CA House • 87-89 Pembroke Road • Dublin 4

TEL: +353-1 637 7200
FAX: +353-1 668 0842
e-mail: ca@icai.ie

THE INSTITUTE OF
Chartered Accountants
IN IRELAND

26th July 2004

Annette Kimmit,
Senior Project Manager,
International Accounting Standards Board,
30, Cannon Street,
London EC4M 6XH
United Kingdom

Dear Ms Kimmit,

Exposure Draft of Proposed Amendment to IFRS 3 Business Combinations – Combinations by Contract Alone or involving Mutual Entities

The Accounting Committee (AC) of the Institute of Chartered Accountants in Ireland (ICAI) has considered the proposed changes to IFRS 3 Business Combinations.

Question 1

The Exposure Draft proposes:

(a) **to remove from IFRS 3 the scope exclusions for business combinations involving two or more mutual entities and business combinations in which separate entities are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.**

(b) **to require the acquirer to measure the cost of a business combination as:**

(i) **the aggregate of the following amounts when the combination is one in which the acquirer and acquiree are both mutual entities:**

- **the net fair value of the acquiree's indefinable assets, liabilities and contingent liabilities; and**

- **the fair value, at the date of exchange, of any assets given, liabilities incurred or assumed, or equity instruments issued by the acquirer in exchange for control of the acquiree.**

Therefore, goodwill would be recognised in the accounting for such transactions only to the extent of any consideration given by the acquirer in exchange for control of the acquiree.

(ii) the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities when the combination is one in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest. Therefore, no goodwill would arise in the accounting for such transactions.

Is this an appropriate interim solution to the accounting for such transactions until the Board develops guidance on applying the purchase method to such transactions as part of a subsequent phase of its Business Combinations project? If not, what other approach would you recommend as an interim solution to the accounting for such transactions, and why?

Answer 1

Part (a) of question 1

The Accounting Committee agrees with the requirement to remove the scope exclusion for business combinations in which separate entities are brought together to form a reporting entity by contract alone without obtaining an ownership interest. The Accounting Committee also agrees with removing the scope exclusion for business combinations involving two or more mutual entities, subject to the changes suggested below in 'part (b)' of this question. The Accounting Committee believes that this is more appropriate as an interim measure than continuing to apply IAS 22.

Part (b) of question 1

In both these cases the exposure draft proposes a different measure of the cost of the business combination to be used. Draft paragraph 31A (a) sets out the definition of cost to be used when two or more mutual entities combine and draft paragraph 31A (b) sets out the definition of cost when the combination is effected by contract.

Draft paragraph 31A (b)

The Accounting Committee agrees that it is appropriate to use the definition of cost set out in the proposed paragraph 31A (b) for the bringing together of separate entities by contract alone.

Draft paragraph 31A (a)

In relation to combinations in which the acquirer and acquiree are both mutual entities the Accounting Committee considers that the alternative measure of cost should only be permitted when the resulting combined entity is to continue as a mutual entity and the interest of the members of either the acquiree or the acquirer are not limited to certain activities of the combined entity.

Where the combination is affected by the conversion of, say, the acquirer's trade into a limited entity and then that entity issues shares to the acquiree's members in return for its trade and net assets giving the acquiree a percentage interest in the continuing entity, then it is considered that it is appropriate to apply the general rules of IFRS 3.

In this situation the negotiating parties will have attributed a fair value to the trade and net assets of the acquirer and the acquiree in order to determine the relative shareholdings that will be held in the continuing entity by the two mutual entities. It would seem more appropriate to apply principles similar to those outlined in SIC 13.

Illustrative example

To take a small example, assume there were two co-operative societies and it is agreed that it is in their best interests to combine the operations of the societies in order to achieve economies of scale and mutually advantageous practicing power. Following an extended negotiation process it is agreed that Co-op A will hive down its trade and assets into a newly formed subsidiary company – Newco (it is assumed that Newco is 100% owned by Co-op A which continues to be mutually owned by the members). These entities are under common control and consequently outside the scope of IFRS 3 therefore, the hive down may be accounted for either at fair value or at net book value of existing assets.

The following table sets out the main assumptions:

	Co-op A	Co-op B
Net book value of net identifiable assets	€450m	€150m
Negotiated relative fair values of trades and net assets	€700m	€300m
Comprising:		
Fair value of identifiable net assets	€600m	€250m
Goodwill	€100m	€50m

On the assumption that Newco is originally set up with share capital of 700, it will then issue an additional 300 shares to Co-op B in return for the trade and net assets of Co-op B.

Based on the above numbers the members of Co-op A have given away 30% of the fair value of their business. This represents the consideration they paid to acquire 70% of the trade and net assets of Co-op B. In numerical terms the consideration paid is (30% multiplied by €700m) €210m. The net assets received at fair value are 70% of €250m, which is €175m. This gives good will on the transaction of €35m.

In addition, Co-op A has sold 30% of its existing assets to the members of Co-op B in return for 70% of the fair value of Co-op B's business. In accordance with general accounting rules and SIC 13, the carrying value of the assets sold should be compared with the consideration received to calculate the gain. This gain will probably be recognised outside of the income statement as it is not realised.

As can be seen from the above example, where the continuing entity following a business combination involving two or more mutual entities is capable of being valued and where the relative ownership interests of the previous mutual entities can be determined, the Accounting Committee considers that it is appropriate to apply the normal principles of IFRS 3.

Only in circumstances where the continuing entity is also a mutual entity and it is not possible to identify the relative ownership interest of the previous member groups in the combining mutual entities should the alternative measurement of cost in paragraph 31A(a) be used.

Meaning of paragraph 31A (a)(ii)

There is also some concern with regard to the wording of part (ii) of the definition of cost. This refers to "the fair value, at the date of exchange, of any assets given, liabilities incurred or assumed, or equity instruments issued by the acquirer in exchange for control of the acquiree". This amount is supposed to be added to the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities received in the combination and good will is determined to be the difference.

Based on the example above, the fair value of assets given away could be viewed as comprising the 30% of the fair value of Co-op A's business no longer owned by Co-op A. The Accounting Committee considers that the intention of (ii) was to deal with any transfers out of the acquirer's business directly to the members of the acquiree in compensation for them losing control of their business. However, we believe that the potential exists for the words as stated to apply to the reduction in members' interest in the assets of the acquirer's business.

Summary

Provided the two issues outlined above are addressed in the final exposure draft, the Accounting Committee supports the recommended treatment.

Question 2

The Exposure Draft proposes that no amendments be made to the transitional and effective date requirements in IFRS 3. This would have the effects set out in paragraph 6(a) – (c) above on the accounting for business combinations in which the acquirer and acquiree are both mutual entities or in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.

Is this appropriate? If not, what transitional and effective date arrangements would you recommend for such business combinations, and why?

Answer 2

The Accounting Committee concurs with the decision to propose no amendments to the transitional and effective date requirements in IFRS 3.

The Accounting Committee would be happy to discuss or expand on any of the above issues with you.

Yours sincerely,

Simon Magennis
Secretary
Accounting Committee
Institute of Chartered Accountants in Ireland