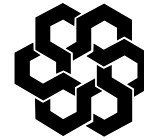

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **14 December 2006, London**

Project: **Business Combinations II**

Subject: **Combinations between Mutual Entities (Agenda Paper 2B)**

INTRODUCTION

1. The Business Combinations Exposure Draft (BC ED) defines a mutual entity as follows:

> A mutual entity is an entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants.

2. The BC ED proposes to require that mutual entities be included in the scope of the standard and apply the acquisition method for combinations between mutual entities. In addition, paragraph 53 of the BC ED states:

> In a business combination involving only mutual entities in which the only consideration exchanged is the member interests of the acquiree for the member interests of the acquirer (or the member interests of a newly combined entity), the amount equal to the fair value of the acquiree shall be recognised as a direct addition to capital or equity, not retained earnings.

3. Based on the deliberation criteria established at the January 2006 Board meetings, the staff asks the Boards to discuss the proposed accounting for combinations

between mutual entities because this was an area of significant concern for respondents.

4. This paper:

   a. summarises the Boards' initial deliberations;

   b. discusses respondents' concerns that a cooperative should not be included in the definition of a mutual entity;

   c. analyses respondents' concerns regarding the application of the acquisition method for combinations between mutual entities;

   d. asks the Boards to affirm the proposal in the BC ED that:

      (1) combinations between mutual entities are included in the scope of the final business combinations standard;

      (2) combinations between mutual entities are accounted for by the acquisition method; and

      (3) the definition of a mutual entity includes cooperatives.

INITIAL FASB DELIBERATIONS

5. During the deliberations leading to FASB Statement No. 141 *Business Combinations,* the FASB concluded that combinations between mutual entities should be accounted for using the purchase method rather than the pooling-of-interests method. However, the FASB decided to defer the effective date of Statement 141 for such combinations until it issued interpretative guidance about how mutual entities should apply the acquisition method. As a consequence, until the issuance of such guidance, APB Opinion No. 16, *Business Combinations,* continues to be applicable for combinations between mutual entities and a majority of those combinations are currently accounted for as poolings-of-interests.

6. After the publication of Statement 141, the FASB began a joint project with the Canadian Accounting Standards Board (AcSB). The objective of that project was to develop guidance for combinations between two or more mutual entities.

7. In October 2001, the FASB and the AcSB held a roundtable discussion meeting with representatives of different types of mutual entities. Between 2001 and 2004, the FASB discussed issues related to the accounting for combinations between

mutual entities at seven Board meetings.[1] In January 2004, the Board held a meeting with representatives of organisations of cooperative and other mutual entities to discuss its tentative conclusions and specific concerns raised by constituents. In addition, the FASB conducted field visits with three mutual entities in 2004. The tentative conclusions reached by the FASB were incorporated in the BC ED.

INITIAL IASB DELIBERATIONS

8. During the IASB's deliberations leading to IFRS 3, the IASB also decided that it should include combinations between mutual entities in the scope of IFRS 3. The IASB decided to require a modified purchase method approach for combinations between mutual entities until it develops guidance on applying the purchase method to such transactions as part of the second phase of its business combinations project. According to that approach, the deemed cost of the business combination is measured as the aggregate of (a) the net fair value of the acquiree's identifiable assets, liabilities, and contingent liabilities and (b) the fair value of any assets given, liabilities incurred or assumed, or equity instruments issued by the acquirer in exchange for control of the acquiree. As a consequence, the acquirer would recognise goodwill only if readily measurable consideration is given as part of the exchange. The amount of goodwill recognised would equal the fair value of the readily measurable consideration given by the acquirer in exchange for control of the acquiree. However, the exposure draft leading to the final IFRS 3 did not foresee a modified purchase method approach for combinations between mutual entities. Therefore, the IASB decided not to incorporate this approach into IFRS 3, but first to expose it for public comment.

9. In April 2004, the IASB published an exposure draft of proposed amendments to IFRS 3 titled *Combinations by Contract Alone or Involving Mutual Entities* proposing the modified purchase method approach for combinations between

[1] The FASB discussed mutual entities at its 19 December 2001, 23 January 2002, 8 May 2002, 4 September 2002, 17 March 2003, 17 December 2003, and 14 April 2004 meetings. *[Sentence omitted from observer notes]*

mutual entities. The majority of respondents disagreed with the exposure draft because:

a. the IASB had at that time already begun with phase two of its business combinations project. Respondents stated that there seemed little reason for proceeding with an interim solution that would be replaced soon after by a revised standard.

b. the modified purchase method was inconsistent with IFRS 3. For example, the proposals would result in different treatments for goodwill depending on whether the combination was between mutual entities or investor-owned entities.

c. the modified purchase method would result in a combination between mutual entities being overstated whenever any consideration given by the acquirer in exchange for control of the acquiree exceeds the amount of goodwill in the acquiree.

d. the exposure draft had been published too close to the 2005 deadline for adoption of IFRSs in Europe and other jurisdictions.

10. In light of respondents' comments, the IASB decided not to proceed with the proposal. This decision implies that combinations between mutual entities should be accounted for by applying the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* on developing accounting policies in the absence of a standard or an interpretation that specifically applies to a transaction or event. The IASB observed that, in accordance with IAS 8, a mutual entity would be excluded from applying a superseded standard. Therefore, mutual entities cannot apply the pooling of interests guidance that was in IAS 22 *Business Combinations* when accounting for combinations between mutual entities. However, mutual entities are permitted to look to IFRS for guidance.

11. As part of the second phase of the IASB's business combinations project, the IASB discussed the accounting for combinations between mutual entities at its September and November 2004 meetings *(footnote reference omitted)*.

CONCLUSIONS REACHED DURING INITIAL DELIBERATIONS

12. Both Boards decided during the deliberations leading to the BC ED to use a 'differences-based' approach for combinations between mutual entities. That approach presumes that the acquisition method should apply to combinations between mutual entities unless the economic conditions or other circumstances of the combination are found to be so different to warrant a different accounting treatment or further guidance for combinations between mutual entities. The Boards concluded that the attributes of mutual entities are not sufficiently different to justify an accounting treatment different from that provided for other entities and, therefore, decided to include mutual entities within the scope of the BC ED.

13. Two Board members (one FASB, one IASB) disagreed with this decision. The FASB Board member cited the following in his Alternative View:

> The Board member has significant concerns over the use of the acquisition method for particular combinations involving mutual entities. In some of these transactions (including one included in the Board's field visits relating to this Statement), no consideration is exchanged, the combining entities are of similar size, and the governing board and management of the combined entity are drawn equally from each of the combining entities. In such cases the Board member believes that properly identifying an acquirer is an essentially futile exercise that results in arbitrary revaluation of part of the combined entity and in an accounting treatment that is not representationally faithful of the underlying combination transaction. In his view, such combinations of mutual entities do not represent the acquisition of one entity by another, but rather the creation of a new entity. Accordingly in such cases, the Board member believes that "fresh-start" accounting for the entire combined entity would be preferable to what he views as the essentially arbitrary, partial revaluation that would result from applying the provisions of this proposed statement. This Board member therefore disagrees with the Board's decision not to reconsider the alternative of the fresh-start method and this Statement's tentative affirmation of the conclusion reached in Statement 141 that precludes the use of the fresh-start method in those circumstances …

14. The IASB member disagreed for similar reasons and cited the following in his Alternative View:

> … combinations of mutual entities have characteristics that are more likely to have the characteristics of true mergers rather than acquisitions […]. And they are also likely to have characteristics, such as lack of measurable financial consideration (which will apply particularly when combinations are achieved by contract alone), that make acquisition accounting difficult to implement reliably. Therefore, it would be better to defer changes in accounting for combinations of such entities until more appropriate methods, such as fresh start accounting […], have been explored properly.
>
> The Board member supports the alternative view of the FASB Board member who has also concerns about the proposed accounting for mutual entities …

COMMENT LETTER ANALYSIS

15. A few respondents agreed with the conclusions drawn in the BC ED and stated that mutual entities should apply the acquisition method. For example, CPA Australia (CL #118) wrote:

> CPA Australia takes the view that all business combinations should be accounted for by applying the acquisition method regardless of the legal form of the combining businesses. We acknowledge that there may be difficulties in identifying the acquirer under some forms of business combination, but we do not take the view that these difficulties are insurmountable. We therefore support the increase in scope.

16. However, most respondents disagreed with the proposal. They disagreed with the application of the acquisition method for conceptual, practical, and cost-benefit reasons. In addition, many cooperatives that responded to the BC ED objected to the apparent inclusion of mutuals and cooperatives into a single definition.

Conceptual concerns regarding the acquisition method

17. Respondents believed that the economic conditions or other circumstances of a combination between mutual entities are so different that a different accounting treatment for such combinations would be warranted. They believed that combinations between mutual entities often represent mergers of equals rather than acquisitions of one entity by the other. Respondents argued that classifying one of the combining parties as the acquirer and one as the acquiree would

contradict the idea of a merger between equal parties, and, therefore, the acquisition method would not be reflective of the true economics of those combinations. Some respondents were also concerned that the requirement to designate an acquirer and an acquiree in each business combination could impede negotiations in those situations in which a merger of equals is the intended outcome of the combination.

18. For example, American Council of Life Insurers (CL #46) wrote:

> We do not believe the objective and definition of a business combination should apply to business combinations involving only mutual entities. A mutual merger is a true pooling of interest transaction with no consideration exchanged between the parties. With no consideration in a transaction it is not practical to determine an accurate fair value of the acquired company to the acquirer. We are concerned that by using purchase accounting for a mutual merger the results may be misleading to the financial statements users, who for the most part are regulators, bondholders and policyholders. The factors that motivate a merger between two mutual companies very different than the factors that motivate an acquiring company paying cash or stock for a business.

19. The staff notes that both Boards concluded as part of the first phases of their business combinations projects that the acquisition (purchase) method is the only appropriate method of accounting for business combinations in which one entity obtains control of one or more other entities or businesses. BC 44 of IFRS 3 (see also B29 of Statement 141) states:

> …The purchase method views a combination from the perspective of the combining entity that is the acquirer (ie the combining entity that obtains control of the other combining entities or businesses). The acquirer purchases net assets and recognises in its financial statements the assets acquired and liabilities and contingent liabilities assumed, including those not previously recognised by the acquiree. The nature of the consideration exchanged does not affect the recognition or measurement of the assets acquired and liabilities and contingent liabilities assumed. Because the exchange transaction is assumed to result from arm's length bargaining between independent parties, the values exchanged are presumed to be equal. The measurement of the acquirer's assets and liabilities is not affected by the transaction, nor are any additional assets or liabilities of the acquirer recognised as a result of the transaction, because they are not involved in the transaction. Therefore, the purchase method faithfully represents the underlying economics of business combinations in which one entity obtains control of another entity or business.

20. Furthermore, the FASB concluded during the first phase of its business combinations project that 'true mergers' or 'mergers of equals' are non-existent or so rare as to be virtually non-existent; thus, a separate accounting treatment would be not warranted. The IASB decided that it should not, in the first phase of its business combinations project, rule out the possibility of the existence of a combination of entities in which one of the combining entities does not obtain control of the other combining entity or entities. However, the IASB agreed with the FASB's conclusion that if 'true mergers' exist, they are likely to be rare. In addition, if true mergers are to be accounted for using a method other than the purchase method, suitable non-arbitrary and unambiguous criteria would be needed to distinguish those transactions from business combinations in which one entity obtains control of another entity or entities. The IASB observed that it currently does not have such criteria and that it would be likely to take considerable time and be extremely difficult to develop such criteria. The Boards also noted that even if such criteria could be found, it would not necessarily follow that the pooling-of-interests method is the appropriate of accounting for a true merger. The Boards observed during the first phase of their business combinations projects that a better method would be the fresh-start method.

21. The staff believes that the Boards' conclusions are equally applicable to combinations between investor-owned entities and to combinations between mutual entities. We believe that most combinations between mutual entities are either initiated to gain access to suppliers, customers, personnel, production equipment, intellectual capital or funding or to achieve synergies between the combining parties regarding those points. We, therefore, believe that the economic motivations of combinations between mutual entities are comparable to combinations between other investor-owned entities that generally are initiated for the same economic reasons.

22. The staff acknowledges that many mutual entities view their combinations as mergers rather than acquisitions. In those situations, the requirement to designate one of the combining entities as the acquirer and one as the acquiree could impose psychological barriers during merger negotiations. However, the

staff agrees with the Boards' conclusion that regardless of the parties' initial intentions, virtually all business combinations result in one entity achieving control over another. Thus, combinations between mutual entities should be accounted for in accordance with the acquisition method.[2]

Practical concerns in applying the acquisition method

23. Constituents highlighted the following practical concerns associated with the adoption of the acquisition method for combinations between mutual entities:

    a. it is often not possible to identify an acquirer;

    b. a business combination of mutual entities normally does not involve cash or any other readily measurable consideration;

    c. mutual entities have unique legal and economic characteristics that significantly complicate the use of valuation techniques in absence of readily measurable consideration; and

    d. application of the acquisition method negatively affects the equity presentation of the combining mutual entities as only the retained earnings of the acquirer are carried forward.

Identifying the acquirer

24. Some respondents believed that often it might be difficult, if not impossible, to identify an acquirer in a combination between mutual entities.

25. For example, the European Association of Cooperative Banks (CL #212) stated:

> … while it can certainly be argued that in some business combinations between mutual entities acquirers could be technically identified according to the criteria suggested by the IASB […], it is less certain that an acquirer can be readily identified for a majority of merger situations between mutuals.
>
> […] we expect that in the context of ongoing consolidation in the banking sector at national level, there will be many borderline

[2] However, the staff acknowledges that this conclusion could change once the Boards have investigated the fresh-start method on a more comprehensive basis in a subsequent phase of their business combinations projects.

> cases in merger situations between small local cooperative banks, where either "true mergers" occur or where at least control cannot be positively established and an acquirer cannot be identified. Choosing an acquirer then will become an arbitrary choice, which could lead to quite diverging results, depending on which entity is labeled as being the "acquirer".

26. The staff acknowledges that in a combination between mutual entities, it might be difficult to identify an acquirer. However, we note that this difficulty is not special to combinations between mutual entities. That difficulty also arises in combinations between two virtually equal investor-owned entities. Therefore, paragraphs 10–17 of the BC ED provide some indicators for identifying the acquirer in a business combination when it is not completely clear which party obtained control of the other. During initial deliberations, the Boards concluded that the indicators in IFRS 3 and Statement 141, which were codified in the BC ED, were equally applicable to mutual entities and no additional indicators were necessary for those combinations. Constituents did not present any specific examples where it would be impossible to identify the acquirer given the indicators in the BC ED. Therefore, the staff does not believe any additional indicators are needed.

Absence of reliably measurable consideration

27. Many respondents were concerned that combinations between mutual entities generally do not involve the payment of cash or any other readily measurable consideration and, therefore, it might be difficult to apply the acquisition method.

28. For example, the National Society of Accountants for Cooperatives (CL #90) wrote:

> We continue to believe that the vast majority of cooperative entities (mutual enterprises) are unique, in that no consideration (above the book value of their existing equity interest) is paid to the members of one cooperative when combining/merging with another cooperative. Since the members' equity interests of combining cooperatives are most often simply pooled together at book value, there is no "purchase cost" to the acquiring cooperative […] with which to objectively measure the basis of an acquisition…

29. The staff notes that business combinations without an exchange of cash or other readily measurable consideration also take place between investor-owned entities. For example, there is no readily measurable consideration in a merger of two privately held investor-owned entities. Therefore, although combinations between mutual entities are more likely to take place without an exchange of cash or other readily measurable consideration, that circumstance is not unique to mutual entities and entities are already applying the purchase method when two private companies combine.

Availability of valuation techniques

30. Some respondents stated that the unique economic and legal characteristics of mutual entities cause complex valuation issues that would not occur for combinations between investor-owned entities. Therefore, those respondents questioned the appropriateness of the acquisition method for combinations between mutual entities.

31. For example, PwC (CL #66) wrote:

> The interest of a member of a mutual entity is often different from the holder of an equity interest in other entities. The rights of a member of a mutual entity are sometimes limited to the repayment of their investment or savings. They often do not have a fair value ownership interest in the residual benefit to be derived from the entity and therefore do not own a proportionate share of the net assets of the entity. The aggregate of the 'fair value' of the interests of the members of a mutual entity may not necessarily equate to the fair value of the acquiree as a whole. Given the complexities associated with such combinations, we do not support including such combinations within this standard unless these issues are addressed comprehensively.

32. The staff notes that mutual entities have many characteristics in common, and some characteristics that distinguish them from investor-owned entities. Admittedly, mutual entities generally do not have shareholders in the traditional sense of investor-owners. However, we believe that mutual entities are in effect 'owned' by their members and are in business to serve their members or other stakeholders. Like other businesses, mutual entities strive to provide their 'owners' with a financial return or benefit. But, a mutual entity generally does that by focusing on providing its members with its products and services at lower prices.

33. During initial deliberations, FASB resource group members indicated that the valuation methods used to value a mutual entity are essentially the same as those used to value investor-owned entities even though refinements or adjustments to market data would have to be considered when valuing a mutual entity. Informal staff inquiries with valuation experts support this theory. Practitioners confirmed that they apply the same valuation methodology to investor-owned and mutual entities even though the applicable valuation models are likely to be adjusted for the unique characteristics of mutual entities. Practitioners generally do not consider the additional technical challenges associated with the special legal and economic nature of a mutual entity to be insurmountable or exceedingly burdensome. Paragraphs A24–A26 of the BC ED contain high-level guidance on the fair value measurement of mutual entities. Practitioners do not see any need for additional guidance.

Equity classification

34. Some respondents expressed concerns about the effect the application of the acquisition method could have on their capital requirements for regulatory purposes. Paragraph 53 of the BC ED states that in a combination between mutual entities an amount equal to the fair value of the acquiree shall be added 'to capital or equity, not to retained earnings'. However, at the time the BC ED was issued, some regulatory agencies evaluated the financial soundness of credit unions on the basis of their accumulated retained earnings measured under generally accepted accounting principles rather than their total equity. Under the acquisition method, only the retained earnings of the acquirer are carried forward in the combined entity. Accordingly, without changes to the regulatory requirements, credit unions would have a reduced net worth ratio after a combination. Constituents feared that this might discourage mergers between credit unions and, therefore, suggested that such combinations between mutual entities should be allowed to be recognised as an increase in the retained earnings of the combined entity.

35. For example, New York State Credit Union League (CL #81) stated:

> We believe that the proposal to amend FASB Statement 141 would have unintended negative consequences on credit union mergers, as the rule change would prohibit a surviving credit union from combining the retained earnings of the non-surviving credit union with its own retained earnings. The consequence could be a significant decrease in net worth of the surviving credit union, possibly to the extent that it would be subject to sanctions and prohibitions under NCUA's Prompt Corrective Action regulation, Part 702. This could discourage or even prevent credit union mergers, especially those between credit unions of like size.
>
> Under Part 702, credit unions are required to maintain a net worth ratio of at least seven percent to be classified as "well-capitalized". If a credit union were to fall below the seven percent net worth ration it would be subject to regulatory sanctions. In the event that credit unions of like size merge, the surviving credit union may potentially fall below the "well-capitalized" threshold due to the inability to combine the retained earnings of the non-surviving credit union. This situation could prevent a credit union merger that is in the best interest of both credit unions…
>
> Therefore, we respectfully recommend that FASB reevaluate its position requiring the retained earnings of the non-surviving credit union be allocated separately on the surviving credit union's balance

sheet as acquired equity and not combined with the retained earnings of the surviving credit union.

36. After the issuance of the BC ED, the Financial Services Regulatory Relief Act of 2006 was passed into U.S. federal law. That legislation included provisions related to the federal credit union capital requirements and clarified the definition of net worth in circumstances in which two credit unions are combined. That legislation fixes the concern raised in the comment letter (from a federal level) because it amends the Federal Credit Union Act, which legally binds the NCUA for federally chartered credit unions. As a result of this legislation, state regulators may also consider making similar changes to their regulations, when appropriate. The final standard will not be effective until 2009. Hence, if other regulators believe that the requirements in the final business combination standard affect laws and regulations that are based on U.S. GAAP or IFRSs, the staff believes that there should be sufficient time for lawmakers and regulators to consider whether modification of those laws or regulations would be appropriate.

37. IFRSs and U.S. GAAP strive to provide decision-useful information to users of financial statements. As part of the first phases of their business combinations projects, the Boards concluded that applying the acquisition method for combinations between mutual entities best serves this purpose. Therefore, the staff believes that the final business combinations standard should require application of the acquisition method for combinations between investor-owned entities and combinations between mutual entities. The staff disagrees that laws and regulations, even though they might be based on U.S. GAAP or IFRSs, should guide the content of the final standard. Creating an exception for combinations between mutual entities would negatively affect comparability with combinations between investor-owned entities and violate the principle of neutrality. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Cost-benefit aspects

38. Some respondents expressed concerns that the acquisition method would not be cost-beneficial for combinations between mutual entities. For example, Michigan Credit Union League (CL #117) wrote:

> Currently, while most credit unions determine if they are compatible to merge, many do not feel the need to utilize outside accountants to perform an economic analysis of the value of the credit unions. Because credit unions are more interested in determining whether their institutions are well-matched from a philosophical, operational, and "field of membership standpoint, the focus is not on determining their combined value. Requiring an economic analysis of the merger may prove to be a significant expense on the two merging credit unions, without providing any significant value.

39. The staff does not share those concerns. Like investor-owned entities, mutual entities strive to provide their members with a financial return or benefit even though some mutual entities might not exclusively pursue economic goals. We also believe that combinations between mutual entities follow the same economic motivations as combinations between investor-owned entities. Hence, in the staff's view, an owner, member, or participant in a mutual entity is likely to have similar financial information needs as other investors. The Boards decided during the first phase of their business combinations projects that those information needs are best served by adopting the acquisition method.

40. [Paragraph omitted from observer notes]

*41. **Analysis of alternative accounting methods***

42. Respondents recommended several alternative accounting methods for combinations between mutual entities that, in their view, would better reflect the economics of those combinations. They suggested that either (a) the pooling-of-interests method, (b) the net-asset method, or (c) the fresh-start method should be applied for combinations between mutual entities.

43. For example, the National Cooperative Business Association (CL# 50) stated:

> The pooling method is appropriate for cooperatives because it allows cooperatives to bring all the members together to form a new entity without having to identify the acquirer. The method employs historical cost accounting or book values, which are more appropriate for cooperatives. Cooperatives believe there is no need for more intricate, complicated accounting for the fairly simple transactions in which they are involved.

44. American Community Bankers (CL #96) wrote:

> ACB maintains the position that the use of acquisition accounting, as described in the ED, is inappropriate for mutual combinations and will result in arbitrary and costly revaluations, and financial statements that will not truly reflect the essence of the underlying combination transaction. We are not advocating the maintenance of pooling-of-interests, rather we believe that FASB should require mutuals to use a net asset value approach, or similar variation of acquisition accounting using estimations of the fair market values of assets and liabilities assumed.

45. The UK Accounting Standards Board (CL #130) wrote:

> We wish to emphasise that in our view it is inappropriate to require a single method of accounting for all business combinations. Acquisition accounting is capable of providing a representationally faithful depiction of reporting the acquisition of one business by another. It is, however, not a representationally faithful way of reporting a business combination in which one entity does not acquire another - no party to the transaction is an acquirer and accounting should not be based on the fiction that one of them is. For this reason ASB continues to advocate research into 'fresh start accounting'. The staff disagrees with respondents that any of the alternatively suggested accounting methods should be applied for combinations between mutual entities.

Pooling-of-interests method

46. According to the pooling-of-interests method, assets and liabilities of the combining entities are carried forward at their pre-combination book values, and no additional assets or liabilities are recognised as a result of the combination. Both Boards rejected the pooling-of-interests method during the first phases of their business combinations projects because in no circumstances does the pooling-of-interests method provide information superior to that provided by the purchase method.

47. Those respondents who recommended adoption of the pooling-of-interests method for combinations between mutual entities stated that, in their view, this method better reflects the fact that some combinations between mutual entities are 'true mergers'. They maintained that combinations between mutual entities often purely aim to achieve a uniting of commercial strategies between the combining parties and that the pre-combination ownership interests are effectively continued in such a transaction.

48. The staff acknowledges that a combination between mutual entities will often result in the continuation of ownership interests. However, we believe that the nature of the ownership interests changes as a result of the transaction because the members of the combining mutual entities have, as a result of the combination, a residual interest in the net assets of the combined mutual entity. The information provided by the pooling of interests method would fail to reflect this and, therefore, would lack relevance. Because the assets and liabilities of all the combining entities would be recognised at their pre-combination book values rather than at their fair values at the date of the combination, users of the combined entity's financial statements would be unable to reasonably assess the nature, timing, and extent of future cash flows expected to arise from the combined entity as a result of the transaction.

49. Finally, the staff acknowledges that in some combinations between mutual entities application of the acquisition method might be more expensive than application of the pooling-of-interests method. However, we agree with the Boards' conclusions during the first phases of their business combinations

projects that having more than one accounting method for business combinations would lead to higher costs associated with applying, auditing, enforcing, and analysing the information produced by them. Therefore, the staff believes that adoption of the pooling-of-interests method for combinations between mutual entities is not cost-beneficial.

Net asset approach

50. FASB Proposed Statement *Not-for-Profit Organizations: Mergers and Acquisitions* introduces what is sometimes described as a net asset approach to account for any goodwill and inherent contributions for all mergers and acquisitions by not-for-profit organisations (NFPs). According to this NFP approach, assets acquired and liabilities assumed in the merger or acquisition would be measured, with limited exceptions, at their fair values. Goodwill or a contribution received would be measured as follows:

> Under that approach an acquirer would recognise either goodwill acquired, to the extent that consideration transferred is **more than** the identifiable net assets acquired, or a contribution received, to the extent that the consideration transferred, if any, is **less than** the identifiable net assets acquired. The Board decided to require that alternative and less costly approach for measuring goodwill or a contribution received because of the difficulties and cost of obtaining information for making the measure, because of concerns about the reliability of the measure, because of concerns about the reliability of the measure, and because of questions about the benefits of information about goodwill to users of the financial statements [Paragraph B122, emphasis omitted.]

51. Therefore, NFPs would not be required to measure the fair value of the acquiree as a whole. In some transactions, NFPs may recognise less goodwill and less of a contribution received than would be recognised by applying the BC ED. In other situations, the amount of goodwill recognised would be the same as in a business combination (for example, where readily measurable consideration is transferred between the contracting parties and the NFP acquires 100% of the acquiree). Additionally, similar to the acquisition method in the BC ED, an NFP would be required to identify an acquirer in all mergers or acquisitions within the scope of that ED.

52. Some respondents requested that the Boards consider extending the NFP approach to combinations between mutual entities. However, the staff notes that the FASB proposed that approach for reasons that are unique to certain types of mergers and acquisitions by NFPs. Mergers and acquisitions by NFPs could either involve a bargained exchange or a contribution of the net assets of the acquiree to the acquirer for no consideration or consideration that is substantially less than the value of the net assets. Difficulties in measuring the fair value of the acquiree arise with respect to the later type of transactions because of the non-reciprocal character of the transaction. The FASB observed that the application of valuation approaches could be significantly more problematic for acquisitions of a nonprofit activity (i.e., an integrated group of assets or an entity that operates to fulfill an organization's purpose or mission).

53. The FASB considered whether the recognition of goodwill enhances the decision usefulness of the NFP's financial statements. The FASB observed that performance measures for NFPs differ from those used to evaluate business entities because an NFP is not operated with the goal of maximising financial returns in the typical business sense. Thus, the FASB was not convinced that reporting goodwill based on the fair value of the acquiree or reporting the impairment of goodwill on that basis would better meet the objective of decision usefulness than the proposed method.

54. The staff believes that the NFP approach should not be applied to mutual entities. We believe that the same economic motivations underpin a combination between mutual entities and a combination between investor-owned entities. Therefore, we presume that non-reciprocal transactions between mutual entities do not exist or are at least likely to be rare. As a consequence, the aforementioned difficulties in applying the acquisition method should not occur for mutual entities. In the staff's view, owners, members, or participants in mutual entities pursue mainly economic objectives with their investment in a mutual entity. Thus, the same performance measures should be used for all for-profit entities—both mutual entities and investor-owned entities.

55. The staff also notes that the NFP approach is similar to the modified purchase method proposed by the IASB in its exposure draft of proposed amendments to

IFRS 3 *Combinations by Contract Alone or Involving Mutual Entities*. The IASB decided not to proceed with the proposals in the exposure draft because a modified accounting method for combinations between mutual entities would be inconsistent with the accounting for combinations between investor-owned entities. For example, a special accounting treatment would result in two different treatments of goodwill depending on whether the combination was between mutual entities or between investor-owned entities.

Fresh start method

56. Under the fresh-start method, none of the combining mutual entities are viewed as having survived the combination as an independent reporting entity. Rather, the combination is viewed as the transfer of the net assets of the combining entities to a new entity that assumes control over them, and the history of that new entity, by definition, begins with the combination. All assets and liabilities (including goodwill) of the combining parties would initially be measured at fair value.

57. The staff agrees with constituents that for combinations between mutual entities in which one of the combining entities does not obtain control of the other combining entity, the fresh start method might be more representationally faithful than the acquisition method.

58. However, the staff notes that the Boards have not deliberated how or when to apply the fresh-start method. Therefore, the Boards would have to develop new accounting guidance for implementing this method and would have to address many issues (such as whether goodwill should be recognised and how it should be measured) before it could be applied. Some constituents also agreed that the application of the fresh-start method could impose material costs on mutual entities and cause other practical difficulties.

59. Adoption of the fresh-start method for combinations between mutual entities would bear the same disadvantages as the existence of any two accounting methods for business combinations and, thus, provide incentives for accounting arbitrage, impair comparability, and not be cost-beneficial.

60. The staff notes that the Boards have stated that they might explore the fresh-start method in subsequent phases of their business combinations projects. However, the conduct of further research on the fresh-start method is currently not included in the technical work plans of the FASB or the IASB. A comprehensive analysis of fresh-start accounting would therefore require a formal agenda decision. The staff believes that the application of the fresh-start method for combinations between mutual entities should be revisited if and when the Boards consider the fresh-start method comprehensively.

Should cooperatives be included in the definition of a mutual entity?

61. FASB Concepts Statement No. 4 *Objectives of Financial Reporting by Nonbusiness Organizations* refers to a mutual entity as 'an entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants.' Similarly, IFRS 3 defines a mutual entity as 'an entity other than an investor-owned entity, such as a mutual insurance company or a mutual cooperative entity, that provides lower costs or other economic benefits directly and proportionately to its policyholders or participants'.[3]

62. During initial deliberations, the Boards noted that U.S. GAAP and IFRSs essentially use the same definition of a mutual entity. Hence, the BC ED defines a mutual entity in essentially the same way as it was defined in IFRSs and U.S. GAAP.

63. The Boards received a number of comment letters from cooperatives that apply IFRSs. Those respondents argued that the term and definition of "mutual entity" used in the BC ED is inappropriate for cooperatives. According to those constituents, the proposed definition mixes different business structures that should not be defined or accounted for in the same manner.

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[3] IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* contains neither a definition of a mutual entity nor of a co-operative entity. However, paragraph 1 of this interpretation states:

> Co-operatives and other similar entities are formed by groups of persons to meet common economic and social needs. National laws typically define a co-operative as a society endeavouring to promote its members' economic advancement by way of a joint business operation (the principle of self-help). Members' interest in a co-operative are often characterised as members' shares, units or the like …

64. The European Cooperative Group (CL #210) stated:

> The IASB term "mutual entity has no clear boundaries and mixes different business structures. The IASB uses only examples, such as "mutual insurance companies", "mutual cooperative entities", (BC 184, p 54), "credit unions" (BC 182, a "wholesale buying cooperative" (ibid) etc. The IASB never states the clear boundaries and definitive scope of "mutual entities".
>
> Cooperatives and mutuals differ in their capital formation: cooperatives issue member shares; mutuals do not. Mutuals' difference with the IAS Board's "mutual entity" concept is strong: Mutuals have neither nominal nor transferable shares. […]
>
> In terms of corporate governance and control, the cooperative is "jointly owned and democratically controlled" A cooperative society is "controlled" collectively by its members as the latter (or their delegates) designate its executive directors at the general assembly according to the "one person, one vote" principle. […]
>
> …the IASB's "mutual entity" appears to allocate profit exclusively to capital owners. Yet in a cooperative the allocation of dividend to member is only a possibility defined by the cooperative itself through its general assembly, and in any case is always limited. The allocation of dividends in a cooperative is not a "gain" nor a "profit" as described under the "mutual entity" concept, but only an adjustment aimed to compensate the members for what they paid in excess or received less in their transactions with the cooperative. It is for this reason that those dividends are normally taxed to the cooperative members as individuals, not to the cooperative.
>
> If dividends are distributed, it is only on the basis of the surpluses, the most substantial part of which is usually destined to reserves, the development of the cooperative, or other activities beneficial to the community at large. In particular, when the cooperative provides goods or services to third parities that are not members, the surplus of such activities is often destined to indivisible reserves or educational activities. […]
>
> Distributing dividends is not part of the objectives of a cooperative, which in turn are stated in the definition of cooperative ("to meet their common economic, social and cultural needs and aspirations").
>
> The main motivations of members in joining a cooperative is to obtain, together with other members, the satisfaction of a specific need, according to the type of cooperative, such as creating employment, building their own housing, accessing credit, ensuring access to food of quality at the most reasonable cost, accessing electricity in marginalized and rural, ensuring a fairer income to individual farmers through joint commercialization of their products, etc.

65. The staff disagrees with those respondents who believe that cooperatives do not fit into the definition of a mutual entity. We believe that cooperatives, generally, provide dividends, lower costs, or other economic benefits directly and proportionately to its members and, therefore, share the same economic characteristics with other entities captured by the definition of a mutual entity.

66. The staff agrees with respondents that, contrary to investor-owned entities, cooperatives often pursue more than mere economic interests and provide valuable social and cultural services to their communities. However, cooperatives generally do not meet the definition of a not-for-profit organisation. Even though a significant part of a cooperative's activities might comprise social and cultural activities, the main objective of a cooperative is to provide economic benefits to its members. It is this essential characteristic of a cooperative upon which the definition of a mutual entity is based.

67. Furthermore, the staff acknowledges that cooperatives possess legal characteristics that distinguish them from other entities captured by the definition of a mutual entity. For example, contrary to most other mutual entities, a cooperative issues member shares. However, the staff does not believe that those legal characteristics affect the economic nature of a cooperative in such a way that cooperatives do not fit into the definition of a mutual entity.

68. The definition of a mutual entity focuses on the provision of direct and/or indirect economic benefits to their owners, members, or participants. Respondents argued that a cooperative does not provide significant direct economic benefit to its members. In their opinion, the allocation of dividends in a cooperative cannot be compared to the allocation of dividends in other mutual entities because most of the cooperative's net income is either used for its further development, other activities beneficial to the community or attributed to reserves and only a minor share is distributed to shareholders. In their view, distributions to members of a cooperative represent a compensation for what members paid in excess or received less in their transactions with the cooperative. However, the staff notes that, regardless of the underpinning motivation, all direct distributions provided by the cooperative to its members represent economic benefits, and those benefits are distributed to its members proportionally. The fact that only a minor share of the

cooperative's surpluses is distributed to its shareholders does not exclude those entities from the scope of the definition of a mutual entity. The definition of a mutual entity does not require that *all* surpluses of the entity are distributed to its members; just that the surpluses are distributed directly and proportionally.

69. The staff believes that, in addition to direct economic benefits, a cooperative also provides indirect economic benefits to its members. Members of a cooperative are likely to profit from lower procurement costs, shared access to capital intensive resources, common distribution channels, and easier access to funding. Therefore, a cooperative shares the characteristic that it provides direct and indirect benefits to its members with other mutual entities.

70. Additionally, the definition requires that all direct and indirect benefits be provided on a proportional basis. The staff believes that cooperatives will generally meet this condition because the amount of direct and indirect benefits received by a member of a cooperative will largely be determined as a percentage of its transactions as a member with the cooperative.

STAFF RECOMMENDATION AND QUESTIONS FOR THE BOARDS

71. The BC ED defines mutual entities as entities other than investor-owned entities that provide dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants. That definition is intended to include cooperatives. The staff believes that cooperatives share many common characteristics with other mutual entities and that those characteristics are appropriately reflected in the definition. Therefore, we do not recommend modifying the definition of a mutual entity as part of this project.

72. Furthermore, the BC ED proposes to remove the scope exception in IFRS 3 and Statement 141 for mutual entities and to require that mutual entities, similar to investor-owned entities, apply the acquisition method. The staff did not identify differences arising from the special nature of mutual entities or the economic circumstances surrounding a combination between mutual entities that would justify a different treatment for combinations between mutual entities. The staff acknowledges that the application of the acquisition method often imposes

technical challenges for combinations between mutual entities. However, we note that many of these difficulties are not specific to combinations between mutual entities but can occur in combinations between investor-owned entities as well.

73. Furthermore, the staff disagrees with those constituents who argued that either the pooling-of-interests method or the net asset method should be used for some combinations between mutual entities and notes that application of the fresh start method has not been fully explored by the Boards. We do not believe that under the acquisition method mutual entities should be allowed to account for a business combination as an addition to retained earnings. In the staff's view, application of the acquisition method as the only allowed accounting treatment is conceptually superior for relevance, comparability and cost-benefit reasons.

74. The staff recommends that the Boards reaffirm that the definition of a mutual entity applies to cooperatives and reaffirm their decision to remove the scope exclusion for mutual entities and to require that those entities apply the acquisition method.

Do the Boards agree that cooperatives fit into the definition of a mutual entity, which is defined as an entity other than an investor-owned entity that provides dividends, lower costs or other economic benefits directly and proportionately to its owners, members or participants?

Do the Boards agree that mutual entities should be included in the scope of the final business combinations standard and that combinations between mutual entities should be accounted for by applying the acquisition method?