NZ ACCOUNTING STANDARDS BOARD

EXTERNAL REPORTING BOARD
Te Kāwai Ārahi Pūrongo Mōwaho

12 November 2012

Ms Stephenie Fox
The Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
277 Wellington Street West
Toronto
Ontario M5V 3H2
CANADA

Submitted to: www.ifac.org

Dear Stephenie

Consultation Paper *Public Sector Combinations*

The New Zealand Accounting Standards Board (NZASB) is pleased to submit its comments on Consultation Paper *Public Sector Combinations* (the CP). The CP has been issued for comment in New Zealand and as a result you may also have received comments directly from New Zealand constituents.

The CP clearly explores all the issues considered by the IPSASB regarding public sector combinations and has helped us to develop our views.

The NZASB has considered the CP and, while supportive of the overall project to create an accounting standard addressing combinations in the public sector, is of the opinion that the approach taken in the CP is not the most appropriate.

The main concerns that the NZASB has with the CP are:

1. the approach taken in the CP to determining the type of public sector combination;
2. accounting for an acquisition under common control; and
3. the distinction between an acquisition and an amalgamation of entities NUCC.

These concerns are discussed in the General comments section of the appendix to this letter together with our response to the specific questions posed in the CP. If you have any queries or require clarification of any matters in this submission, please contact Sarah Bate (sarah.bate@xrb.govt.nz), Vanessa Sealy-Fisher (vanessa.sealy-fisher@xrb.govt.nz) or me.

Yours sincerely

Michele Embling

Chairman – New Zealand Accounting Standards Board

Email: Michele.Embling@xrb.govt.nz

APPENDIX

General comments

The NZASB is of the view that:

- an acquisition is uncommon in the public sector;
- a public sector combination under common control (UCC) would rarely, if ever, be an acquisition; and
- consequently, an amalgamation is the usual type of combination in the public sector.

When developing IFRS 3 *Business Combinations*, the IASB finally decided that it was too difficult to clearly distinguish between acquisitions and mergers. Hence it was decided to treat all combinations as acquisitions because in the for-profit sector most combinations are more likely to be acquisitions. However, in the public sector most combinations are directive in nature and do not involve the transfer of consideration, hence these combinations are more akin to mergers or amalgamations.

It may, therefore, be more appropriate in the public sector to treat combinations as an amalgamation unless the transaction is a combination not under common control and is clearly an acquisition.

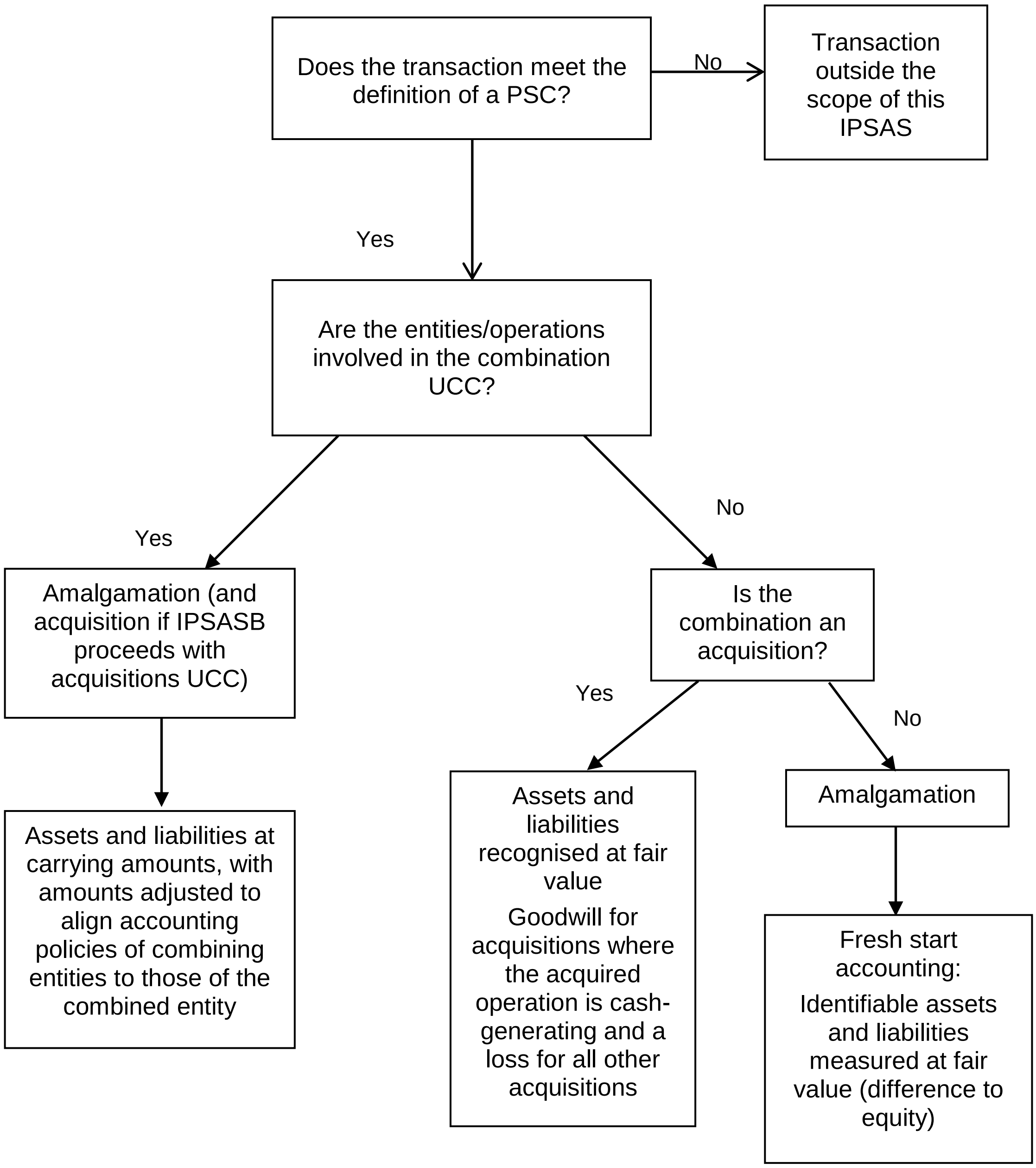
Approach taken in CP

Paragraph 1.10 states that the approach taken in the CP is to distinguish between combinations where the parties to the combination are under common control (UCC) and combinations where the parties to the combination are not controlled by the same ultimate controlling party (NUCC). A further distinction is made between an acquisition and an amalgamation. However, the diagram in Appendix C (page 58 of the CP) distinguishes first between an acquisition and an amalgamation and then considers whether the combination is UCC or NUCC.

The NZASB is of the view that the approach outlined in paragraph 1.10 is the appropriate approach to take, that is, first determine if the entities involved in the combination are UCC or NUCC before addressing the structure of the transaction. Determining whether the combination is UCC or NUCC as the first step results in fewer issues for consideration, such as whether the combination is an acquisition or an amalgamation followed by the appropriate accounting for the combination (as discussed below).

The approach outlined in paragraph 1.10 would be shown diagrammatically as follows (based on the NZASB's view that an acquisition UCC would be uncommon in the public sector as discussed below):

The NZASB's proposed approach (and proposed accounting treatment)



Under Common Control

Appendix A defines a public sector combination under common control as

> *"a public sector combination in which all of the entities or operations involved are <u>ultimately</u> controlled by the same entity <u>both before and after</u> the public sector combination."* [Emphasis added]

The NZASB supports the use of this definition as it is consistent with the explanation of a business combination of entities or businesses under common control in paragraph B1 of IFRS 3 *Business Combinations*.

The NZASB considered whether a combination genuinely represents an acquisition when all parties are under common control (UCC). When an entity combines with another entity UCC, it can be difficult to determine whether one entity genuinely gained control of another entity.

If all the entities involved are ultimately controlled by the same entity both before and after the combination, the combination is more likely to be a reorganisation or restructure of the operations of the group. This type of combination also occurs in the for-profit sector, sometimes for the same reasons as in the public sector. For example, this type of combination may be undertaken in both the public and the private sector for the purposes of reducing costs or for increased efficiency of operations.

Having determined that a combination UCC is highly unlikely to be an acquisition, and given the difficulty of drawing a robust distinction between amalgamations and acquisitions, particularly when the combining entities are UCC, the NZASB is of the view that all combinations of entities UCC should be accounted for as an amalgamation/reorganisation.

Distinction between an amalgamation and an acquisition of entities NUCC

The NZASB does not agree that the sole definitive criterion for distinguishing an amalgamation from an acquisition should be that none of the combining operations gains control of the other operations. Although gaining control is a necessary condition for an acquisition to occur, it is not of itself sufficient. All facts and circumstances need to be considered together with the substance of the transaction. For example, the combination is more likely to be an amalgamation where it is imposed on one level of government by a higher level of government for the purposes of reducing costs or for increased efficiency of operations.

The CP does not provide sufficient guidance for distinguishing between an acquisition and an amalgamation. The other characteristics to be considered when distinguishing between an acquisition and an amalgamation, briefly discussed in paragraphs 3.11 to 3.15, should be considered in more detail. For example, paragraph 3.12 talks about the PSC being imposed on one level of government by another level of government and expresses the view that "…then it may indicate that it could be an amalgamation." This characteristic should be further explored and a definitive view formed as a PSC imposed in this manner could be an amalgamation even if one entity appears to gain control of another entity.

Another matter to consider in distinguishing between an acquisition and an amalgamation is whether all the combining entities are public sector entities, or whether the combination involves a private sector entity being combined with a public sector entity, such that the private sector entity becomes part of the public sector. An example of the latter type of combination is where a government takes over a failing private sector entity because allowing the entity to go into liquidation is not considered to be in the public interest. Such combinations result in the expansion of the public sector and are more likely to be an acquisition rather than an amalgamation.

Any guidance developed to help distinguish an acquisition from an amalgamation needs to ensure that the type of PSC is not determined by the legal form or process of combining the entities or operations involved in the combination. Governments undertake their operations and activities by means of legal structures, for example, independent crown entities, and by means of departments, which are not legal structures.

For example, assume that a PSC is imposed by the government. The combination could be achieved either by entity B becoming a legal subsidiary of entity A or by the net assets of entity B being transferred to entity A and entity B being wound up. In both cases, the operations of both entities are combined but that combination was achieved in different ways. The legal form of the transaction should not be the determining factor.

Overall, the distinction between acquisitions and amalgamations needs further consideration, in particular to ensure it is based on economic substance rather than legal form. The diagrams in Chapter 2 (as set out in diagrams 1, 2 and 3) imply that the type of combination is dependent on legal form. If the combining operations maintain their separate legal structure, with one entity becoming the legal subsidiary of another entity (as in diagrams 1 and 2), the combination is viewed as an acquisition. But if the two operations are combined to create a single legal entity (as in diagram 3 and discussed in paragraphs 2.39 and 2.40), the combination is viewed as an amalgamation. Given that the definition of a public sector combination is “the bringing together of separate operations into one entity, either as an acquisition or an amalgamation”, it’s not clear why legal form is so important in distinguishing between an acquisition and an amalgamation. Furthermore, even when one entity becomes the legal subsidiary of another entity in an acquisition, it does not necessarily follow that the legal parent is the acquirer.

The NZASB recommends that in developing a final standard, the IPSASB clarifies that legal form is not the determinant of the type of combination.

Response to Preliminary Views and Specific Matters for Comment

The responses to the preliminary views and the specific matters for comment are in the order in which they arise in the CP.

Preliminary View 1

A **public sector combination** is the bringing together of separate operations into one entity, either as an acquisition or an amalgamation.

The key definitions are as follows:

(a) An **acquisition** is a transaction or other event that results in a recipient gaining control of one or more operations.

(b) An **amalgamation** is a transaction or other event where (a) two or more operations combine, (b) none of the combining operations gain control of the other operations, and (c) the transaction or other event is not the formation of a joint venture.

(c) A **combining operation** is an operation that combines with one or more other operations to form the resulting entity.

(d) An **operation** is an integrated set of activities and related assets and/or liabilities that is capable of being conducted and managed for the purpose of achieving an entity's objectives, by providing goods and/or services.

(e) A **recipient** is the entity that gains control of one or more operations in an acquisition.

(f) A **resulting entity** is the entity that is the result of two or more operations combining where none of the combining operations gains control of the other operations.

(g) A **transferor** is the entity that loses control of one or more of its operations to another entity (the recipient) in an acquisition.

Apart from the definitions discussed below, the NZASB supports the proposed definitions in the CP. In particular, the NZASB supports the efforts of the IPSASB to align the definitions of 'acquisition', 'operation', 'recipient' and 'transferor' with the relevant definitions in IFRS 3 *Business Combinations*. The NZASB also supports the use of 'recipient' and 'transferor' being consistent with the way in which those terms are used in IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*.

Definition of Public Sector Combination

The definition of a Public Sector Combination as per the CP is *"the bringing together of separate operations into one entity, either as an acquisition or an amalgamation".*

The definition requires the forthcoming IPSAS to be applied to all types of PSCs. The words "either as an acquisition or an amalgamation" are not needed in the definition of a PSC as "the bringing together of separate operations into one entity" would encompass all types of combinations.

Definition of Amalgamation

The CP defines an amalgamation as *a transaction or other event where (a) two or more operations combine, (b) none of the combining operations gain control of the other operations, and (c) the transaction or other event is not the formation of a joint venture.*

The NZASB is of the view that this definition is too narrow and therefore does not encompass the range of possible combinations that would fall into the realm of an amalgamation (i.e., combinations that are not an acquisition). The Board considers that more emphasis should be put on the outcome of a combination, rather than on the process, which appears to be the main focus of the CP. To this end a future ED should be drafted in two separate sections, one addressing pure acquisitions and the other addressing amalgamations or reorganisations. The NZASB considers it is important that the type of combination is identified clearly before any accounting treatment is considered.

Preliminary View 2
A **public sector combination under common control** is a public sector combination in which all of the entities or operations involved are *ultimately controlled* by the same entity both before and after the public sector combination. [Emphasis added]

The NZASB agrees with Preliminary View 2 as it is consistent with the explanation of a business combination of entities under common control in paragraph B1 of IFRS 3.

Specific Matter for Comment 1:
In your view, is the scope of this CP appropriate?

The NZASB is of the view that the scope of the CP is appropriate because the scope covers the different types of combinations that occur in the public sector. However, the NZASB considers that a future ED should be structured differently – refer to the discussion and diagram in the main concerns section of this appendix.

Specific Matter for Comment 2:
In your view, is the approach used in this CP of distinguishing between acquisitions and amalgamations, with a further distinction for PSCs NUCC and UCC, appropriate? If you do not support this approach, what alternatives should be considered? Please explain your reasoning.

The NZASB is of the view that the approach outlined in paragraph 1.10 is the appropriate approach. This would require determining first whether the parties to the combination are UCC or NUCC before determining whether the combination is an acquisition or an amalgamation (see our general comments). As explained under our general comments, the NZASB is of the view that an acquisition involving entities UCC is uncommon in the public sector and that the first question to be considered if a combination is within the scope of the forthcoming IPSAS is whether the entities to the combination are UCC or not.

Preliminary View 3

The sole definitive criterion for distinguishing an amalgamation from an acquisition is that, in an amalgamation, none of the combining operations gains control of the other operations.

Specific Matter for Comment 3:

In your view, are there other public sector characteristics that should be considered in determining whether one party has gained control of one or more operations?

The NZASB does not agree that the sole definitive criterion for distinguishing an amalgamation from an acquisition should be that in an amalgamation, none of the combining operations gains control of the other operations.

Please refer to our earlier comments on this point.

Preliminary View 4

An acquisition NUCC should be recognised in the financial statements of the recipient on the date the recipient gains control of the acquired operation.

The NZASB agrees that an acquisition NUCC should be recognised in the financial statements of the recipient on the date the recipient gains control of the acquired operation. This is consistent with IFRS 3 and is appropriate for an acquisition.

Specific Matter for Comment 4:

In your view, should the recipient in an acquisition NUCC recognise in its financial statements, the acquired operation's assets and liabilities by:

(a) Applying fair value measurement to the identifiable assets acquired and liabilities assumed in the operation at the date of acquisition for all acquisitions (Approach A);

(b) Distinguishing between different types of acquisitions (Approach B) so that:

  (i) For acquisitions where no or nominal consideration is transferred, the carrying amounts of the assets and liabilities in the acquired operation's financial statements are recognized, with amounts adjusted to align the operation's accounting policies to those of the recipient, at the date of acquisition; and

  (ii) For acquisitions where consideration is transferred, fair value measurement is applied to the identifiable assets acquired and liabilities assumed in the operation at the date of acquisition; or

(c) Another approach?

Please explain why you support Approach A, Approach B or another approach.

The NZASB supports Approach (a) because this is consistent with IFRS 3 and is the most appropriate method to account for an acquisition. This conclusion assumes that the combination is, in fact, an acquisition. As discussed in our earlier comments, this matter requires further consideration. However, if the combination is an acquisition, the NZASB is of the view that Approach (a) above should be applied to all acquisitions, irrespective of whether the entities involved in the combination are in the public sector or the for-profit sector.

Furthermore, we note that if no or nominal consideration is transferred, that does not mean that the combination should be accounted for in a different way. If the entity's net assets are close to zero (i.e., total assets are approximately equal to total liabilities) or the entity has net liabilities (such as when a public sector entity acquires a failing private sector entity), it is likely that the lack of consideration simply reflects the acquiree's financial position.

Preliminary View 5

The recipient in an acquisition NUCC recognises in its financial statements on the date of acquisition, the difference arising as:

(a) A gain where the recipient acquires net assets in excess of consideration transferred (if any); and

(b) A loss where the recipient assumes net liabilities.

Specific Matter for Comment 5:

In your view, where the consideration transferred is in excess of the net assets acquired, should the difference arising in an acquisition NUCC (for both Approach A and Approach B, acquisitions where consideration is transferred) be recognized 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 a 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).

Conceptually, the NZASB supports Approach (b) – the difference arising in an acquisition NUCC should be recognised as goodwill. The recognition of goodwill is consistent with the acquisition method in IFRS 3.

However, from a practical perspective, the NZASB supports Approach (a) because of the difficulty of measuring the impairment of goodwill in respect of non-cash-generating activities.

Preliminary View 6

An acquisition UCC should be recognized in the financial statements of the recipient on the date the recipient gains control of the acquired operation.

In the rare event that a PSC is an acquisition UCC, the NZASB agrees with this Preliminary View.

Preliminary View 7

The recipient in an acquisition UCC recognizes in its financial statements of the date of acquisition the carrying amounts of the assets and liabilities in the acquired operation's financial statements with amounts adjusted to align the operation's accounting policies to those of the recipient.

As discussed earlier, the NZASB is of the view that an acquisition amongst entities UCC is uncommon in the public sector and recommends that all combinations of entities UCC be treated as amalgamations or some other form of reorganisation. However, if the IPSASB decides to proceed with treating some combinations of entities UCC as acquisitions, then the NZASB agrees with the proposed approach.

Specific Matter for Comment 6:

In your view, should the recipient in an acquisition UCC recognise in its financial statements, on the date of acquisition, the difference arising as:

(a) A gain or loss recognized in surplus or deficit (in the statement of financial performance);

(b) A contribution from owners or distribution to owners recognized directly in net assets/equity (in the statement of financial position); or

(c) A gain or loss recognized directly in net assets/equity (in the statement of financial position), except where the transferor is the ultimate controlling entity and then the gain or loss meets the definition of a contribution from owners or distribution to owners?

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

If the IPSASB decides to proceed with treating some combinations of entities UCC as acquisitions, the NZASB supports Approach (b). In a transaction between entities UCC this difference is likely to reflect the common control nature of the transactions rather than an arm's length economic gain or loss of the acquirer. Therefore, treating this difference as a contribution from/distribution to owners more accurately reflects the nature of the transaction.

Specific Matter for Comment 7

In your view, should the accounting treatment for the recipient and transferor of an acquisition UCC be symmetrical.

If the IPSASB decides to proceed with treating some combinations of entities UCC as acquisitions, the NZASB agrees that the accounting should be symmetrical with the accounting treatment of acquisitions of entities UCC. In a transaction between entities UCC any "gain" or "loss" on derecognition is likely to reflect the common control nature of the transaction, rather than an arm's length economic gain or loss of the transferor. Therefore, treating this difference as a contribution from/distribution to owners more accurately reflects the nature of the transaction.

Preliminary View 8

A resulting entity in an amalgamation should apply the modified pooling of interests method of accounting.

The NZASB supports the modified pooling of interests method of accounting for amalgamations involving entities UCC on the condition that the financial statements of the combining entities prior to the amalgamation are publicly available, given that comparative information is not presented under the modified pooling of interests method. The availability of the financial statements of the combining entities is necessary because these financial statements provide information for the users of the financial statements of the resulting entity that is not otherwise available.

However, the NZASB supports fresh start accounting for amalgamations of entities that are NUCC. This method of accounting is applied in New Zealand in these situations.

Guidance should be provided on the modified pooling of interest method so that there is consistency in the accounting treatment for a resulting entity. In particular, guidance is needed on:

(a) the elimination of intercompany transactions and balances;

(b) which carrying values should be used – the carrying values in the combining entities' individual financial statements or the carrying values of those entities assets and liabilities as reported in either the immediate parent's or the ultimate parent's consolidated financial statements; and

(c) the treatment of reserves in the combining entities' individual financial statements that, had the combination not occurred, would have been recycled to the statement of financial performance in the future (e.g., cash flow hedge reserve) or otherwise would have been used to record particular types of subsequent gains/losses (e.g., asset revaluation reserve).

Preliminary View 9

Where combining operations continue to prepare and present GPFSs using accrual-based IPSASs in the period between the announcement of the amalgamation and the date of the amalgamation, these GPFSs are prepared on a going concern basis where the resulting entity will fulfil the responsibilities of the combining operations.

The NZASB is of the view that Preliminary View 9 is appropriate.