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30 April 2012

Dear Sir,

Accounting for Business Combinations Under Common Control - a Discussion Paper

We are pleased to respond to EFRAG's invitation to comment on the above Discussion Paper (the DP). Following consultation, this letter summarises views of the BDO Network¹.

We welcome the issue of the DP, as a first step in responding to concerns about the lack of consensus about how Business Combinations Under Common Control (BCUCC) should be reflected in financial statements prepared in accordance with International Financial Reporting Standards (IFRS).

While we agree that it would be appropriate to seek to reduce diversity in the approaches followed in accounting for BCUCC, we do not believe that a single accounting approach is appropriate for all of these transactions. Instead, the focus should be on whether a similar accounting approach is followed for BCUCC with similar attributes. As noted in our detailed responses to questions in the DP, while we believe that in most cases it is appropriate for predecessor (or 'carry over') accounting to be followed, there are restrictive circumstances in which the overall judgement may be that it is appropriate to apply IFRS 3 by analogy. In that regard, we consider that an approach similar to that set out in view three in chapter 5 of the DP is most likely to result in a robust approach in determining the appropriate basis of accounting.

In making the distinction between those BCUCC where predecessor accounting should be followed, and those where IFRS 3 should be applied by analogy, we agree that the 'change in ability' model is relevant as part of the judgements involved. However, we believe that it would be appropriate to expand the range of aspects to consider to include changes in shareholder rights, or in the composition of shareholders; in some restricted cases, significant changes in the amount of an entity's borrowings and/or the identity of its lenders may be relevant.

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We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact the undersigned at +44(0)20 7893 3300.

Yours faithfully



Andrew Buchanan

Global Head of IFRS

Appendix

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?

We agree that the concerns have been adequately described.

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?

In our experience, it is rare for a BCUCC to be accounted for using acquisition accounting, meaning that the scope for diversity in practice is limited mainly to which book values are used (principally, whether they are the amounts at which assets and liabilities are recorded in the transferred entity's books, or amounts recorded on consolidation further up the group following the earlier application of acquisition accounting). Those who support the latter approach may argue that, because it is the parent that controls whether the transaction takes place, it is the parent's basis that should be used for the purposes of the newly combined entity.

In many cases, a form of merger (or 'pooling of interest') accounting is followed, with comparative information being restated as if the enlarged group had always been in existence. This approach has typically been justified by application of the hierarchy at IAS 8.10-12 and reference to the requirements of either US GAAP or UK GAAP, both of which contain guidance for BCUCC; depending on the literature that is followed, this can include a requirement that common control existed throughout the periods being presented in the financial statements. In others, although book values have been used (as described above), comparatives have not been restated. The justification for this approach is that (as with acquisition accounting in accordance with IFRS 3) the new group should not reflect transactions that took place before the acquisition of the new business under common control but, because the transaction involves entities or businesses under common control, it is inappropriate to reflect fair values that would arise from the application of IFRS 3. This is viewed as being inappropriate because a controlling entity could otherwise artificially revalue assets and liabilities (and recognise certain other assets and liabilities) that would not be permitted by an entity on a stand-alone basis.

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?

While the majority of BCUCC transactions are relevant to consolidated financial statements, in some cases the transfer of a business under common control is by way of a 'trade and asset' transfer, under which a trade and its related assets and liabilities is transferred from

one entity to another. This may have implications for the separate (or individual) financial statements of the transferee.

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 these issues are and how they should be addressed.

As noted above, and in the DP, a transferee can obtain control over a group of assets and liabilities that meet the definition of a business without acquiring a legal entity. We do not consider that there are additional issues to be dealt with from an accounting perspective, and are not convinced that the approach should be different from that which would be applied in an entity's consolidated financial statements following a BCUCC that involves the transfer of a legal entity.

Where a transferee entity obtains control over one or more additional subsidiaries following a BCUCC, then questions do arise over the appropriate carrying value of the investment in the transferee's separate financial statements. It would be helpful for this aspect to be covered in addition to whether acquisition or predecessor accounting should be applied in the consolidated financial statements.

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?

No.

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? If not, how else would you set out an approach that satisfies the objectives of financial reporting?

We agree that it is necessary to understand the information needs of users of financial information, with those users being as set out in the Conceptual Framework, and users identified in paragraph 6(a) of the Preface to IFRSs. However, while the needs of users are important, this should not override the underlying concepts and guidance in IFRS.

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?

We agree.

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?

We agree that this may be an appropriate approach. However, it will also be appropriate to reference the needs of users of financial statements that include a BCUCC with the outcome from the IAS 8 hierarchy, in order to ensure that these are met.

For example, an entity that is involved in a BCUCC might acquire an entity that has significant external debt meaning that, for a pre-existing lender to the transferee, fair value information about a business that has been transferred to that entity may be important. This would be in order that the overall effect of the BCUCC on the financial position of the transferee entity can be better understood; this might be particularly the case for a transfer at an amount which is less than fair value. However, we believe that if this were to be contemplated, it would be appropriate for the circumstances in which an IFRS 3 approach might be taken to be restrictive, and limited only to those rare circumstances in which the effect on an entity's financial position is very significant (for example, resulting in a change from significant net liabilities to significant net assets, or vice versa). Fair value information might be less important for a shareholder, if all of the entities involved are wholly owned by an ultimate parent entity.

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?

We agree that, if in rare circumstances it is considered appropriate to draw an analogy to IFRS 3, this assumption is appropriate. In this context, we note that a BCUCC has similarities to a business combination that involves unrelated third parties.

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?

We agree (please also see our response to question 3.3 above).

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?

We agree.

However, while we agree that an absence of market conditions (as described in paragraphs 11 to 19) means that a BCUCC can have different attributes from a combination involving unrelated entities, we do not agree with the assertion in paragraph 19 that a BCUCC is never

the subject of an equal exchange. In some jurisdictions, depending on the financial position of the transferor or transferee, it may be necessary from a legal perspective for the transaction to be at fair value. In other cases, a decision may be taken that the transferee will pay a market price for the business that has been transferred.

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.

While there are differences between certain aspects of these two types of transaction, from the perspective that a BCUCC involves the combination of two or more businesses we do not consider that there is a substantive difference between a BCUCC and a combination of entities involving unrelated parties. We note that this is acknowledged in paragraph 7 of Chapter 4, where it is noted that the 'purposes and reasons behind BCUCC transactions do not alter their economic substance'. Instead, the differences arise from the motivations for the BCUCC, and the fact that the consideration payable or receivable is, in many cases, not the fair value of the business or businesses being transferred.

In contrast to a business combination involving unrelated parties, a BCUCC is not typically driven primarily by a desire to expand or enhance an existing business, and the potential to enhance operational efficiencies through the combination of separate businesses. Instead, while efficiencies may be relevant, other factors can drive the reorganisation of an existing group of entities. In practice, these can include tax considerations where a particular structure and/or location of an entity in a particular jurisdiction might give rise to savings, and circumstances where a reorganisation is carried out in contemplation of the disposal or listing of part of an existing group. This latter category of BCUCC might be entered into in order to organise entities or businesses that are to be disposed of into a new subgroup, which could make it easier from an operational perspective for both the seller and potential acquirer or from the perspective of raising funds from capital markets.

This means that while the economic substance of a BCUCC and a combination involving unrelated parties is similar, the nature of BCUCC means that their primary drivers can be different in nature from those that apply to a transaction involving unrelated entities. This can be in respect of the transaction price, and the fact that the transaction takes place at all.

Question 4.3 - Understanding the 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?

We agree with much of the analysis.

From the perspective of a controlling shareholder, the question of whether financial information at 'sub consolidation' level (that is, the level at which the BCUCC has taken place) is important will depend on a number of factors. These can include whether hoped for efficiencies have been realised at subgroup level, including tax planning or financing arrangements as well as operational aspects; there may also be questions around whether the management of the newly combined entities is performing satisfactorily. Consequently, whether a controlling shareholder is interested in sub consolidation financial information will depend on a range of factors, which can and will vary depending on the precise attributes of,

and drivers for, a BCUCC. However, because (from the ultimate controlling shareholder perspective) the overall group is unchanged, the application of acquisition accounting in accordance with IFRS 3 may be less important.

Where a BCUCC involves a transfer to a wholly owned entity to one which is not wholly owned, and has Non Controlling Interests (NCI), the position is different. This is because the controlling shareholder's interest in the transferred business will have been diluted; the NCI will have acquired an interest in the fair value of the business that has been transferred together with (as noted in paragraph 43) the effect that it may have on future cash flows and dividends. We agree with the observation in paragraph 44 that NCI will be interested in whether the consideration payable by the transferee is in the form of cash or shares, due to the potential dilution of the NCI holders' interest, but this again links back to the potential for future cash flows that might be received by the holders of NCI, or generated from the sale of their shares.

We are sceptical that existing and potential lenders (and other creditors) will focus on separate/individual financial statements of an entity that has been a transferee in a BCUCC and has acquired a new subsidiary. We would expect that, in the absence of circumstances such as where a lender to a group benefits from group wide cross guarantees of funds advanced, a lender would be interested in changes to the composition of a subgroup to which it either has already lent, or might lend, funds. This implies that such a lender would also require consolidated financial statements; alternatively, if the transaction was undertaken as contemplated in scenario 2 in paragraph 52, separate or individual financial statements might provide the required information.

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)?

While it may be difficult to identify the acquirer in certain circumstances, we believe that that in all cases it will be possible to make this identification. While the example set out in paragraph 83 might, in theory, take place we believe that in practice there are likely to be distinguishing features that mean the combining entities do not all have equal attributes.

We note that there is an inconsistency between paragraphs 81(b) and the heading above paragraph 86. The former states that 'an acquirer can always be identified but is not meaningful' while the latter states 'an acquirer can always be identified but it may not be meaningful'. In the context of this section of the DP being based on the application of IFRS 3, we believe that the latter statement is more appropriate, in that while an acquirer can always be identified, it may not be meaningful to apply acquisition accounting.

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?

We believe that while an analogy to IFRS 3 might, in certain restricted circumstances, be appropriate, in almost all cases this approach should not be followed. This is linked to the comment made in the question, that the parent entity can direct the identification of the acquirer in order to achieve a desired accounting outcome which may not be appropriate. In

particular, it would be possible for a parent entity to be able to trigger a revaluation of assets, which would not be permitted by an entity on a stand-alone basis, simply by organising a BCUCC among a number of selected group entities. In our view, this would be inappropriate.

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?

We agree.

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?

We agree.

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?

While it is likely that the absence of a market based transaction might affect the judgements involved (in particular, in determining the fair value of the business that has been transferred which, as acknowledged in the DP would in many cases be a level 3 valuation), the approach involved in determining fair values of identifiable assets and liabilities would be very similar (if not identical) to those used for the purposes of a business combination involving unrelated entities. For example, in determining the fair values of identifiable intangible assets, we would expect a similar approach to be used for both a business combination involving unrelated parties and a BCUCC.

We note that paragraph 102 refers to goodwill as a residual. While this, mechanically, will be the case for the transfer of a wholly owned business in a BCUCC, because goodwill would simply be the difference between the fair value that has been determined for the business as a whole and the amounts determining for the identifiable net assets, this may not be the case for a majority owned business that has NCI. In this latter case, the approach adopted would vary, depending on whether the transferee adopted an approach of grossing up goodwill for the portion attributable to NCI.

In circumstances in which there is a gain from a bargain purchase, we believe that it would be inappropriate for the transferee to recognise a gain in its income statement. Instead, because the transaction involves entities under common control, any gain should be recognised as a credit to equity (that is, a contribution from an equity participant, being the parent entity).

Similarly, any shortfall between the carrying amount of the net assets transferred, and the consideration received, by the transferor should be recognised as a debit to equity, as it effectively represents a distribution to the parent (followed by a capital contribution to the transferee). The same approach would be appropriate in circumstances in which the transferee paid more than the fair value of the transferred business; the excess amount above fair value would be treated as being a distribution in the transferee's financial statements.

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?

Yes. However, we believe that it would only be appropriate to apply the measurement principles in IFRS 3 in strictly limited circumstances. In almost all cases, an analogy to IFRS 3 will be inappropriate, for reasons that we have included in our comments above.

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

Our responses to these questions have been made on the basis of view one being the appropriate approach. However, we do not consider that always to apply IFRS 3 by analogy is appropriate.

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.

We agree with the approach outlined in the question.

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?

No. If IFRS 3 is applied by analogy, it should be applied in full. While the determination of the fair value of the acquired business would be a level 3 valuation (rather than the transaction price), there is no reason to presume that a fair value cannot be obtained. Please also see our response to question 4.8.

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?

We believe that the difference should be reflected as a capital contribution from the parent entity (please also see our response to question 4.8).

Questions 5.4 and 5.5 - 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?

No. We also disagree with the notion that a BCUCC is the transfer of a business, as there will always be an entity that acquires a business as a result of the transaction.

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

No. In particular, we disagree that there are circumstances in which it would be appropriate to apply 'fresh start' accounting.

We note again that we disagree with the notion that an acquirer cannot be identified in a BCUCC. Our primary concern in relation to the application of IFRS 3 by analogy to a BCUCC is that a parent entity can direct whether a BCUCC takes place at all, and its timing, and can also decide on the identity of both the transferor and the acquirer. In consequence, if IFRS 3 were to be applied, a parent entity would be able to decide which business or businesses (and related identifiable assets and liabilities, as set out in IFRS 3) should be revalued at a particular point. In many cases, these revaluations would not be permitted under IFRS on a 'stand alone' entity basis, meaning that a parent entity would be provided with a mechanism to circumvent the requirements of IFRS, simply by arranging a BCUCC. We believe that this is inappropriate.

If 'fresh start' accounting were to be applied, the issue would be compounded as a parent entity would then be able to direct IFRS 3 recognition criteria and revaluations to two entities or businesses, rather than one.

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?

We agree that the approaches set out in Appendix 3 should not be pursued, and agree with reasons that have been given for not considering each of them further. However, it is possible that for certain transactions, the information provided would be decision useful depending on the precise facts and circumstances.

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?

We agree. While we consider that in many cases it will be inappropriate to apply IFRS 3 by analogy, instead using predecessor values for the purposes of accounting for a BCUCC, in some circumstances the application of IFRS 3 would be appropriate.

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

We agree with many of the arguments presented in relation to view three. However, we do not agree with the suggestion that, if an analogy to IFRS 3 is not valid, 'fresh start' accounting should be followed. While the IASB gave some consideration to 'fresh start' accounting during the development of IFRS 3 (see IFRS 3.BC55-57), this approach is not currently contemplated in IFRS and we do not believe that it would be appropriate to introduce it in the context of BCUCC. In addition, as noted above, we believe that this could give rise to the artificial recognition and revaluation of certain assets and liabilities.

While we agree with the overall approach of the 'change in ability' model that is outlined in paragraph 63, we believe that additional considerations are relevant. In particular, where a BCUCC involves a transaction (or series of transactions) that result in a change in shareholder rights, or a change in the composition of shareholders, this may indicate that it would be appropriate to apply IFRS 3 by analogy. Similarly, significant changes in the amount of the transferee's borrowings and/or in the identity of its lenders may indicate that the application of IFRS 3 would be appropriate.

While we acknowledge that this would almost inevitably result in a degree of diversity in practice, due to the judgements involved, in our view this is no different from other aspects of IFRS for which judgements are involved. We agree with the comments in paragraph 71, that IFRS is a principles based set of standards that requires the application of judgement. For the purposes of a BCUCC, we consider that a judgemental approach is superior to one based on a rigid set of rules; as has been found in practice, a 'bright line' rule often leads to deliberate structuring of transactions to achieve a desired outcome, while a judgemental approach often has the potential to reduce the extent of 'accounting abuse'.