcome the issuance of the DP as a first step in addressing the concerns about the lack of consensus on how BCUCC should be accounted for under IFRS, and as a contribution towards the project on the topic.

Although we can understand why the scope of the DP has been limited to BCUCC, we believe that a number of the issues raised in the DP are also relevant for common control transactions generally (e.g. transfers of a group of assets that do not constitute a business, reorganisations within a group that do not constitute business combinations, the accounting by the transferring entity, etc.). We therefore believe that the IASB's project should not just be focussed solely on BCUCC, but should deal with common control transactions generally.

In addition, in our response to the IASB's Request for Views, we indicated that the project should be expanded to include combined financial statements resulting in a broader project than what is proposed in the IASB's Request for Views. This is not to say that EFRAG and the OIC should necessarily expand its project as part of the next steps to be taken, but they should consider whether some of these matters should be addressed. Determining a potential solution for the accounting for BCUCC transactions for the consolidated financial statements of the transferee is only a partial solution, without considering the wider issue of common control transactions generally.

Accounting should be based upon the IFRS Framework

The DP proposes two underlying perspectives to approach the discussion, the application of the IAS 8 hierarchy and the reference to user needs as a basis for a development of an accounting approach for these transactions. Taking an IAS 8 approach would be appropriate for a preparer seeking an accounting policy choice for a BCUCC within the confines of current IFRS. We believe, however, that the accounting for a BCUCC should be addressed by the IASB Board as a project. The Board is not confined by the IAS 8 hierarchy, only by the IFRS Framework. Therefore, consistent with the IFRS Framework, this project should focus on the needs of users and provide decision-useful information based on the economic substance of these transactions.

In assessing the needs of users, an important concept raised in the DP is whether the controlling shareholder is considered to be a user of the financial statements. If the controlling shareholder is not considered to be a user of the financial statements, the DP asserts that this could lead to the development of an accounting approach based on fair value (similar to IFRS 3) given that the information needs of the other users may be similar. We believe the controlling shareholder is a user; although, the controlling shareholder may not necessarily rely on general purpose financial reporting. Thus, we believe that further research should be performed to distinguish between the needs of the controlling shareholder from other users (existing and potential investors, lenders and creditors) and how those needs would drive the accounting model (weighting the needs of other users vs. the needs of the controlling shareholder).

While understanding the needs of users is an important step in determining an accounting model to account for BCUCC, we also believe that given the unique nature of common control transactions, any accounting model should consider whether the transaction possesses economic substance. For example, if the transaction does not possess economic substance, we would challenge whether an accounting approach based on fair value (similar to IFRS 3) would be appropriate. Factors that may help determine whether a transaction possesses economic substance include the following:

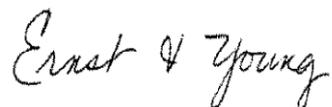
- a) the purpose of the transaction,
- b) the involvement of outside parties in the transaction, such as non-controlling interests or other third parties,
- c) whether or not the transaction is conducted at fair value,
- d) the existing activities of the entities involved in the transactions,
- e) whether or not it is bringing entities together into a “reporting entity” that did not exist before, and
- f) where a Newco is established, whether it is undertaken as an integral part of an IPO or spin-off or other change in control and significant change in ownership.

After this additional research is performed, we believe the Board would be in a better position to develop an accounting model that addresses the needs of users and provides decision useful information. If, based on the additional outreach, it is determined that there is a change in control at the level of the reporting entity (transferee) and the information needs of users are best satisfied through fair value measurement, we believe the acquisition method in IFRS 3 could serve as the starting point for developing an accounting model. However, given the unique nature of common control transactions, it is likely that the information gathered from this research may result in modifications to the IFRS 3 acquisition model.

In summary, while fully supportive of the work that has been performed on common control transactions, we believe that further research should be performed to develop a framework that could be consistently applied to common control transactions that would increase comparability.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +44 (0)20 7951 3152 or Arne E. Weber at +49 40 361 32 12353.

Yours faithfully

A handwritten signature in cursive script that reads 'Ernst & Young'.

Appendix

Business Combinations Under Common Control (BCUCC) DP

Questions

1.1 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?

We think that most of the concerns have been accurately described.

In our cover letter, we include some additional concerns about BCUCC under the heading "Acknowledgement of the concerns regarding BCUCC".

1.2 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?

In addition to our comments included in our cover letter under the heading "Acknowledgement of the concerns regarding BCUCC", where a predecessor accounting approach is applied, we are aware of the following approaches:

- ▶ The predecessor amounts are based on consolidated figures of the ultimate parent of the Group.
- ▶ The predecessor amounts are based on consolidated figures of an intermediate parent.
- ▶ The predecessor amounts are based on the historical amounts of the acquired entity.
- ▶ The application of predecessor accounting with or without restatement of information prior to the date of the transaction giving rise to the BCUCC.
- ▶ The difference between the consideration paid and the predecessor accounting value of the net assets received can be accounted for in different ways within equity.

Where the IFRS 3 acquisition method is applied, if the fair value of the consideration transferred differs from the fair value of the business acquired, the measurement of goodwill (or gain on bargain purchase) can be based on (1) the actual consideration transferred or (2) the actual consideration transferred plus an imputed additional equity contribution (or distribution) to recognise total consideration equivalent to the fair value of business acquired.

2.1 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?

We believe the presentation requirements with respect to BCUCC should also be considered. As indicated in Question 1.2, when the predecessor basis of accounting is applied, diversity in practice exists on whether prior period financial information should be restated.

As commented in our cover letter, we think the scope of the project should be extended to all common control transactions.

2.2 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.

If a transferee obtains control of a group of assets that constitute a business, we believe that the accounting issues for that BCUCC in the separate financial statements or individual financial statements are effectively the same as those arising in consolidated financial statements of a transferee and therefore should be addressed in the same way.

Where a transferee obtains an investment in a subsidiary, we agree that this should be accounted for in the separate financial statements under IAS 27. Examples of issues that should be considered are:

- ▶ Depending on the accounting principles applied in the consolidated financial statements the accounting of the acquired business in the separate individual financial statements may be at the cost of the contribution transferred or the fair value of the business acquired
- ▶ How to account for the difference between the consideration transferred and the business acquired

2.3 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?

We believe the information that should be disclosed in the notes to the financial statements will ultimately depend on the model to account for BCUCC. Consequently, we cannot respond to this question at this stage.

3.1 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?

See cover letter section "Accounting should be based upon the IFRS Framework".

3.2 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?

Yes, we agree that the analysis should be done from the perspective of the transferee. However, given the involvement of the controlling shareholder in a BCUCC, we believe that it would be inappropriate to ignore the role of that controlling shareholder in determining the appropriate accounting model.

3.3 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?

No. We believe BCUCC should be addressed by the IASB Board as a project based on the IFRS Framework. This makes the IAS 8 hierarchy irrelevant.

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?

As indicated in our cover letter, we believe further research must be performed to develop an accounting model based on the IFRS Framework to account for BCUCC. To the extent this research results in an accounting model consistent with IFRS 3 or concludes an analogy to IFRS 3 is appropriate, we agree that fair value at initial recognition is more decision-useful than predecessor amounts.

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?

As indicated in our cover letter, we support an approach to account for BCUCC that is based on the IFRS Framework. In applying the IFRS Framework to determine the appropriate measurement attribute, we fully agree that it is important to understand the information needs of users.

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

We generally agree with the main features described in chapter 4. Although not explicitly mentioned, we believe that the main feature of these transactions is the fact that the controlling shareholder remains the controlling party before and after the transaction.

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?

Situations where this might be the case include:

- ▶ Combining entities within a pre-existing group to maximise tax savings.
- ▶ Combination of specific activities to get grants or finance resources from third parties or governmental bodies.
- ▶ Reorganisation within a group to separate different activities, risks or regional businesses.
- ▶ Combinations where the consideration transferred does not represent the fair values of the business received.

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

See cover letter section "Accounting should be based upon the IFRS Framework"

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)?

The DP analyses the application of the acquisition method in IFRS 3 to account for BCUCC. As stated in the DP, the acquisition method is predicated on the identification of an accounting acquirer and the existence of a change in control. While we believe it is possible to identify an accounting acquirer, the common control nature of the transaction and the presence of a controlling shareholder may result in that determination to lack meaning.

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?

Please see above response to question 4.4.

4.6 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?

We agree that the definition of 'control' in IFRS 10 should be assessed from the perspective of the reporting entity.

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

We agree, but as indicated in our cover letter, we believe this project should cover common control transactions involving the transfer of assets that do not meet the definition of a business.

4.8 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?

We agree with the DP that goodwill is a residual and is based on the consideration transferred. Considering that the common control transactions are generally not conducted at arm's length, this could result in an arbitrary measurement of goodwill.

4.9 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?

See our response to Question 3.4.

5. All questions

We believe further outreach should be performed to understand the needs of users of the financial statements, including the controlling shareholder. Therefore, we believe it is premature to comment on the potential accounting for BCUCC.