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AASB 7-8 September 2011
Agenda paper 17.2

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Mr Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
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Our ref **MT/288**
Contact **Mary Tokar**

11 August 2011

Dear Mr Upton

Tentative agenda decisions: IFRS 3 Business Combinations – business combinations involving newly formed entities

We appreciate the opportunity to comment on the IFRS Interpretations Committee's publication in the July 2011 IFRIC Update of the two tentative decisions relating to Newco formations prior to an initial public offering (IPO):

- business combinations under common control; and
- factors affecting identification of the acquirer.

While in both cases we agree with the Committee's decision not to take the issue onto its active agenda at this point, we do not believe that the agenda decisions should respond to the issues at such a level of detail. Further, we are concerned that some of the statements made in the IFRIC Update may be interpreted inappropriately by readers as a directive to follow the specific accounting discussed, especially when coupled with the staff analysis in the public observer notes.

The accounting for business combinations under common control is a complex area because of the wide array of such transactions, either stand-alone or linked with other transactions, that occur in practice. Since in practice the issue of Newco formations is inextricably linked with business combinations under common control, subject to the outcome of the Agenda Consultation 2011, we would expect that the Board's project on common control business combinations would address this area as well. Only if the Board decides not to proceed with the common control project would we expect the Committee to consider adding Newco formations to its agenda and issuing a formal interpretation, which would need to include appropriate transitional guidance.

Without a formal project (at the Board or Committee level), any attempts to consider isolated aspects of the accounting are at risk of being applied more prescriptively and more broadly than would be appropriate.



- **Business combinations under common control.** If the wording of the tentative agenda decision is retained, then we believe that it could be read as requiring a Newco to be identified as the acquirer in a business combination under common control. For entities that choose to apply IFRS 3 by analogy in accounting for such business combinations, this means that acquisition accounting would be applied to the acquired businesses. The practical implication is that Newcos could be used as structuring mechanisms to achieve the re-basing of the carrying amounts of assets and liabilities when the same transaction effected without the use of a Newco would not result in such re-basing.

Further, in our view, in transactions in which a Newco controlled by a Group acquires another Group entity, generally the definition of a business combination is not met and therefore the transaction is not considered a business combination under common control. Our basis for this view is set out in Appendix 1 to this letter.

- **Factors affecting identification of the acquirer.** Regarding the wording of the tentative agenda decision, we believe that the IFRIC Update as written could increase the prevalence of conditional Newco formations in IPOs to achieve a desired accounting outcome without a change in economic substance. In many jurisdictions it will not be difficult to insert a conditional Newco into the listing process, if the desired outcome is that Newco can apply acquisition accounting.

Conversely, the decision may result in an undesirable outcome for entities that operate in jurisdictions in which the structure addressed by the Committee is prevalent, who do not believe that they should apply acquisition accounting based on the substance of the transaction. We are aware that at least in Australia this structure is not uncommon, and the decision may be interpreted as providing a clear mandate as to how such transactions should be accounted for.

Accordingly, we believe that the final agenda decisions should refrain from offering any analysis of the accounting.

Appendices 1 and 2 to this letter contain our detailed technical responses to the tentative agenda decisions. We have published guidance on Newco formations and would be happy to discuss our comments in more detail.

Please contact Mary Tokar or Julie Santoro at +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix 1: Business combinations under common control

We agree with the Committee that the fact pattern considered is widespread in practice.

Is there a business combination under common control?

In order for there to be a business combination under common control, first and foremost there must be a business combination. In the fact pattern presented we believe that there is not a business combination.

One of the difficult areas in common control transactions is identifying the acquirer; this is because of the involvement of a controlling shareholder. However, in the fact pattern presented we believe that Business A would be the acquirer based on B18 of IFRS 3: if a new entity is formed to effect a business combination, then one of the combining entities that existed before the business combination is identified as the acquirer. In this example that would be Business A.

Accordingly, since Business A is the acquirer, Newco would be the acquiree in an IFRS 3 analysis. However, since the acquiree is not a business, there is no business combination.

As a general comment, when a Newco controlled by the Parent acquires another subsidiary for cash, we believe that B15-B18 rather than B14 should be considered in identifying the acquirer. This is because in substance the transaction has still been effected through the issue of equity instruments, as the transaction was initiated through the issue of equity instruments when the Newco was created.

Another possibility, which might be inferred but is not stated in the IFRIC Update, is that Business A is a group of entities. In that case there might be a temptation by some to identify one entity within Business A as the acquirer, and the other entities within Business A as the acquirees. However, we believe that such an analysis generally would not be appropriate in accordance with IFRS 3. The following example best explains our reasoning:

- Business A acquires Business B (two independent groups) in a business combination.
- In identifying an acquirer, it would be either Business A or Business B; we would not conclude, for example, that part of Business A was the acquirer, with acquisition accounting then applied to both Business B and the remaining parts of Business A.

Similarly, we would not conclude that only part of Business A is the acquirer in the fact pattern described in the IFRIC Update.

Agenda decision wording

As noted in our covering letter, if the wording of the tentative agenda decision is retained, then we believe that it could be read as requiring a Newco to be identified as the acquirer in a business combination under common control. For entities that choose to apply IFRS 3 by analogy in accounting for such business combinations, this means that acquisition accounting would be applied to the acquired businesses. The practical implication is that Newcos could be used as structuring mechanisms to achieve the re-basing of the carrying amounts of assets and liabilities when the same transaction effected without the use of a Newco would not result in such re-basing.

Appendix 2: Factors affecting identification of the acquirer

We agree with the Committee that the fact pattern considered (Newco formation conditional on an IPO) generally is not widespread in practice; however, we are aware that at least in Australia such structures are not uncommon.

Who is the acquirer?

The accounting for Newco formations is complex. At some level we can understand a conclusion that Newco is the acquirer in a business combination when the acquisition is conditional on the IPO, which represents a change in control. However, typically there are many issues that need to be considered in respect of Newco formations. The following are some of the issues that we believe need to be addressed in the specific fact pattern considered by the Committee.

- The IFRIC Update discussion appears to conclude that there is linkage between the set up of the conditional Newco and the issue/sale of shares through the IPO to external parties. However, it also could be argued that there is no such linkage: the creation of the conditional Newco is the preferred structure of the existing owners to allow them to IPO at some point in the future, to which the future shareholders after the IPO have no input; on that basis it could be argued that the two transactions are unrelated.
- Is the conditionality in the fact pattern an indicator of the substance of the transaction or a conclusive fact that drives the accounting?
- If the transfer of the subsidiaries to Newco results in a requirement to apply acquisition accounting to those subsidiaries, then why would the same accounting (a step-up in values) not be available when no Newco is involved, e.g. if the business to be listed is already in a holding group structure? In other words, in what instances should the structure of a transaction change the accounting outcome? This is particularly relevant since a Newco has no substance on its own (i.e. it is somebody's vehicle in any transaction) and could be transitory (e.g. if a downstream merger follows the IPO, such that Newco then ceases to exist).

We acknowledge that these are difficult questions to answer. As emphasised in our covering letter, we believe that this issue is too complex to be dealt with as an agenda decision of the IFRS Interpretations Committee.

Agenda decision wording

As noted in our covering letter, we believe that the IFRIC Update as written could increase the prevalence of conditional Newco formations in IPOs to achieve a desired accounting outcome without a change in economic substance. In many jurisdictions it will not be difficult to insert a conditional Newco into the listing process, if the desired outcome is that Newco can apply acquisition accounting.

Conversely, the decision may result in an undesirable outcome for entities that operate in jurisdictions in which the structure addressed by the Committee is prevalent, who do not believe that they should apply acquisition accounting based on the substance of the transaction. We are aware that at least in Australia this structure is not uncommon, and the decision may be interpreted as providing a clear mandate as to how such transactions should be accounted for.