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Date: Friday, October 28, 2005 11:01 AM
To: Michelle Crisp
Subject: Response 10 Comments from the Building Societies Association

Letter of Comment No: 264
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Dear Michelle

Thank you for the opportunity to comment on FRED 36, which we have reviewed primarily for specific building society implications. To help us in our response, we asked one society that has been party to a significant merger in recent years for comments, which we reproduce below:

Treatment of fair value of acquiree

The key issue is in respect of paragraph 53 [of IFRS 3], which states:

"In a business combination involving only mutual entities in which the only consideration exchanged is the member interests of the acquiree for the member interests of the acquirer (or the member interests of the newly combined entity), the amount equal to the fair value of the acquiree shall be recognised as a direct addition to capital or equity, not retained earnings."

Putting aside the fair value issues for now, if we assume that the fair value equates to the book value of the acquiree, the standard implies that the reserves (being the net assets acquired) of the acquiree are not added to the reserves of the acquirer. This could cause problems in several areas for building society mergers:

1. It is not clear how recognising the amount as a direct addition to capital is to be achieved. If the acquired reserves can't be added to retained earnings/general reserves, the only option would be to create a new reserve.
2. This new reserve would sit on the balance sheet forever.
3. It is unclear what the capital implications of this new reserve would be, in respect of solvency, tier 1 treatment, etc.

For our merger with the Society X, we simply added their reserves to ours. If my interpretation of IFRS 3 is correct, we could not have done this and would have had to set up a new reserve, the treatment of which is unclear.

Fair value of acquiree

The standard implies that the fair value of the entity should be assessed as a whole, or failing that, a line by line assessment should be made. This will lead to variations in techniques and valuations. For our merger with Society X, we assumed that the book value broadly equated to fair value (with the exception of a fair value adjustment for a pension liability). IFRS 3 requires a much more stringent approach in assessing fair value.

There are also practical implications to consider. For example, if the mortgage portfolio of the acquiree was fair valued upwards, this FV adjustment would presumably amortise as the book rolls off. Should this amortisation pass through profit (thus penalising the merged organisation), or be charged against the new acquisition reserve?

I hope this is of help to you.

Have a great weekend.

Best wishes

Andrea

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THE BUILDING SOCIETIES ASSOCIATION

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