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EFRAG Discussion Paper Accounting for Business Combinations under Common Control

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as by enhancing investor protection.

ESMA has considered EFRAG's discussion paper *Accounting for Business Combinations under Common Control* (DP BCUCC). We thank you for this opportunity to contribute to EFRAG's proactive work and to comment on your discussion paper. We are pleased to provide you with the following comments aimed at improving the decision-usefulness of financial statements and the transparency and enforceability of IFRSs.

ESMA has urged the International Accounting Standards Board (IASB) in the past to provide guidance on how to account for *Business Combinations under Common Control* (BCUCC) transactions as the lack of further guidance has hampered comparability between reporting entities. Issuers often provide no rationale for the chosen accounting treatment or disclosures such as those required in IFRS 3 – *Business Combinations* as issuers argue that IFRS 3 is not applicable. ESMA therefore welcomes EFRAG's discussion paper, a helpful initiative stimulating debate and supporting the IASB's work.

ESMA regrets that the discussion paper does not address how to define a common control transaction and that the paper scopes out BCUCC-transactions in separate financial statements and the role of disclosures. Though ESMA understands that the definition of a common control transaction is not easy, it is a key issue as it triggers the accounting treatment. ESMA believes that it is very important to investigate further whether adding a new holding company to a group changes the factual circumstances in the group and could be labelled as a transaction with economic substance. Furthermore, ESMA believes that EFRAG should elaborate on the effects of a BCUCC-transaction for non-controlling interests.



Consequently, ESMA believes that the accounting treatment should reflect the economic substance of the BCUCC-transactions. Though it seems as the pooling of interest method/predecessor accounting is most relevant, ESMA understand that applying acquisition accounting as required by IFRS might be relevant if economic substance is present. ESMA would encourage EFRAG to continue the development of its work on BCUCC-transactions and more in particular on the case where entities are fully owned versus entities with non-controlling interests.

Most important is that BCUCC-transactions should be addressed from an investor's perspective. Disclosure requirements ensuring an appropriate level of transparency on the accounting policy and management's motivation and judgment can play an important role in this area.

Our detailed comments on the discussion paper are set out in the Appendix to this letter. We would be happy to discuss all or any of these issues further with you.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'S/M'.

Steven Maijoor
ESMA Chair

A handwritten signature in blue ink, appearing to be 'Julie Galbo'.

Julie Galbo
Chair of ESMA's Corporate Reporting Standing Committee

Appendix – ESMA’s comments on EFRAG’s discussion paper on *Business Combinations under Common Control*

1. At this stage ESMA would like to share some of its initial thinking with EFRAG. Items developed below are structured by topic rather than responding to the individual questions raised in the discussion paper. ESMA does not provide comments to all questions identified in the discussion paper but focused on the main issues concerning BCUCC-transactions. ESMA believes that further thinking on how to account for BCUCC-transactions is necessary and in particular, that EFRAG should also deal with BCUCC-transactions in separate financial statements and with disclosure requirements.

Scope

2. ESMA encouraged the IASB to provide further guidance on how to account for BCUCC transactions and believes that the need for guidance are again clearly iterated by EFRAG in its discussion paper.
3. ESMA regrets that the discussion paper does not deal with the initial determination whether a transaction could be labelled as a common control transaction. ESMA believes that before deciding on the accounting treatment for BCUCC-transactions clear guidelines should be in place to be able to determine whether a transaction qualifies as a common control transaction or not. ESMA believes that IFRS 3 is not clear on this subject.
4. The discussion paper scopes out BCUCC-transactions in the separate and individual financial statements of the transferee. The accounting treatment for BCUCC-transactions in the individual financial statements has major implications (including the amount of potential dividends). Though we understand the complexity surrounding the issue, ESMA notes that it is difficult to deal with the accounting treatment at the parent level without addressing the transferee level. Especially as the accounting treatment at both levels are linked and further explanations on the differences would be needed.
5. ESMA encourages EFRAG to further investigate the structuring of BCUCC-transactions. ESMA believes that the example on pages 29 and 30 of the paper is lacking an important feature: the presence of non-controlling interests (NCI) in the BCUCC-transaction.
6. ESMA believes that the presence of NCI’s in parent companies or combining companies on a lower level should be taken into consideration in setting/allowing an accounting treatment. The accounting of a BCUCC-transaction is relevant to NCI’s. Their interests in the combining companies can change and consequently, the BCUCC can have economic substance for the NCI’s. At the same time,

no economic substance will be identified at group level as in the group structure no effective change occurs.

7. ESMA also believes that on the other hand parent companies with 100 per cent controlled entities could use the exemption provided in paragraph 10 of IAS 27 – *Consolidated and Separate Financial Statements* to draw up consolidated accounts, if certain conditions are met.
8. ESMA also regrets that the discussion paper scopes out disclosures. Disclosures are very important to understand the rationale for the accounting treatment and the impact of BCUCC-transactions on the financial position and performance.

Approaches

9. Some BCUCC-transactions have attracted ESMA's attention and it is noted that the accounting policies applied in practice are the 'pooling of interest method' and the 'acquisition method'. Both accounting treatments are applied in combination with a reference to IAS 8 – *Accounting Policies, Changes in Accounting Estimates and errors*.
10. To ensure providing decision-useful information, an important step in the development of a new financial reporting standard is to understand the information investors need on BCUCC-transactions.
11. To achieve that objective, ESMA believes that the accounting treatment should reflect the economic substance of the operation from the investor's perspective. ESMA notes that economic substances of BCUCC-transactions differ significantly in practice and believes that identifying different accounting treatments seems appropriate.
12. ESMA believes that the examples used in the discussion paper do not always represent economic substance. The internal restructurings in a group should not change the accounting base, as assets move from one group company to another. In addition, the incorporation of a new company, intended to act, as a new holding company with the goal to apply IFRS 3 and acquisition accounting, should only be possible under strict guidelines.
13. ESMA believes it is important to set clear criteria in a possible standard for selecting an accounting policy, in order to ensure consistent application to transactions with the same economic substance, resulting in comparable financial information.

Methodology

14. ESMA considers that a business combination under common control is usually different from a business combination and that it is relevant to have a specific accounting treatment those transactions.
15. In its discussion paper EFRAG discusses in paragraphs 60 to 64 the analogy between acquisition accounting in IFRS 3 and the re-measurement of the acquired business (and transferee) to fair value. ESMA believes that a reliable fair value measurement both of the business combination and the identified assets and liabilities at initial recognition in a BCUCC-transaction are difficult to achieve due to the absence of market conditions and the extensive management judgements involved in the determination of fair value, even if external valuers are involved. External valuers also have to base the fair value measurement on management representations and information. ESMA believes that EFRAG should elaborate further on the reliability issues surrounding the measurement of fair value in a BCUCC-transaction.
16. ESMA believes that the absence of market-based transactions does have consequences when applying the recognition and measurement principles in IFRS 3. BCUCCs principally should not lead to recognising goodwill, identifiable intangible assets, profits or losses. In most situations, the effects of the BCUCC should be recognised in equity.
17. Though it seems as the pooling of interest method/predecessor accounting is most relevant, ESMA understand that applying IFRS 3 might be relevant in some situations. ESMA would encourage EFRAG to continue the development of its work on these transactions and more in particular on the case where entities are fully owned versus entities with non-controlling interests.
18. ESMA also believes that the absence of market-based transactions does have consequences when applying the measurement principle in IFRS 3. This is because measurement reliability fully depends on management judgement, even if external valuers are involved. External valuers also have to base the fair value measurement on management representations and information.
19. However, ESMA believes that, in some situations and under strict guidelines, the economic substance of the BCUCC-transaction would be best reflected by applying the fair value measurement principles of IFRS 3.

The three different views in the discussion paper

20. Concerning the three different views set out in the discussion paper, ESMA does not prefer view 1 due to the unreliability of the measurement and the dependence to extensive management influence for some BCUCC-transactions.
21. With respect to view 2, ESMA believes that fresh start accounting is not a preferred view as it is based on the determination of the fair values of all combining entities. As indicated above, the reliability issue of fair value measurement is also valid to fresh start accounting.
22. With respect to view 3, ESMA believes that further analysis should be performed to draw out the effect of a change in the ability of the entity to meet the claims against the combining entities that existed prior to the BCUCC transaction. ESMA has a different view than the discussion paper (as expressed in pages 5 and 16 of the discussion paper) in situations where the transaction is at fair value, because ESMA believes that the ability to meet the claims may not change in some of these instances. Moreover, ESMA questions the relevance of the characteristics used. ESMA therefore suggests that further work should be performed in order to better explain what EFRAG means by the ability to meet the claims.

Disclosures

23. ESMA would like to highlight that clear disclosure requirements resulting in appropriate disclosures are critical for investors and regrets that EFRAG has not considered these further at this stage of the project. ESMA agrees that to understand the information needs of investors in the financial reporting of a BCUCC-transaction is an important step. The objective of financial reporting should aim at providing decision-useful information to primary users of the financial statements.
24. ESMA believes that the disclosure requirements to inform investors should at least include:
 - The names of the combining entities in the BCUCC;
 - The purpose of the transaction;
 - The accounting policy used to recognize the BCUCC, including the motivation of the use of the policy; *and*
 - The financial effects of the BCUCC, including the financial information before and after the BCUCC.