STAFF PAPER

June 2019

IASB® meeting

Project	Business Combinations under Common Control
Paper topic	Transactions that do not affect non-controlling shareholders

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Purpose of this paper

1. In June 2018, the International Accounting Standard Board (Board) directed the staff to develop an approach based on the acquisition method set out in IFRS 3 *Business Combinations* for transactions that affect non-controlling shareholders of the receiving entity. In December 2018, the Board discussed whether a current value approach based on the acquisition method should be applied to all or only some such transactions.

2. In March and April 2019, the Board discussed transactions that affect lenders and other creditors of the receiving entity and transactions between wholly owned entities undertaken in preparation for a sale, for example in an initial public offering (IPO). The Board tentatively decided that it need not pursue a single measurement approach for all transactions within the scope of the project. Specifically, the Board could pursue:

   (a) a current value approach for all or some transactions that affect non-controlling shareholders of the receiving entity; and

   (b) a different approach, such as a form of a predecessor approach, for transactions that affect lenders and other creditors of the receiving entity but do not affect non-controlling shareholders.

3. The Board also directed the staff to continue developing measurement approaches for transactions within the scope of the project by considering, among other factors, whether and how such transactions can be different from business combinations that are not under common control.

4. This paper considers:

   (a) whether transactions that do not affect non-controlling shareholders of the receiving entity are different both from transactions that affect such shareholders and from business combinations that are not under common control; and

   (b) if so, whether the Board could therefore pursue an approach that is not based on the acquisition method for transactions that do not affect non-controlling shareholders of the receiving entity, such as a form of a predecessor approach.

5. This paper is for information only. The staff plan to ask the Board for decisions on a package of topics at a future meeting.

Structure of this paper

6. This paper discusses:

   (a) summary of the work performed by the staff (paragraphs 7–9);

   (b) overview of findings in the staff's research (paragraphs 10–18);

   (c) whether all transactions in the scope of the project are acquisitions (paragraphs 19–32); and

   (d) summary of the staff's observations (paragraphs 33–37).

Summary of the work performed by the staff

7. In developing this paper, the staff reviewed:

(a) national requirements and guidance on business combinations under common control, group restructurings and related party transactions in various jurisdictions;

(b) guidance on business combinations under common control, group restructurings and related party transactions published by accounting firms;

(c) IPSAS 40 *Public Sector Combinations* issued by the International Public Sector Accounting Standards Board (IPSASB); and

(d) recent consultation documents on business combinations under common control issued by national standard-setters, including Discussion Paper *Accounting for Business Combinations under Common Control* published in 2011 by the European Financial Reporting Advisory Group (EFRAG) and Organismo Italiano di Contabilità (OIC) (EFRAG and OIC Discussion Paper), and the comment letters on that Discussion Paper.

8. In undertaking that review, the staff particularly focused on:

(a) identifying the conceptual rationale for using different measurement approaches for different types of business combinations under common control and group restructurings; and

(b) understanding the specific conditions for using a particular measurement approach in particular circumstances.

9. An overview of findings in the staff's research is presented in the next section.

Overview of findings in the staff's research

10. The staff identified a number of jurisdictions that require a form of a predecessor approach for all business combinations under common control and group restructurings, including transactions that affect non-controlling shareholders in the receiving entity. The staff also identified jurisdictions that used to require a current value approach for all business combinations, including all business combinations under common control, until those jurisdictions adopted IFRS Standards.

11. Other jurisdictions make a distinction between different types of business combinations under common control and group restructurings. Those jurisdictions

require or permit a current value approach or a predecessor approach, depending on whether specified conditions are met. Sometimes such provisions are specified in the national GAAPs. In other cases the guidance is provided by accounting firms. The specified conditions for the use of a particular measurement approach vary and include the following:

(a) the effect of the transaction on the ownership interests in the underlying items. That assessment considers the effect of the transaction on the owners of the reporting entity rather than on the reporting entity itself.

(b) commercial or economic substance of the transaction, which is often assessed by reference to the effect of the transaction on the reporting entity's future cash flows.

(c) the form or the amount of the consideration transferred, and whether the amount of the consideration is supported by independent valuation or observable market prices.

12. The staff note that the effect of the transaction on ownership interests or rights of owners is a common condition in determining the appropriate accounting treatment. For example, Section 3840 *Related Party Transactions* of the Accounting Standards for Private Enterprises developed by the Canadian Accounting Standards Board (AcSB)[1] specifies that one of the conditions for measuring a related party transaction at the exchange amount[2] is a substantive change in the ownership interest in the item transferred. The change in the ownership interest is considered substantive when an unrelated party has acquired or given up at least 20 per cent of the total ownership interests. Paragraph 32 of Section 3840 explains the rationale for these requirements:

> 'when the ownership interests in an item transferred, or the benefit of a service provided, change, the ability to obtain future economic benefits from the item transferred, or the service provided, also changes. When the continuity of influence over an item transferred, or the beneficial interests of a service provided, has not changed, the transaction has insufficient substance to justify a change in measurement for financial reporting purposes and, hence, its carrying amount is retained. Generally, the greater the change in the ownership interests, the more likely the change is substantive.'

[1] Section 3840 is currently applied by Canadian private entities.
[2] The amount of consideration paid or received as established and agreed to by related parties.

13. Similarly, Section 19 *Business Combinations and Goodwill* of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* issued by the UK Financial Reporting Council[3] requires an assessment of the effect of the transaction on the ownership interests and in particular on non-controlling shareholders in determining whether a predecessor method can be applied to a group reconstruction or a public benefit entity combination. Specifically, paragraph 27 of Section 19 sets out the following provisions:

> 'Group reconstructions may be accounted for by using the merger accounting method provided:
>
> (a) the use of the merger accounting method is not prohibited by company law or other relevant legislation;
>
> (b) the ultimate equity holders remain the same, and the rights of each equity holder, relative to the others, are unchanged; and
>
> (c) no non-controlling interests in the net assets of the group is altered by the transfer'.

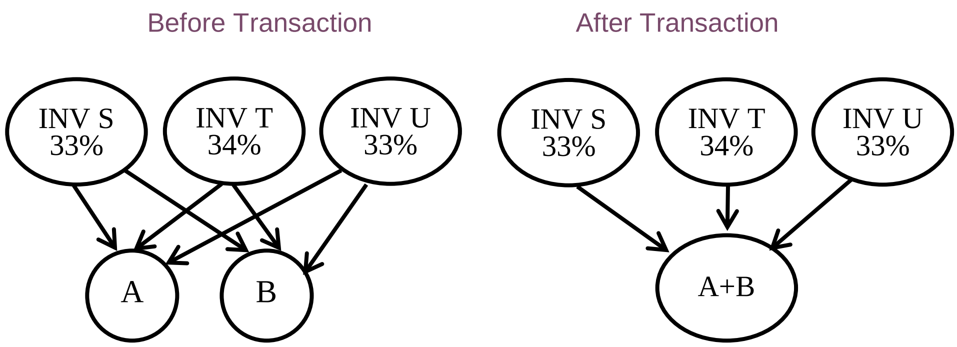
14. In accordance with US GAAP ASC 805-50 *Related Issues*, business combinations under common control are accounted for by applying a predecessor approach in all circumstances. However, according to guidance issued by an accounting firm, a change in the ownership of the underlying business is considered in determining the appropriate accounting treatment for so called transfers between entities with a high degree of common ownership. A high degree of common ownership is present if different investors own a similar interest in different entities, but none of the investors control those entities. A transfer between entities with a high degree of common ownership may be accounted for by applying a predecessor approach if all the shareholders retain the same ownership interests before and after the transaction. If the ownership interests of the shareholders change after the transaction, applying a predecessor approach would generally not be permitted. These conclusions are based on the historical interpretation of FTB 85-5 *Issues Relating to Accounting for Business Combinations* by Securities and Exchange Commission (SEC) staff[4]. The application of these concepts is presented in the illustrative example below.

[3] FRS 102 applies to UK entities that are not applying EU-adopted IFRS Standards, FRS 101 or FRS 105, including entities that are not constituted as companies and entities that are not profit oriented. https://www.frc.org.uk/accountants/accounting-and-reporting-policy/uk-accounting-standards/standards-in-issue/frs-102-the-financial-reporting-standard-applicabl

[4] FTB 85-5 was superseded by ASC 805 *Business Combinations*. However, the accounting firm's view

Illustrative Example—Transaction between entities with a high degree of common ownership

Investor S, Investor T and Investor U hold the same ownership interests in both Entity A and Entity B. Entity A and Entity B merge into a single legal entity. After the merger, the ownership interest of each investor is retained. In this scenario, the transaction may be accounted for applying a predecessor approach. A predecessor approach would not be permitted if the ownership interests of the investors changed as a result of the transaction.



15. IPSAS 40 generally requires public sector combinations to be accounted for applying a current value approach if they are considered acquisitions and applying a predecessor approach if they are considered amalgamations. One of the factors considered in determining whether a public sector combination is an acquisition or an amalgamation is the identification of the acquirer. If none of the parties gains control over one or more businesses as a result of the transaction, the transaction is considered an amalgamation and a predecessor approach applies.

16. The Basis for Conclusions for IPSAS 40 explains that while it may always be possible to identify an acquirer in a business combination in the scope of IFRS 3, that is not the case for public sector combinations where 'true mergers' or 'mergers of equals' are common. This is because, as stated in the Basis for Conclusions, combining entities in the scope of IFRS 3 will always have owners. Indeed, some of the requirements in IFRS 3 for identifying the acquirer 'look through' the combining entities onto the effects of the combination on the entities' owners. In contrast, as explained in the Basis for Conclusions, in the public sector there may be no quantifiable ownership

presented in the guidance is that SEC staff's historical interpretation continues to apply in absence of a new interpretation.

interests in the combining entities which can make it impossible to identify an acquirer.

17. Similar concepts of ‘looking through’ the combining entities onto the effects on their owners in selecting an appropriate accounting treatment for different types of business combinations under common control were suggested in comment letters on the EFRAG and OIC Discussion Paper. In particular, 11 out of 26 respondents discuss a change in the ownership interests or a similar concept, and in particular effects of the transaction on non-controlling shareholders, as a key factor to consider in determining which accounting approaches to adopt for different types of business combinations under common control. Those respondents suggest that a current value approach is not appropriate if existing shareholders have merely reorganised their existing ownership interests. They see such transactions as legal reorganisations rather than acquisitions. In contrast, they suggest that a current value approach is appropriate when non-controlling shareholders have acquired an interest in the transferred business as a result of the transaction.

18. Respondents to the EFRAG and OIC Discussion Paper also commented on the challenges of identifying a ‘meaningful’ acquirer in business combinations under common control and expressed mixed views on whether it is possible in all such transactions.

Are all transactions within the scope of the project ‘acquisitions’?

19. As discussed in April 2019 Agenda Paper 23A *Update on the staff’s approach*, in principle, to the extent that transactions within the scope of the Business Combinations under Common Control project are similar to business combinations not under common control, the same information should be provided and to the extent they are or could be different, different information may need to be provided. As noted in paragraph 1 of this paper, the Board tentatively decided that a current value approach based on the acquisition method in IFRS 3 would provide the most useful information to non-controlling shareholders of the receiving entity. The question arises whether transactions that do *not* affect non-controlling shareholders of the

receiving entity are different from those that do and from business combinations in the scope of IFRS 3.

20. Let us consider those different types of transactions more closely:

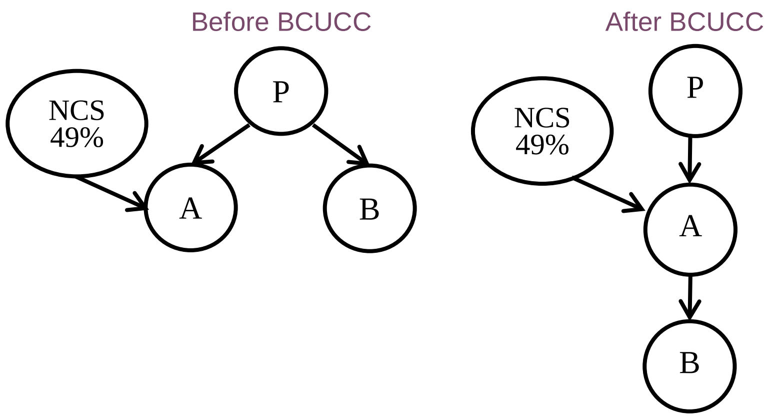
(a) transactions that affect non-controlling shareholders of the receiving entity (paragraph 21); and

(b) transactions that do not affect non-controlling shareholders of the receiving entity (paragraphs 22-28).

Transactions that affect non-controlling shareholders of the receiving entity

Scenario 1

Parent P owns 51% of Entity A and wholly owns Entity B and controls both entities. Entity B is a business. Entity A acquires 100% of the shares of Entity B.



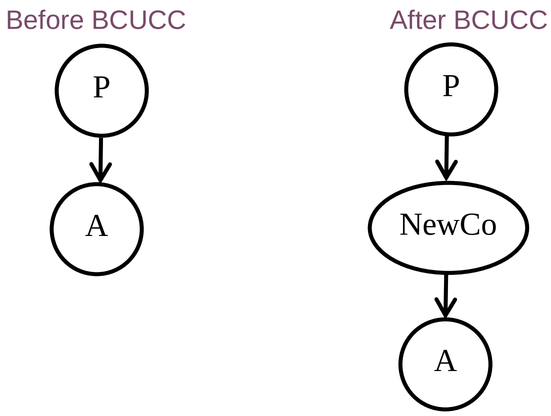
21. The transaction presented in Scenario 1 is a business combination under common control that affects non-controlling shareholders of the receiving entity, Entity A. This transaction is similar to a business combination in the scope of IFRS 3 in how it affects residual interests (equity claims) in the transferred entity, Entity B. Before the transaction, non-controlling shareholders had residual interest (an equity claim) only in the receiving entity, Entity A. As a result of the transaction, non-controlling shareholders acquired residual interest (an equity claim) in the transferred entity, Entity B. The change in the economic position of non-controlling shareholders of the receiving entity in a business combination under common control is similar to the change in economic position of shareholders of the acquiring entity in a business combination. In both cases, the combination results in the acquisition of the residual interest (equity claim) in the transferred entity by the shareholders of the receiving

entity. Accordingly, the same or similar information should be provided about such transactions.[5]

Transactions that do not affect non-controlling shareholders

Scenario 2

Parent P wholly owns and controls Entity A. Entity A is a business. NewCo is formed to issue shares to Parent P in exchange for all shares of Entity A.

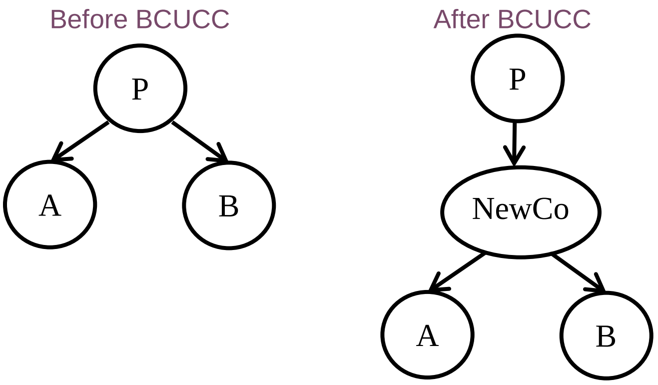


22. The transaction presented in Scenario 2 is different from the transaction in Scenario 1. This transaction under common control is not a business combination as defined in IFRS 3. This is because applying the definition in IFRS 3 a business combination involves an acquirer. In Scenario 2, NewCo that is formed to issue shares to effect a combination cannot be identified as the acquirer. Entity A cannot be identified as the acquirer either, because Newco is not a business. Applying a current value approach based on the acquisition method to a transaction that is not an acquisition may not be possible and may not result in useful information. The staff note that economically the combined entity in Scenario 2 is a continuation of Entity A rather than a new set of economic activities brought together. Accordingly, in the staff's view, retaining the carrying amounts of Entity's A net assets and using those carrying amounts in NewCo's consolidated financial statements, that is applying a form of a predecessor approach, would arguably provide users of the combined entity's financial statements with the most useful information about such a transaction.

[5] As discussed in para. 13 of December 2018 Agenda Paper 23 *Approach for transactions that affect non-controlling interest*, to the extent these transactions are different the acquisition method set out in IFRS 3 may need to be modified.

Scenario 3

Parent P wholly owns and controls both Entity A and Entity B. Entity A and Entity B are both businesses. NewCo is formed to issue shares to Parent P in exchange for all shares of Entities A and B.



23. Unlike the transaction in Scenario 2, the transaction presented in Scenario 3 is a business combination under common control. However, unlike the transaction in Scenario 1, this transaction does not result in an acquisition of residual interest (equity claim) in the transferred entity by shareholders of the receiving entity (in this case, Parent P). The residual interest (equity claim) in the transferred entities is retained by Parent P unchanged. The question arises whether such a transaction:

    (a) is more akin to a business combination not under common control and should be accounted applying a current value approach based on the acquisition method; or

    (b) is more akin to a group restructuring presented in Scenario 2 and should be accounted applying a form of a predecessor approach.

24. The staff note that if the acquisition method were applied to this transaction, NewCo that is formed to issue shares to effect a business combination would not be identified as the acquirer. Instead, one of the combining entities that existed before the combination, Entity A or Entity B, would need to be identified as the acquirer.

25. IFRS 3 defines the acquirer in a business combination as the entity that obtains control of the acquiree. Identifying the acquirer in a business combination is based on the guidance for assessing control in IFRS 10 *Consolidated Financial Statements*.

However, where the guidance in IFRS 10 does not clearly indicate which of the combining entities is the acquirer, the guidance in paragraphs B14–B18 of IFRS 3 should be considered. That guidance on identifying the acquirer 'looks through' the combining entities and focuses on the position of the owners of the combining entities as a result of the combination. Such an approach is conceptually similar considerations in determining the appropriate accounting treatment for business combinations under common control identified by the staff in some of the national GAAPs and other literature, as discussed in paragraphs 10–18 of this paper.

26. If the acquisition method were applied to the transaction in Scenario 3, identifying an acquirer in a meaningful way that would result in useful information may be not possible. This is because there is no acquisition of the residual interests (equity claims) in the transferred entities, Entities A and B, as a result of the transaction. The residual interest (equity claim) of Parent P in those entities continues unchanged, similar to Scenario 2. Accordingly, applying a form of a predecessor approach both in Scenarios 2 and 3 could arguably be more appropriate.

27. The staff think that a similar analysis also applies to transactions that do not affect non-controlling shareholders of the receiving entity, even if those transactions do not involve a formation of a NewCo. Consider variations of Scenario 3 that were presented to the Board in March 2019 Agenda Paper 23A *Overview of the staff's approach* and are reproduced below. In all those scenarios, Parent P controls and wholly owns Entity A and Entity B and decides to undertake a restructuring in preparation for an IPO of Entities A and B. Instead of forming a NewCo to effect a business combination, Parent P can:

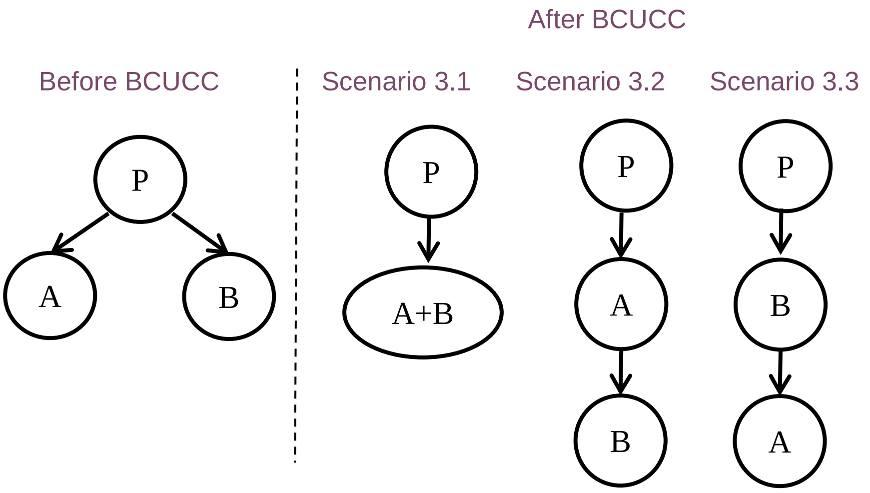
    (a) undertake a legal merger of Entity A and Entity B (scenario 3.1);

    (b) direct Entity A to acquire Entity B (scenario 3.2); or

    (c) direct Entity B to acquire Entity A (scenario 3.3).

Scenario 3 (continued)

Parent P controls and wholly owns Entity A and Entity B. Both Entity A and Entity B are businesses. Parent P decides to sell Entity A and Entity B together in an IPO and undertakes a restructuring in preparation for an IPO.

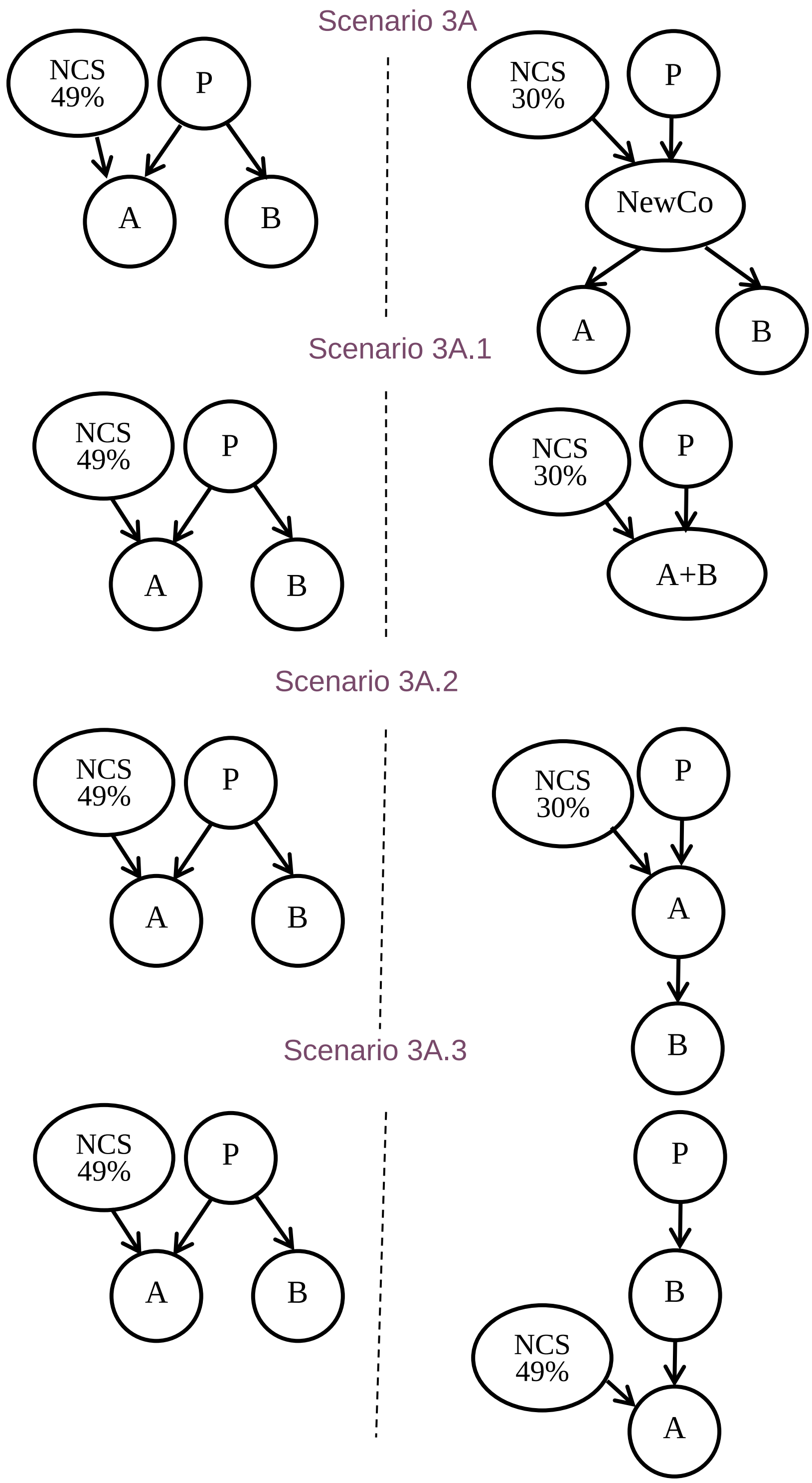


28. In all those scenarios identifying the acquirer and requiring that entity to apply a current value approach based on the acquisition method may not result in useful information. In all these scenarios, similar to Scenario 3 discussed in paragraphs 23-26, there is no change in residual interests (equity claims) in the transferred entity as a result of the transaction. The residual interest (equity claim) of Parent P, the shareholder of the receiving entity, in the transferred entity continues unchanged in all these scenarios. Hence, as discussed in March 2019 Agenda Paper 23A *Overview of the staff's approach*, applying a form of a predecessor approach may be appropriate in all these scenarios.

29. However, in the staff's view, the conclusion changes if non-controlling shareholders of the receiving entity acquire residual interests (equity claims) in the transferred entity as a result of the transaction. Consider Scenario 3A below that presents variations of scenarios 3-3.3 affecting non-controlling shareholders.

Scenario 3A

Parent P owns 51% of Entity A and wholly owns Entity B and controls both entities. Parent P undertakes a restructuring. As a result, Parent P owns 70% of the combined entity in Scenario 3A, 3A.1 and 3A.2 (but not in Scenario 3A.3).



30. In Scenarios 3A-3A.2, non-controlling shareholders of the receiving entity acquire residual interest (equity claim) in the transferred entity, Entity B. Accordingly, applying a current value approach based on the acquisition method in Scenarios 3A-3A.2 would provide useful information to non-controlling shareholders that are affected by the transaction. From the perspective of those non-controlling shareholders, the receiving entity acquired a new investment and applying a current value approach based on the acquisition method would assist non-controlling shareholders in assessing that investment.

31. In contrast, in Scenario 3A.3, the residual interests (equity claims) of shareholders of all combining entities, including both Parent P and non-controlling shareholders of Entity A, remains unchanged. In other words, there is no acquisition from the point of view of shareholders of the combining entities. In those circumstances, identifying an acquirer and requiring that entity to apply a current value approach based on the acquisition method may not result in useful information.

32. The staff acknowledge that paragraph 3.8 of the *Conceptual Framework for Financial Reporting* requires that the perspective of the reporting entity rather than of its capital providers is considered in providing information about transactions and other events. However, the staff emphasise that IFRS 3 already requires consideration of the effects of the transaction on the shareholders of the combining entities in determining which entity has made an acquisition. The staff think that it may be appropriate to extend that logic to determining whether an acquisition is present in the first place. As discussed in paragraphs 15–16, a similar approach is taken in IPSAS 40 that requires identifying the acquirer in determining whether a public sector combination is an acquisition or an amalgamation, and in selecting the appropriate accounting treatment.

Summary of staff's observations

33. Based on the research and analysis discussed in paragraphs 10–32, the staff think that transactions within the scope of the project that do not result in non-controlling shareholders of the receiving entity acquiring residual interest (equity claim) in transferred entities or businesses, are arguably different from both:

(a) transactions within the scope of the project that result in non-controlling shareholders acquiring such residual interest; and

(b) business combination not under common control.

34. If non-controlling shareholders of the receiving entity do not acquire residual interest in the transferred entities or businesses, and the controlling party's residual interest in the transferred entities or businesses is retained unchanged, there is arguably no acquisition that these shareholders need information about. In addition, if a current value approach based on the acquisition method is applied to such transactions, identifying an acquirer may not be possible or may not result in useful information.

35. As the staff's research indicated, such an approach is not new. Assessment of the change in the ownership interests in the underlying items or a similar concept is already applied in practice in some jurisdictions in determining whether a current value approach or a predecessor approach should be applied to a business combination under common control or a similar transaction.

36. Accordingly, the staff think that a distinction based on whether non-controlling shareholders of the receiving entity acquire a residual interest in the transferred entities or businesses is a viable approach to explore in determining when to apply a current value approach, and when to apply a form of a predecessor approach, to transactions within the scope of the Business Combinations under Common Control project. This distinction would result in:

(a) applying a current value approach based on the acquisition method to transactions within the scope of the project that affect non-controlling shareholders of the receiving entity; and

(b) applying a different approach, such a form of a predecessor approach, to transactions within the scope of the project that do not affect non-controlling shareholders of the receiving entity, including transactions that affect lenders and other creditors of the receiving entity and transactions undertaken in preparation for a sale of the combining entities, for example in an IPO.

37. The staff emphasise that such a distinction would be consistent with the Board's tentative decisions to date:

(a) to develop a current value approach based on the acquisition method for transactions that affect non-controlling shareholders of the receiving entity.

(b) that there is no need to pursue a single measurement approach for all transactions within the scope of the project. Specifically, that the Board could pursue a form of a predecessor approach for transactions that affect lenders and other creditors of the receiving entity but do not affect non-controlling shareholders.

Question for the Board

Question
Does the Board have any questions or comments on the staff's analysis presented in this paper?