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International Organization of Securities Commissions
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28 April 2011

Mr. Michael Stewart
Director of Implementation Activities
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Our Ref: 2011/JE/TCSC1/IASB/67

Re: Potential agenda item– business combinations and common control transactions

Dear Mr. Stewart:

The International Organization of Securities Commissions Standing Committee No. 1 on Multinational Disclosure and Accounting (Standing Committee No. 1) thanks you for your consideration of the issues contained in this letter. IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement. Members of Standing Committee No. 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. Unless otherwise noted, the comments we have provided herein reflect a general consensus among the members of Standing Committee No. 1 and are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

We are providing this letter to express our concerns with divergent accounting treatments under IFRS relating to common control transactions. IFRS does not provide guidance on accounting for common control transactions, and situations such as those outlined in this letter are not treated consistently by the large accounting firms and are also not treated consistently by securities regulators. The result is that the application of IFRS does not produce consistent financial reporting for similar transactions of this nature. We are aware that some of these issues have been considered in the past by the IFRS Interpretations Committee as well as by the International Accounting Standards Board (IASB or the Board) in considering a project for common control transactions. However, we ask the IFRS Interpretations Committee to consider these issues and determine if it should contemplate adding these as potential agenda items, or whether the Board could resolve some of these concerns through its annual improvements. We note that these issues are becoming more

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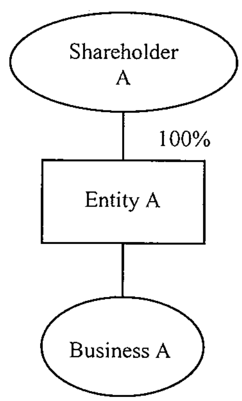
prevalent as additional countries adopt IFRS and believe that some form of additional guidance should be issued.

Example transaction

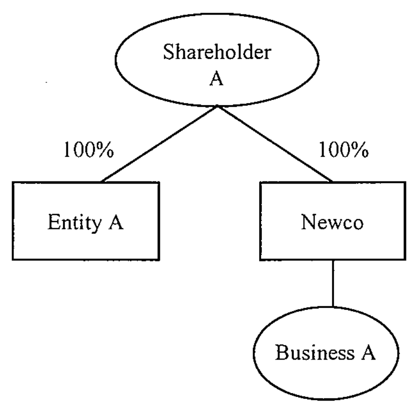
The following is an example of one type of common control transaction that results in inconsistent treatment:

Entity A, owned 100% by Shareholder A, transfers a business (Business A) into a Newco that has been formed for the purpose of acquiring Business A. Eventually Newco will raise new capital from public shareholders; however a period of several months may lapse before a prospectus offering may occur.

Prior to transaction



After transaction



Issue 1 – What is the accounting by Newco?

It would appear as though this transaction does not result in a change in substance or ultimate ownership of Business A and we have observed inconsistent accounting treatment for this type of transaction.

IFRS 3 *Business Combinations* provides guidance on accounting for the acquisition of a business. However, the above transaction is not in the scope of IFRS 3 as:

- The guidance in IFRS 3 paragraphs B13-B18 indicates that the Newco cannot be the acquirer.
- Business A cannot be the acquirer in a business combination as Newco is not a business.

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- The guidance in IFRS 3 paragraph B1 indicates that IFRS 3 does not apply to a business combination of entities or businesses under common control.

Given that IFRS is silent on the appropriate accounting treatment, an entity is required to apply IAS 8 *Accounting Policies, Changes in Estimates, and Errors* to determine an appropriate accounting policy. The large accounting firms have some discussion in their IFRS accounting publications and there is a divergence of opinions on this issue.[1] Commonly used accounting policies are:

(a) **Acquisition Method**– Assets and liabilities of Business A are accounted for at fair value from the date of the acquisition through analogy to IFRS 3. Comparative information includes only the results of Newco. The results of Business A are included from the date of acquisition.

(b) **Pooling Method of Accounting or Uniting of Interests Method of Accounting**: – Assets and liabilities of both commonly controlled entities are presented at book values as if the entities had always been combined from the beginning of the earliest period presented. Comparative information includes the combined results of both Business A and Newco.

(c) **Reverse recapitalization accounting:** Other standard setting bodies or securities regulators have issued guidance to reflect the substance of similar transactions as a recapitalization of Business A, equivalent to the issuance of stock by Business A for the net monetary assets of Newco. [2] The accounting is similar to that resulting from a reverse acquisition, except that no goodwill or other intangible assets are recorded.

Although we recognize the above accounting treatments are the most widely used, it has been observed that inconsistencies exist between these accounting approaches and IFRS standards. Additionally, we have noted use of other accounting policies identified as potential alternatives in accounting literature, such as the use of book values of the acquired business accounted for from the date of the transaction.

Issue 1 concern

In substance, Business A has not changed other than the transaction may have resulted in a change to its capital structure. In option (a) above, the accounting results in an omission of the results of operations prior to the acquisition by Newco, and also results in an omission of comparative information. For purposes of a prospectus, securities regulators often require

[1] Appendix A contains short extracts from the Large accounting firm publications on this issue.
[2] Topic 12 *Reverse Acquisitions and Reverse Recapitalizations*, US Securities and Exchange Commission, Division of Corporation Finance Financial Reporting Manual and Emerging Issues Abstract 10 *Reverse Takeover Accounting*, Canadian Accounting Standards Board

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financial statements for several years of Business A, however on an ongoing basis there is incomplete information in the financial statements of Newco.

We note that, in May 2006, the IFRS Interpretations Committee considered a request for guidance on how to apply IFRS 3 to reorganisations in which control remains within the original group. The IFRIC decided not to add this topic to the agenda, since it was unlikely that it would reach agreement in a reasonable period, existing diversity in practice, and the explicit exclusion of common control transactions from the scope of IFRS 3. We are concerned with this decision, given diversity continues and securities regulators differ on how to approach financial reporting for these transactions.

Issue 2 - What impact does an imminent public offering have on the accounting for Newco?

We understand that some conclude on the appropriate accounting in these situations by considering, among other factors, whether Newco is substantive, and/or whether Shareholder A's control over Newco is transitory in nature.

a) Is Newco substantive?

It is common for transactions such as the one in the example to precede a public offering of Newco shares. Some are of the view that a subsequent transaction resulting in a change of control over Newco and Business A that occurs shortly after the formation of Newco suggests that Newco is a substantive entity that should be considered to be the acquirer of Business A in a business combination. Other are of the view that Newco is a substantive entity when the subsequent transaction results in a *significant* change of ownership interests in Newco, even when control is still maintained by Shareholder A. Accordingly, we believe that clarification regarding if, and when, a Newco can be considered an acquirer is necessary.

b) Is the transitory nature of control of Newco by Shareholder A relevant?

If, in the circumstances described in part a), there is a change of control as a result of a public offering or similar transaction, we believe it should also be made clear whether the 'transitory' nature of control of Newco by Shareholder A may be relevant in determining whether the transaction is in the scope of IFRS 3.

We note that IFRS 3 *Business Combinations* does not apply to a business combination of entities or businesses under common control. Paragraph B1 of IFRS 3 provides the following definition:

> "a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory" (emphasis added).

In paragraph BC28 of IFRS 3 (2004) the Board explained that business combination accounting should not be avoided simply because an unrelated entity is temporarily placed under the control of a parent before it is combined with an entity under existing control of the parent. However, there are differing views on whether common control of Newco and Business A should also be considered transitory where Newco is only temporarily controlled by Shareholder A for the purposes of facilitating a public offering.

We have noted that there is significant diversity in practice with respect to the accounting for these transactions and believe that clarification on whether, and how, a subsequent public offering can or should impact the accounting for the business combination would reduce this diversity.

Issue 3 – Can a 'business' be an acquirer?

We also believe the Interpretations Committee should address a question regarding reverse acquisitions. Note we have previously raised this issue in our comment letter for the 2009 annual improvements cycle, and have included it in this submission in order to obtain clarification on the subject. Specifically, an entity may legally acquire the business of another entity or the business segment of another group of entities. An acquired business segment might include businesses extracted from parts of entities within a larger vendor group. An acquired business segment could also include some legal entities in their entirety. If a business (including a business segment) as well as an "entity" (presuming this means a legal entity) can be treated as an acquirer, this will affect which assets are recognized at fair value and the amount of goodwill recognized in the transaction.

We understand that there are some accounting practitioners that hold the view that IFRS 3 was intended to allow a business (that is, not a legal "entity") as an acquirer in a reverse acquisition, and to account for business combinations on this basis. However, IFRS 3 describes an acquirer as an entity and an acquiree as a business. The reverse acquisition provisions also require the selection of an entity as the acquirer. These provisions would seem to preclude the possibility of a business that is not an entity being the acquirer in a reverse acquisition.

Those who believe that a business can be an acquirer in a reverse acquisition offer the logic that it would be inconsistent to have different outcomes for the substance of a transaction depending upon whether a legal entity exists. They believe that there are errors in the standards, and that the wording of the standards should be disregarded. Some of the practitioners who support the view that a business may be an acquirer argue that the term "entity" includes a business, but this view seems inconsistent with the construction of the standards.

Other practitioners believe that a business cannot be an acquirer in a reverse acquisition given the wording of IFRS 3 that an acquirer is "an entity." Further, most of the transactions in which debate is occurring involve cash acquisitions but as the reverse acquisition accounting provisions and the notion behind a reverse acquisition only refer to exchanges of equity interests, it would not seem possible that a reverse acquisition can occur in a cash exchange. IFRS 3 also specifically contemplates the situation where one of several legal entities from a larger group can be treated as the acquirer, with the assets of the other entities being recognized at fair value. Practical issues would include when to choose a business rather than an entity as the acquirer (particularly as businesses and entities can overlap) and how to determine the share capital and reserves attributable to a business.

If the IASB is of the view that a business can be the acquirer in a reverse acquisition, IFRS 3 would need to be amended to address the current uncertainty and diversity.

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We appreciate your thoughtful consideration of the comments raised in this letter. If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact us.

Sincerely,

Julie A. Erhardt

Julie A. Erhardt
Chairman
IOSCO Standing Committee No. 1
International Organization of Securities Commissions

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Appendix A

Brief Survey of Accounting Literature

The following extracts on this issue are noted in various publications:

Deloitte

"There is currently no specific guidance on accounting for common control transactions under IFRSs. In the absence of specific guidance, entities involved in common control transactions should select an appropriate accounting policy using the 'hierarchy' described in paragraphs 10-12 of IAS 8...
(*Source:* Deloitte iGAAP IFRS for Canada 2nd edition 38.2.2.2)

KPMG

"In our view, the acquirer in a common control transaction has a choice of applying either book value accounting or IFRS 3 accounting in its consolidated financial statements"
(*Source:* KPMG Insights into IFRS 2010-11 5.13)

"In our view, in its consolidated financial statements the acquirer is permitted, but not required, to restate its comparatives and adjust its current year prior to the date of the transaction as if the combination had occurred prior to the start of the earliest period presented. However, this restatement should not, in our view, extend to periods during which the entities were not under common control"
(*Source:* KPMG Insights into IFRS 2010-11 5.13.60.30)

"In our experience usually it is appropriate to conclude that [where newco formations are used in a restructuring] no business combination has occurred...
... accordingly, we believe that Newco should use book value accounting in its consolidated financial statements on the basis that there has been no business combination and in substance nothing has occurred".
(*Source:* KPMG Insights into IFRS 2010-11 Extracts, 5.13.200.10; 5.13.200.50)

E&Y

"in the absence of specific guidance in IFRS, management shall use its judgement in developing and applying an accounting policy that is relevant and reliable...management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, to the extent that these do not conflict with the Framework or any other IFRS or Interpretation. Several such bodies have issued guidance and some allow or require the pooling of interests method (or predecessor accounting or merger accounting as its known in some jurisdictions) in accounting for business combinations involving entities under common control. Accordingly, until such time as the IASB finalises its conclusions under its project on common control transactions, we believe that entities should apply either the: (a)

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pooling of interests method; or (b) acquisition method (as in IFRS 3) in accounting for business combinations involving entities or businesses under common control."
(*Source:* E&Y International GAAP 2011 Chapter 10, 3.1)

"it would only be if the facts and circumstances meant that there was substance to the transaction [example 10.10] such that Newco could be regarded as the acquirer that the application of the acquisition method in IFRS 3 would result in fair values being attributed to the assets acquired and liability of the A group and the recognition of goodwill. For example, where the transaction was contingent on the completion of an IPO that resulted in a change in control of the A group"
(*Source:* E&Y International GAAP 2011 Chapter 10, 4.2)

PwC

"Business combinations involving entities under common control are excluded from IFRS 3's scope. However, management could refer to IFRS 3 in determining a policy for such transactions and decide to adopt the acquisition method as their accounting policy. IFRS 3 is the standard that applies to most business combinations. Business combinations between entities under common control are business combinations by definition, and it is legitimate to choose to apply IFRS 3 to such transactions. In that case, the requirements of IFRS 3 are applied in full.

Alternatively, as business combinations involving entities under common control are excluded from IFRS 3's scope, management could use predecessor accounting. This would be in line with some other GAAPs (for example, US and UK) that permit predecessor accounting to be used for group reconstructions and other common control transactions...

...The acquirer's financial statements can either:

(1) include the acquired entity's full year's results, even though the business combination may have occurred part of the way though the year; or
(2) include the acquired entity's results from the date of the business combination"...

... *Complications may arise where a common control transaction involves a new company set up by the group, in the case of an entity that adopts a policy of accounting for common control transactions under IFRS 3. In the context of IFRS 3, the combination of a new company and a single reporting entity is unlikely to meet the definition of a business combination: the new company will not be the acquirer, and the new company is not a business to allow the existing entity to be the acquirer in a reverse acquisition. As a result, the transaction would be accounted for as a capital reorganisation. Where a policy of predecessor accounting is used the transaction will qualify for the predecessor accounting method if it involves an entity acquiring a business."*

(*Source:* PwC Manual of Accounting, 2010, Extracts 25.403-25.407)

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