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Response to Exposure Draft of a Proposed Amendments to IFRS 3 Business Combinations: Combinations by Contract Alone or Involving Mutual Entities

Dear Sir David,

We welcome the opportunity to comment on the *Exposure Draft of a Proposed Amendments to IFRS 3 Business Combinations: Combinations by Contract Alone or Involving Mutual Entities*. The views expressed in this letter are those of KPMG International on behalf of its member firms.

Summary of comments

We agree that combinations by contract alone or involving mutual entities should be within the scope of IFRS 3.

However, we believe that the existing purchase accounting requirements of IFRS 3 should be applied to combinations by contract alone. We do not agree with applying a modified purchase method for this type of transaction, because we believe that the differences are more a matter of legal form and not substantive economic differences. Therefore we do not believe that a special accounting model should be applied. Rather we think that more guidance is needed how to apply IFRS 3 to these transactions.

Due to the specific characteristics of the ownership structure of mutual entities we believe that it might not be possible to apply the current business combination accounting rules to combinations involving these entities. Although the proposed approach is an interim solution we agree with it on the basis that it is more consistent with conclusions reached in developing IFRS 3 not to allow uniting of interest accounting for these transactions. We suggest to include more specific guidance for the application of the proposed method.

We agree with the transitional provisions as we believe that this change was signalled sufficiently clearly so that retrospective application to 31 March 2004 would not be overly burdensome.

Question 1

Modified purchase accounting

We agree that combinations by contract alone or involving mutual entities should be within the scope of IFRS 3. In our experience combinations by contract alone or of mutual entities are sufficiently similar to other business combination transactions so that there is no basis for excluding either class of transaction from IFRS 3. As discussed below we do agree with the Boards' proposed modification to purchase accounting to be applied for combinations of mutual entities. Although the Board suggests an interim solution as the discussion about the accounting for "true mergers" is postponed to a later phase of the business combination project, this does not seem to be a sufficient argument for a scope exclusion. Transactions other than those covered by the exposure draft might be affected by a change in the accounting concept for "true mergers" as well.

Combinations by contract alone

We do not agree with the proposed accounting for combinations by contract alone. In our view, it is not appropriate to introduce special accounting rules for certain transactions based solely on the legal structure of the transaction. In our view, combinations by contract do not as a group present unique or extreme issues regarding the identification of an acquirer or measurement of consideration. While identification of an acquirer or measurement of consideration may be difficult in some cases this is no more so than in some other business combinations. In our experience in business combinations by contract alone it is normally possible to measure reliably the value of the business as a whole (as opposed to being able to measure only the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities which is what the ED requires) and the cost of the acquisition.

In our view, purchase accounting, including identification of an acquirer, and measurement of the consideration involved, can be applied to these transactions. The effect is the same as when entities combine through one entity issuing shares to the other's shareholders. There is a single management (typically through arrangements that make the board compositions identical). Both sets of shareholder share in the profits of the whole in fixed proportions (usually there are arrangements such that the dividend rights on one side's shares is fixed in proportion to the other side's and income sharing agreements exists between each leg to assist to make this fully effective). Both sets of shareholders vote together as if they were a single electorate (there are arrangements, for example via specials shares, such that each side's annual general meeting vote result is cast as votes at the other side's annual general meeting). As the interests of the acquiring entity's shareholders in the combined entity can be identified readily, there is no practical issue in identifying the consideration paid by the acquiring entity to the acquired entity – it is the value allotted to the acquiree's shareholders. This can be computed with no more difficulty than the equivalent computations in reverse acquisition accounting.

As a consequence there does not appear to be a case that such transactions should be treated differently from the existing requirements of IFRS 3 (including treatment of directly attributable costs). Therefore we believe that there should be no modification to IFRS 3's purchase accounting requirements for combinations by contract alone. However, as mentioned previously we believe that there are business combinations in which it might not be possible to reliably measure fair value of the business and/or the cost of the combination. Circumstances when the fair value of the combination can not be determined reliably will not be limited to transactions involving combinations of by contract alone.

Further clarification needed

If the Board wished to define a special class of transactions for which differential accounting requirements applied, we believe that the definition of the classes of transactions would have to be more robust than the description in the exposure draft.

With respect to combinations by contract alone there are legal structures, for example "stapling transactions" in Australia, that by legal form are not by contract alone because the shareholders of each entity involved receive shares of the other entity at a notional amount. The economic substance however can be viewed as not being different from a dual listing. This is one example to illustrate that it is necessary to define more clearly what the requirements are for a transaction to qualify as "by contract alone".

We also note that stapling contracts and dual listed entity arrangements may involve a premium being paid by one group of shareholders to the other. We believe that this is in substance goodwill. In our view, only dual listed entities and stapled securities without any transfer of value should be exempted from the requirement to recognise goodwill.

It would be helpful if the difference in economic substance between a "by contract alone transaction" and similar transactions were described. For example it would be helpful to have an explanation as to how a "by contract alone" transaction is in economic substance different from a transaction in which entities combine their businesses by means of founding a new holding company and exchange of shares by the shareholders of the existing entities for shares of the new company. Further it is not clear whether cash payments always lead to the conclusion that the transaction is not "by contract alone". We have seen transactions structured as the creation of dual holding companies that involve transactions in anticipation of the combination such as "special dividends" to one of the existing shareholder groups.

Furthermore, does a combination "by contract alone" mean that none of the entities involved may hold a direct investment in the other entity? This can be the case because one of the entities has acquired an investment in the other one in former transactions or the direct investment may be part of the combination transaction. In the latter case the acquisition would be partly by direct investment and partly by contract alone. It could be argued that "by contract alone" <u>control</u> is obtained and therefore the proposed rules would apply. We do not support such an analysis.

If some business combinations that legally take place at the level of the shareholders are considered to not result in the acquisition of an ownership interest of the entity itself, it would be very helpful if the Board provided some illustration of what accounting should be applied to those business combinations. An example like the one for reverse acquisition would be helpful. Guidance also would be needed on how to account for such transactions in separate financial statements of the entities.

Mutual entities

Due to the specific characteristics of the ownership structure of mutual entities we agree that it might not be possible to apply the current business combination accounting rules to these entities. Although the proposed approach is an interim solution we believe that it is more consistent with conclusions reached in developing IFRS 3 not to allow uniting of interest accounting for these transactions. Therefore we support the solution suggested in the ED.

Further clarification needed

In order to ensure consistent application of the accounting rules in different jurisdictions it is necessary to define what the specific characteristics of mutual entities are.

In the case of combinations of mutual entities it is not uncommon for the acquired entity to make bonus distributions to its members if the combination is approved. These payments may be considered to be an inducement to members to approve the combination and/or a payment to equalise reserves prior to combination. Consideration should be given as to whether such payments should be treated as consideration paid in exchange for control or as a pre-combination distribution/expense.

The requirement to revalue assets and liabilities of the acquired mutual entity creates a difference from historical equity of that mutual. It is unclear how this difference is classified or presented in the financial statements of the combined entity. For example some transactions involving mutual entities such as credit unions do not entitle the existing interest holders to any greater interest after the combination. Presumably existing interest holders would in these cases not be entitled to the increase in equity arising from the fair value adjustments. An illustrative example like the one for reverse acquisitions might be useful.

Question 2

We agree that no amendments should be made to the transitional and effective date requirements in IFRS 3.

Amendments to the transitional and effective date requirements in IFRS 3 for business combinations involving combinations by contract alone or mutual entities could, in theory, have the effect that an entity would have to apply two different "interim solutions" before the IASB develops final guidance on the accounting for such combinations. In our view, this would reduce both comparability and transparency of the financial statements.

Moreover, it should be noted that the IASB flagged the proposed amendments (IFRS 3.BC34) when it finalised IFRS 3. Hence, the IASB's constituents should be aware of possible changes to the accounting for such combinations.

Please contact Mark Vaessen at 020 7694 8089 or Anne Schurbohm at 020 7694 8369 if you wish to discuss any of the issues raised.

Yours faithfully

KPMG International

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