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Comments on the Exposure Draft of the IFRS on Business Combinations

The Russian Financial Reporting Council is pleased to submit to you its comments on the Exposure Draft of IFRS on Business Combinations.

Should you have any questions, please contact me by e-mail lgorbatova@ccmd.ru, or fax +7 (095) 797 9566.

With best regards,

Larissa Gorbatova,
The FRC Chairperson

Comments on the Exposure Draft "Business Combinations"

Question	FRC'Opinion
Question 1 – Scope The Exposure Draft proposes: (a) to exclude from the scope of the IFRS business combinations in which separate entities or operations of entities are brought together to form a joint venture, and business combinations involving entities under common control (see proposed paragraphs 2 and 3 and paragraphs BC9-BC11 of the Basis for Conclusions). Are these scope exclusions appropriate? If not, why not? (b) to include in the IFRS a definition of business combinations involving entities under common control, and additional guidance on identifying such transactions (see proposed paragraphs 9-12 and Appendix A, and paragraphs BC12-BC15 of the Basis for Conclusions). Are the definition and additional guidance helpful in identifying transactions within the scope exclusion? If not, what additional guidance would you suggest, and why?	In general, the FRC supports the proposals in question. However, business combinations involving entities under common control are quite common among Russian companies. Such transactions are excluded from the scope of the existing IAS 22 on business combinations resulting in diverse accounting practices when some companies use applicable US GAAP provisions, other use the uniting of interests method, with limited disclosures not providing necessary information for user to understand clearly substance of, and accounting treatment for, the transaction. Partly the necessary disclosures are provided by reference to the disclosure requirements set in the IAS 1, IAS 23, and IAS 27, but these requirements are quite general, the entities involved are not necessarily included in the same consolidated group, for instance, those under the common control of individuals which do not prepare consolidated accounts. Thereby, FRC proposes to the Board to include in the new IFRS on business combinations more detailed disclosure requirements, as of the business combinations involving entities under common control, for both individual and consolidated financial statements to be presented by combined entities. Disclosure of the economic substance of the transaction, of the prices, and of the accounting treatment applied to the transaction will help users of financial statements to make better use of the information the statements provide. In the connection with the issue of the scope the FRC would like to raise a question about accounting for business combinations involving the entities in which government is the main shareholder. Should such business combinations be treated as business combinations involving entities under common control (of the government), and, thus, be excluded from the requirements of the new IFRS, or there should be a special treatment for such transactions?

Question 2 – Method of accounting for business combinations The Exposure Draft proposes to eliminate the use of the pooling of interests method and require all business combinations within its scope to be accounted for by applying the purchase method (see proposed paragraphs 13-15 and paragraphs BC18-BC35 of the Basis for Conclusions). Is this appropriate? If not, why not? If you believe the pooling of interests method should be applied to a particular class of transactions, what criteria should be used to distinguish those transactions from other business combinations, and why?	The proposed elimination of the pooling of interests method is not unanimously supported by the FRC who find this proposal challenging. FRC views this proposal positively from the point of convergence with US GAAP. Companies listed on different international markets currently preparing both US GAAP and IAS accounts will benefit from this new approach. And, in any case, elimination of an option leads to better comparability of different entities financial statements. As for Russia, the pooling of interests method is not in use, so its elimination won't cause any serious consequences for Russian companies. At the same time the FRC sees a certain lack of logic in addressing this issue in the ED which, by eliminating the pooling of interests method, refuses to recognize existence of such transactions as uniting of interests, in substance. Indeed, the method of accounting for such transactions was not satisfactory for those supporting "transparent" and "fair value" accounting. But a bad accounting method for a particular type of transactions yet doesn't mean that such transactions do not exist. Moreover, the requirement to treat all the business combinations as acquisitions may lead to undesirable distortions in financial statements in so-called 'border-line' situations when two or more entities of similar size merge. In such situations the entities will have to select (or even elect) an acquirer on the basis of convenience, but not economic substance of the transaction. For instance, they may consider such factors as level of complexity of measuring fair value of net assets, or one of the entities involved may unwelcome fair-valuing of its net assets, etc. As a preliminary solution, the new standard may retain the possibility to qualify a business combination as a uniting of interests together with changing the accounting method for such transactions, for example, by setting a requirement to measure net assets of all the businesses combined at fair value. In such case entities qualifying a business combination as a uniting of interests will have to fair value their net assets. But the FRC has to observe that the proposed treatment needs to be analyzed in details with a particular emphasis on possible consequences of its adoption, that is why the FRC doesn't view it as an unambiguous solution at this stage. In general, the FRC would like to express its concern about possible negative consequences of eliminating "uniting of interests" as a qualification, in its entirety. Taking into account the importance of this issue for the business combinations accounting the FRC recommends to exclude it from the Phase I of the project and to consider it within the Phase II of the project, together with business combinations in which separate entities or operations of entities are brought together to form a joint venture.

Question 3 – Reverse acquisitions Under IAS 22 *Business Combinations*, a business combination is accounted for as a reverse acquisition when an entity (the legal parent) obtains ownership of the equity of another entity (the legal subsidiary) but, as part of the exchange transaction, issues enough voting equity as consideration for control of the combined entity to pass to the owners of the legal subsidiary. In such circumstances, the legal subsidiary is deemed to be the acquirer. The Exposure Draft: (a) proposes to modify the circumstances in which a business combination could be regarded as a reverse acquisition by clarifying that for all business combinations effected through an exchange of equity interests, the acquirer is the combining entity that has the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. As a result, a reverse acquisition occurs when the legal subsidiary has the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities (see proposed paragraph 21 and paragraphs BC37-BC41 of the Basis for Conclusions). Is this an appropriate description of the circumstances in which a business combination should be accounted for as a reverse acquisition? If not, under what circumstances, if any, should a business combination be accounted for as a reverse acquisition? (b) proposes additional guidance on the accounting for reverse acquisitions (see proposed paragraphs B1-B14 of Appendix B). Is this additional guidance appropriate? If not, why not? Should any additional guidance be included? If so, what specific guidance should be added? Is this appropriate? If not, why not?	The idea of a reverse acquisition is closely connected with the concept of control of one entity over another. This concept is the basis for the consolidation accounting provided in the IAS 27 “Consolidated Financial Statements and Accounting for Investments in Subsidiaries”. IAS 27 defines “control”, “parent” and “subsidiary” doesn’t contain any reference to “a legal parent” and/or “a legal subsidiary”, thus dealing with only substance, not form, of the transaction. In this connection the FRC presumes it should be desirable to provide consistency between the ED and IAS 27 with respect to the “parent – subsidiary” qualification. The additional guidance on the accounting for reverse acquisitions was considered useful and appropriate.

Question 4 – Identifying the acquirer when a new entity is formed to effect a business combination The Exposure Draft proposes that when a new entity is formed to issue equity Instruments to effect a business combination, one of the combining entities that existed before the combination should be adjudged the acquirer on the evidence available (see proposed paragraph 22 and paragraphs BC42-BC46 of the Basis for Conclusions). Is this appropriate? If not, why not?	The issue in question is closely connected with determining a more general concept of an accounting method for business combinations (see par. 2 of the Comments), i.e. with the issue of whether the uniting of interests concept is retained, or dropped. If the uniting of interests is eliminated as a concept, and all the business combinations are qualified as acquisitions, the approach to identify an acquirer proposed in the ED is appropriate. If the Board finds it reasonable t postpone the decision on the uniting of interests till the Phase II, this issue should be reconsidered.
Question 5 – Provisions for terminating or reducing the activities of the acquiree Under IAS 22, an acquirer must recognise as part of allocating the cost of a business combination a provision for terminating or reducing the activities of the acquiree (a 'restructuring provision') that was not a liability of the acquiree at the Acquisition date, provided the acquirer has satisfied specified criteria. The Exposure Draft proposes that an acquirer should recognise a restructuring provision as part of allocating the cost of a business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see proposed paragraph 40 and paragraphs BC55-BC66 of the Basis for Conclusions). Is this appropriate? If not, what criteria should an acquirer be required to satisfy to recognise a restructuring provision that was not a liability of the acquiree as part of allocating the cost of a combination, and why?	The proposed treatment logically follows the general principles for recognition of liabilities, and should be supported.

Question 6 – Contingent liabilities The Exposure Draft proposes that an acquirer should recognise separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably (see proposed paragraphs 36 and 45 and paragraphs BC80-BC85 of the Basis for Conclusions). Is this appropriate? If not, why not?	The proposed accounting treatment for the acquiree's contingent assets and liabilities is not supported by the FRC since it differs from the existing treatment for all the contingent assets and liabilities, regardless they were or were not acquired in a business combination. Adoption of the approach proposed in the ED will lead to a different accounting treatment for contingent assets and liabilities acquired in a business combination than to other contingent assets and liabilities. The main argument of those supporting the proposed treatment deals with an assumption that in a business combination contingent assets and liabilities not recognized previously in the financial statements of the acquiree, may be recognized, due to the new evidences appeared, as to the reliable measurement of, or to the probability of economic benefits outflow/inflow related to, the contingent assets and liabilities. But, in this case, the contingent item ceased to be contingent, and should be accounted for as an existing asset or liability. So, the need for any special accounting for contingent assets and liabilities acquired in a business combination is not evident. The FRC supposes that requirements for recognition of the contingent assets and liabilities, as described in the ED, may introduce some conceptual confusion into the process of recognizing similar items, and to impair comparability of this items, which it highly undesirable, first of all, for users of the financial statements. Though, the proposed approach seems quite relevant if considered not as a different recognition principle, but as an element of the mechanism for allocating the cost of acquisition to the acquiree's identifiable assets and liabilities. If, in substance, it is just a call to the acquirer to pay special attention to the contingent items of the acquiree when allocating the cost of acquisition, the text of the ED should be amended to exclude requirements to recognize the acquiree's contingent assets and liabilities, and, instead, to include additional requirements to consider them when allocating the cost of acquisition to the identifiable assets and liabilities. Thus, the FRC believes that the treatment of the acquiree's contingent assets and liabilities proposed in the ED should be given on a different basis, namely – on the basis of the process of allocating the cost of acquisition to the identifiable assets and liabilities, thereby excluding nay references to any special recognition criteria for contingent assets and liabilities acquired in a business combination.

Question 7 – Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed IAS 22 includes a benchmark and an allowed alternative treatment for the initial measurement of the identifiable net assets acquired in a business combination, and therefore for the initial measurement of any minority interests. The Exposure Draft proposes requiring the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost to be measured initially by the acquirer at their fair values at the acquisition date. Therefore, any minority interest in the acquiree will be stated at the minority's proportion of the net fair values of those items. This proposal is consistent with the allowed alternative treatment in IAS 22 (see proposed paragraphs 35 and 39 and paragraphs BC88-BC95 of the Basis for Conclusions). Is this appropriate? If not, how should the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of a business combination be measured when there is a minority interest in the acquiree, and why?	The FRC agrees with the approach proposed in the ED. It considers fair valuing the only appropriate way to measure the acquiree's identifiable assets and liabilities. Russian companies applying IAS in most cases use this treatment for accounting for business combinations when there is a minority interest.

Question 8 – Goodwill The Exposure Draft proposes that goodwill acquired in a business combination should be recognised as an asset and should not be amortised. Instead, it should be accounted for after initial recognition at cost less any accumulated impairment losses (see proposed paragraphs 50-54 and paragraphs BC96-BC108 of the Basis for Conclusions). Do you agree that goodwill acquired in a business combination should be recognised as an asset? If not, how should it be accounted for initially, and why? Should goodwill be accounted for after initial recognition at cost less any accumulated impairment losses? If not, how should it be accounted for after initial recognition, and why?	The proposed treatment of a goodwill as of a non-amortized asset being tested annually for impairment was not unanimously supported by the FRC. On the one hand, the proposed treatment corresponds to the general inclination of IAS to fair value accounting. In addition, adoption of the proposed treatment as a part of the convergence between IAS and US GAAP will be useful for companies listed on different public markets. Though, a whole range of factors exist causing doubtfulness in the appropriateness of the approach proposed. 1. The proposed treatment of goodwill seems to be relevant when assets and liabilities of entities are measured at fair value, but the existing IAS offer so-called 'mixed measurement model', including fair valuing assets and liabilities along with measuring them at cost/amortized cost. Under these circumstances the change to accounting for goodwill at costs minus accumulated impairment losses, in substance very close to fair value accounting, looks a premature step. A logical question arises concerning other assets and liabilities, which are more 'tangible' than goodwill, but are accounted for at amortized cost. 2. Another problem which follows the conceptual weakness of the proposed treatment is complications of the practical use of this treatment. The goodwill is proposed to be tested for impairment annually. The whole concept of impairment when applying to goodwill may cause some uncertainties, including those associated with determining an impairment loss. And then, impairment test is quite a painstaking job, and objectivity of its output may be cause doubts. On the whole, the FRC expresses concern with respect a certain prematurity of the approach proposed for the goodwill accounting comparing to the one for all other assets and liabilities measured at cost/amortized cost. The FRC believes that the existing accounting treatment for goodwill is more consistent with the existing IAS concepts.

Question 9 – Excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities In some business combinations, the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of the combination exceeds that cost. The Exposure Draft proposes that when such an excess exists, the acquirer should: (a) reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and (b) recognise immediately in profit or loss any excess remaining after that reassessment. (See proposed paragraphs 55 and 56 and paragraphs BC109-BC120 of the Basis for Conclusions.) Is this treatment appropriate? If not, how should any such excess be accounted for, and why?	The proposal is supported by the FRC, since it is consistent with the economic substance of an excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets and liabilities (currently referred to as 'negative goodwill') as a benefit obtained by the acquirer in a business combination.

Question 10 – Completing the initial accounting for a business combination and subsequent adjustments to that accounting The Exposure Draft proposes that: (a) if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer should account for the combination using those provisional values. Any adjustment to those values as a result of completing the initial accounting is to be recognised within twelve months of the acquisition date (see proposed paragraphs 60 and 61 and paragraphs BC123-BC126 of the Basis for Conclusions). Is twelve months from the acquisition date sufficient time for completing the accounting for a business combination? If not, what period would be sufficient, and why? (b) with some exceptions carried forward as an interim measure from IAS 22, adjustments to the initial accounting for a business combination after that accounting is complete should be recognised only to correct an error (see proposed paragraphs 62 and 63 and paragraphs BC127-BC132 of the Basis for Conclusions). Is this appropriate? If not, under what other circumstances should the initial accounting be amended after it is complete, and why?	The FRC supports the proposed procedure for completing the initial accounting for a business combination. There is a need in limiting the time period for this procedure, and proposed twelve months is quite appropriate. Consequently, all the adjustments made after the deadline for this procedure can not be treated other than as corrections of errors.

In addition to the issues addressed above we would like to address to the Board the issue of determining the cost of acquisition when a business combination is achieved in stages. This issue was not discussed in the FRC due process, but some FRC members expressed their concerns regarding the way this issue is addressed in the ED.

Business Combination achieved in stages - cost of acquisition (Paragraphs 57-59)

Paragraph 59 of ED 3 determines the accounting treatment of a business combination which have previously qualified as an investment in an associate and was accounted for under IAS 28, Accounting for Investments in Associates. However, the proposed standard does not discuss accounting for a business combination which did not previously qualify as an investment in associate because either the size, or the nature, of the initial equity investment did not give rise to the ability to exercise significant influence over the operating and financial policies of the investee. Such investments are within the scope of IAS 39 which would generally require their remeasurement to fair value after initial recognition. In an example called 'Business combination achieved in stages' included in Draft illustrative examples section of ED 3, remeasurement gain previously recognized by the investor in its income statement is reversed in the period of acquisition to adjust the carrying amount of the investment immediately before the acquisition back to the original cost.

Some FRC members are not comfortable with this approach since the proposed reversal of the previously recognized remeasurement gains and losses in the period of a business combination is not consistent with fair value model. In addition they see no need in such an artificial way of forming goodwill, or income (negative goodwill, under existing IAS 22), in a case of previously recognized losses from fair value changes.

Accordingly, some FRC members doubt appropriateness of the proposed model for determining cost of acquisition in a business combination achieved in stages. Their recommendations with regard to the issue in question are as follows:

First, the guidance in respect of accounting for a business combination should be included in the main body of the standard.

Second, it seems more reasonable, and consistent with fair value model, to determine the cost of the investment for purposes of the new business combinations standard as the fair value under IAS 39 at the date of change in classification plus the cost of the investment which triggers the business combination. Additionally, such successive share purchases should not be treated separately for the purposes of determining the fair value of the identifiable assets and liabilities acquired, and goodwill. As the fair value of the initial investment has already been adjusted for in the 'deemed cost', the fair value and goodwill calculation should be performed as at the date of the latest exchange.

Financial Reporting Council (Russia)