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Private/Confidential
Ms Stephenie Fox
Technical Director of the
International Public Sector Accounting
Standards Board (IPSASB)
International Federation of Accountants
277 Wellington Street West
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CANADA

Consultation Paper: Public Sector Combinations

Dear Ms Fox,

The global organization of Ernst & Young is pleased to comment on the above Exposure Draft (ED).

General comments:

We support and commend the IPSASB's effort in the development of accounting guidance for combinations in the public sector context. However, as a general principle, the IPSASB should maintain its view that deviations from generally accepted private sector accounting standards are only justified, where the nature of the transactions are different in a public sector context.

Amalgamations

A significant deviation from generally accepted private sector accounting standards is the introduction of 'amalgamations'. From a conceptual perspective, the proposed distinction between an acquisition and an amalgamation seems reasonable. However, there is very little discussion in the Consultation Paper about what guidance will be provided to help entities to make this distinction. Given the different treatment of acquisitions and amalgamations, this distinction needs to be made robustly. When developing IFRS 3, the IASB concluded that it was too difficult to distinguish between acquisitions and mergers (IFRS 3 BC 35). In the context of the private sector, most combinations are acquisitions, and therefore they decided to treat all combinations (other than those excluded from the scope of the standard) as acquisitions. That experience indicates that drawing this distinction is difficult. Given that amalgamations are much more common in the public sector, it is agreed that a distinction needs to be drawn, particularly in the case of entities not under common control. However, in our view more work is required to make this distinction based on substance rather than legal form.

Acquisitions with nil or nominal consideration
Another significant derivation from general accepted private sector accounting standards is the proposed introduction of a specific accounting treatment for acquisitions not under common control (NUCC) when no or nominal consideration is transferred. We do not support Approach B as indicated in para. 5.15. In our view, IFRS 3 has already established principles and requirements for accounting of bargain purchases, and it should be applied to combinations transacted by way of a non-exchange transaction. Any fair value difference between the assets acquired and liabilities assumed, and consideration transferred (if any) to the acquiree, should be recognized in surplus or deficit on acquisition date. Moreover, nil/nominal consideration transferred in an acquisition may be indicative of the net assets acquired, and not always a ‘gift or contribution’, and may be an exchange transaction.

Fresh-start accounting for combinations under common control
Finally, the fresh-start accounting has to be mentioned as a general issue. We support the IPSASB's view of using modified Pooling of Interests-Method (POI) for amalgamations for reasons in para 7.12. We do not think that fresh-start accounting, whereby all businesses are re-stated to fair values, are appropriate for combinations under common control. A concern with fresh start accounting is that opportunistic entities may abuse it to inflate assets, and governments may likewise abuse it for structuring opportunities. Furthermore, there are serious doubts, whether the method is appropriate for ‘true mergers’ not under common control (i.e., a new reporting entity is created). Notwithstanding that fair value information is useful for users of the financial statements, the cost to implement fresh-start method is of concern. Furthermore, the question of validity of fair values is not supported by an acquisition (i.e. not market-tested).

Specific matters for comments and other comments
Our views on the specific matters for comments on which the IPSASB is seeking answers are set out in Appendix A of this letter. In addition, we have included other unsolicited comments following Appendix A.

Please contact Mr. Thomas Müller-Marqués Berger, Global Leader for International Public Sector Accounting, at +49 711 9881 15844 or thomas.mueller-marques.berger@de.ey.com should you have any questions on the letter.

Yours sincerely,

Ernst & Young GmbH
Wirtschaftsprüfungsgesellschaft

Prof. Dr. Peter Oser — Thomas Müller-Marqués Berger

Appendix A

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

We suggest more guidance should be provided on differentiating between asset acquisitions, acquisitions (as defined in para 2.8) and amalgamations. Potential confusion could arise with the definition of an 'operation', and what constitutes an integrated set of activities and assets.[1]

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 of PSCs NUCC and UCC, appropriate? If you do not support his approach, what alternatives should be considered? Please explain your reasoning.

Distinction between acquisitions and amalgamations

We agree with the view expressed in chapter 3 that the factors considered in IAS 22 are not relevant, as those factors were intended to result in combinations being treated as amalgamations only in exceptional circumstances involving "true mergers of equals". So the IAS 22 context is different to the public sector context being considered in the CP.

The examples given in Chapter 2 (as set out in diagrams 1, 2 and 3) of acquisitions and amalgamations appear to be based on legal form. In contrast, if the combining operations maintain their separate legal structure (as in diagrams 1 and 2) it appears that 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), it 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.

For example, consider the following two different legal structures of a combination:

- Ownership of the equity instruments of Entity B are transferred to Entity A, so Entity B becomes the legal subsidiary of Entity A.
- The net assets of Entity B are transferred to Entity A, and Entity B is wound up.

[1] IFRS 3.BC18 – The definition of a business under IFRS 3 is broad because an integrated set of activities and assets only needs to be capable of being run as a business; is not required to have any outputs; and does not need all of the inputs and processes that the seller used, in order to qualify as a business. Further, a submission seeking clarification on the definition of a business was made to the IFRS Interpretations Committee (IFRIC), and IFRIC staff is in the midst of performing further outreach and analysis on this issue [IFRIC Agenda Paper 17, September 2012].

Paragraph 2.40 asserts that the form of an amalgamation does not matter, and yet the CP distinguishes between acquisitions and amalgamations based on legal form. If Entity B keeps its separate legal identity and becomes the legal subsidiary of Entity A, it is viewed as an acquisition, whereas if the net assets of Entity B are transferred to Entity A, it's viewed as an amalgamation. Either way, there is now a combined economic entity comprising the operations of what used to be the separate operations of Entity A and Entity B. Given the outcome is the same the Board should express a clear view if the legal structure is determinative of whether this combination is an acquisition or amalgamation.

To put it another way, we would appreciate a clarification if Entity A is considered to have gained control of an operation in the first situation (when equity instruments are transferred), but is not considered to have gained control of an operation in the second situation (when net assets are transferred).

At least, it would be useful to include examples of the types of combinations that would be regarded as being acquisitions rather than amalgamations. For example, I might be argued that all combinations involving a public sector entity and a private sector entity are acquisitions, because such transactions expand the public sector as a whole. As during the Financial Crisis governments took over banks and other private sector entities, all of these combinations involve the public sector entity taking control over a private sector entity seems to be acquisitions, with fair value accounting applied. Another consideration is the following: If amalgamations are public sector specific transactions, then it seems likely that both entities involved in an amalgamation are originally public sector entities.

Further distinction between PSCs NUCC and UCC

A convincing reason for the distinction is only given if it is assumed that acquisitions under common control are not commonly conducted with 'substance' and at fair values. Under this premise the proposed distinction is meaningful.

In the for-profit sector when dealing with combinations amongst entities under common control, which are scoped out of IFRS 3, we take the view that in order to apply acquisition accounting (rather than pooling or modified pooling), the transaction must have 'substance' – and hence there are a range of factors to be considered. In the public sector, we would expect that many combinations amongst entities under common control (UCC) are amalgamations rather than acquisitions. Therefore, if there are difficulties in drawing a robust distinction between acquisitions and amalgamations, perhaps one solution for combinations involving entities UCC is to treat them all as amalgamations. In this context we note that the CP concludes the carrying values (not fair values) should be used for all combinations involving entities UCC, so this proposal may not substantially change the proposed accounting.[2]

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[2] However, this suggestion might have an impact on comparative information. Under the proposals in the CP, there is <u>no</u> comparative information presented for the combined entity if

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?

In our view, no other characteristics need to be considered.

Specific Matter for Comment 4:
In your view, should the recipient in an acquisition NUCC recognize 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.

Approach A is supported for the following two reasons:

First is that the IPSASB has acknowledged during the course of the project that it may be difficult to establish a clear demarcation between all exchange and non-exchange entity combinations [para. 1.7]. A distinction between acquisitions based on whether or not consideration is transferred would result again in this problem. Moreover, a different accounting treatment between those conducted at nil consideration and where some consideration is transferred (but higher than nominal) may open the door for structuring opportunities.

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the combination is an amalgamation (see Table 2, page 30, for the modified pooling of interests method, which is proposed for amalgamations). As a consequence, if all combinations of entities UCC are treated as amalgamations, it would mean the combined entity has no comparative information or other history for the pre-combination period.

Second is that nil/nominal considerations could reflect the fair value of the net assets/ liabilities acquired. Therefore, it is not appropriate to distinguish between those where no (or nominal) consideration is paid and those where consideration is paid. If the acquired entity has net assets close to zero (i.e. FV of assets = FV of liabilities) or has net liabilities, then it is likely to be economically rational that no consideration was paid. Moreover, when a fair value exercise has not been conducted, assets might be overstated and liabilities might be understated (contingent liabilities unrecognized), even with the accounting policies aligned.[3]

Thus, if we are comfortable that a public sector combination is an acquisition (i.e., not an amalgamation), then acquisition accounting is appropriate (i.e., fair value measurement of assets and liabilities acquired). We suspected that where people argue that book values should be used in transactions in which no consideration was paid, it is because they really believe that this particular situation arises in transactions that are really amalgamations, not acquisitions. Hence, this issue should be dealt with as part of distinguishing between acquisitions and amalgamations for combinations involving entities NUCC, rather than as part of accounting for acquisitions NUCC.

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 acquisitions, 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).

From a conceptual perspective, we support approach (b) and the reasons set out in paragraph 5.40. If we assume that the recipient is acting economically rational, it must have had a good reason for undertaking such a transaction – treating it as an immediate loss implies that the entity wasted money by paying more than the fair value of the identifiable net assets. However, we acknowledge that it might be politically rational in some rare cases to spend more than the fair value of the identifiable net assets.

3 If IPSASB believes POI be used, perhaps an impairment test for assets acquired at acquisition date should be required.

In the private sector, goodwill represents the synergies from the acquired assets/liabilities to generate a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. The arguments that support the recognition of goodwill in the acquisition of a cash-generating-unit (the value of the whole can be greater than the sum of the parts, e.g. because of synergies) can also be applied to a service-generating-unit (i.e., greater service potential to constituents). However, where the acquired operation is non-cash-generating operation it is reasonable to assume that it would only be in rare circumstances that a public sector entity would pay a consideration in excess of the net assets acquired.

Nevertheless, we have concerns about the practical application of the proposal regarding the requirement of goodwill impairment test (that should be performed at least annually). In our view, this is a critical aspect and robust guidance on this would be needed. Therefore further work needs to be done to explore what goodwill means, especially for the public sector. Furthermore, the outcome from the framework discussion should be taken into consideration.

If the IPSASB find it practically difficult to develop a robust impairment test for goodwill arising in the acquisition of a service-generating-unit, then we would support approach (a) as the alternative to approach (b) for practical reasons.

Specific matter for comment 6:
In your view, should the recipient in an acquisition UCC recognize 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).

We support approach (b), as we think it reflects the substance of the transaction when dealing with combinations under common control. We would apply the same approach to acquisitions of assets from an entity under common control. The approach commonly applied in practice when an entity acquires an asset for nil consideration from the parent or another group entity is the one described as approach (b).

Specific matter for comment 7:
In your view, should the accounting treatment for the recipient and transferor of an acquisition UCC be symmetrical?

We support the view that the treatment should to be symmetrical.