Ms Stephanie Fox
IPSASB Technical Director
International Public Sector Standards Board
International Federation of Accountants
277 Wellington Street West, 6th Floor
Toronto
Ontario MV5 3H2
CANADA

Charity Commission Direct
PO Box 1227, Liverpool L69 3UG

t: 01823 345470
f: 01823 345424

Your Ref:
Our Ref:

Date: 29 October 2012

Dear Stephanie,

Exposure Draft: Public Sector Combinations

The Charity Commission for England and Wales is established by law as the regulator and registrar of charities in England and Wales. Our aim is to provide the best possible regulation of these charities in order to increase charities' efficiency and effectiveness and public confidence and trust in them. We welcome the opportunity to respond to the consultation on your Exposure Draft: Public Sector Combinations. Our detailed response to the consultation questions is attached as an annex to this letter.

We recognise that the Exposure Draft is framed with reference to the public sector but it deals with issues that apply equally to the wider not-for-profit sector where the commercial model of acquisition accounting does not always provide an appropriate solution.

UK GAAP recognises that in the case of non-exchange transactions that a gift of net assets is treated as a gain or the assumption of net liabilities is a loss. We welcome the recognition in the consultation draft that amalgamations can occur and we would encourage IPSAS to develop an alternate solution based on gift accounting rather than applying a fair value based model which has its origins in acquisition accounting.

If I can be of further help concerning the nature of combinations as they apply in the UK charity sector please do contact me.

Yours sincerely,

Nigel Davies, Deputy Head of Accountancy Policy

nigel.davies@charitycommission.gsi.gov.uk

Annex: Charity Commission response to IPSASB Public Sector Combinations Specific Matters for Comment

Specific matter for comment 1: In your view is the scope of this consultation paper appropriate?

We agree that the paper is correctly scoped as it considers acquisitions and combinations that are amalgamations and considers the components or entities that are acquired or amalgamated.

Specific matter for comment 2: In your view is the approach used in this consultation paper of distinguishing between acquisitions and amalgamations, with a further distinction for public sector combinations not under common control and under common control appropriate? If you not support this approach, what alternatives should be considered? Please explain your reasoning.

We agree that the distinction between acquisitions where control is acquired and amalgamations where control is not acquired is a helpful one. The distinction drawn between amalgamations where existing entities combine as opposed to joint ventures where a new entity is established by venturers sharing control at the outset is helpful. It is also appropriate given that the venturers will continue to exist whereas the parties to an amalgamation are subsumed into an altered entity or new entity going forward.

A distinction based on control is limited in its application. This is because control is defined as 'the power to govern the financial operating policies of another entity so as to benefit from its activities'. Although this concept applies in the public sector quite well as the state ultimately controls the use of any residual interest, it is not such a good fit with certain not-for-profit situations. For example in the case of charities where the trustee administers the funds held on trust on behalf of the beneficiaries and so no direct private benefit to the trustee results from their trusteeship.

The approach taken by the exposure draft for amalgamations is a variation on 'fresh start' accounting where instead of revaluing the assets and liabilities of the combination at fair value, they are taken without re-measurement at carrying value with the only adjustment being that necessary for a common accounting policy. Although this may be expedient, the absence of a a requirement for comparative information implies a discontinuity in operations which does not arise in the case of an amalgamation.

Specific matter fair comment 3. In your view, are there other public sector characteristics that should be considered determining whether one party has gained control of one or more operations?

We are supportive of amalgamation as an alternative to acquisition accounting. The absence of consideration is a factor that does set apart not-for-profit and public sector accounting from commercial for-profit accounting.

When considering IAS 22, criterion (a) can be applied if the ability to exercise voting power or control is substituted in place of voting ordinary shares. An acquirer could be identified if the board of the acquirer exercised the majority or sole voting rights in the resulting entity.

We agree that to apply the criterion (b) of relative size would be misleading. In the for-profit sector all funds are available for corporate use and represent potential return to the owners and this criterion recognises that in the case of a merger the resulting entity is providing approximately equal value to the participating owners.

Identifying an amalgamation in the public sector context arguably should consider the motive for the combination as a factor. Where a combination is ordered and directed by statute or by a higher authority it would seem inappropriate to portray such a combination as an acquisition, except where it is described as such in the order.

Also the reconstruction of an entity needs consideration where an entity is required to change the functions it undertakes. If the changes involve significant new activities being taken across from the other entities participating in the combination then arguably this too is an amalgamation rather than an acquisition. Alternatively it might be viewed as 'fresh start' accounting with the assets and liabilities taken across being measured at fair value but fresh start accounting implies a discontinuity in service provision which may not always be the case.

Specific matter for comment 4. In your view should the recipient in an acquisition not under common control recognize in its financial statements, the acquired operations assets and liabilities by:
a) Applying fair value the identifiable asset acquired and liabilities assumed the operation at the date of acquisition all acquisitions (approach A);
b) Distinguishing between different types of acquisitions (approach B) so that: i) for acquisitions where no nominal consideration is transferred, the carrying amounts of assets and liabilities in the acquired operation's financial statements are recognised, with amounts adjusted to align the operation's accounting policies to those of the recipient, at the date of acquisition; and
ii) for acquisitions were consideration is transferred, fair value measurement is applied to the identifiable assets acquired and liabilities assumed in the operation date of acquisition; or
c) another approach?

Please explain why you support approach A approach B all another approach.

The difficulty in applying approach 'A' is that in the context of whole of government accounts, the fair value basis effectively allows the recognition of internally generated goodwill, as no resources are passing into or out of the public sector. Unless fair value is restricted on an acquisition to only categories of assets and liabilities that are normally subject to revaluation at the financial year end, such as financial instruments or buildings, then intangible assets and the 'goodwill' or 'negative goodwill' will also be recognised.

Although approach 'B' recognises that some assets are gifts, IPSAS requires that gifts are recognised at fair value. However, if the intention is to recognise gifts made to the public sector then approach 'B' is a better solution as it avoids creating and recognising internally generated goodwill.

In the context of charities and gift accounting, the receipt of a gifted asset is not seen as an acquisition with negative goodwill or a 'bargain purchase' because the motivation is not that of an exchange transaction. Instead UK standards simply recognise the net assets gifted as a gain or if net liabilities are gifted as a loss (expenditure).

Specific matter for comment 5. In your view where the consideration transferred is in excess of the net assets acquired, should the difference arising acquisition not under common control (both approach A and approach B, acquisitions where consideration is transferred) be recognised in the recipient's financial statements, on the date of acquisition, as:
a) goodwill for acquisitions where the acquired operation is cash generating and a loss for all other acquisitions;
b) goodwill for all acquisitions (which would require development of the definition of goodwill that encompasses the notion of service potential); or
c) a loss for all acquisitions?

Please explain why you support (a), (b), or (c)

The principle behind recognising goodwill in commercial accounting is that the acquirer has purchased a cash generating unit where the excess consideration is written back over the economic life of the unit so smoothing the effect on reported profit. This is in anticipation of the acquired cash generating unit contributing to profit over its economic life.

In the case of the public and not-for-profit sectors such commercial considerations may apply in some cases but for the majority of combinations this is unlikely to apply.

The application of a simple test as to whether an operation is cash generating may be insufficient because in many cases the cash generated may be below the economic cost of service provision. For those entities governed by IPSAS, solution 'C' provides the most consistent solution reflecting the underlying role of the state in providing goods and services to its citizens. After all state owned for- profit enterprises are scoped out of IPSAS and apply IFRS.

Specific matter for comment 6. In your view, should the recipient in acquisition under common control recognise in its financial statements on the date of acquisition, the difference arising as:
a) a gain or loss recognised in surplus or deficit (in the statement of financial performance);
b) a contribution from owners or distribution to owners recognised directly in net assets/ equity (in the statement of financial position); or
c) a gain or loss recognised directly in net assets/ equity (in the statement of financial position), except where the transferor is the ultimate controlling entity than the gain or loss meet definition of a contribution from owners or distribution to owners?

Please explain why you support A, B, or C.

The advantage of approach 'A' is that any gain or loss is taken through the performance statement and since it is matched a movement of cash between entities upon consolidation it is netted out as part of the intra group consolidation adjustments.

Specific matters for comment 7. In your view should the accounting treatment for the recipient and transferor of an acquisition under common control be symmetrical?

Logically to avoid inadvertently creating internally generated goodwill within the group, the accounting treatment should be symmetrical.