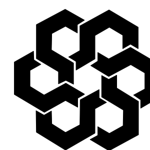

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**14 December 2006, London**
Project:	**Business Combinations II**
Subject:	**Accounting for Business Combinations Achieved By Contract Alone or in the Absence of a Transaction Involving the Acquirer (Agenda Paper 2C)**

INTRODUCTION

1. In the Business Combinations Exposure Draft (BC ED), a business combination is defined as "a transaction or other event in which an acquirer obtains **control** of one or more businesses." As noted in paragraph B28 of the BC ED, the Boards concluded that "all changes of control in which an entity acquires a business are economically similar transactions or events" that should be accounted for by applying the acquisition method. Therefore, the BC ED proposes to include in its scope business combinations that occur by contract alone or in the absence of a transaction involving the acquirer. The purpose of this memo is to ask the Boards to affirm that proposal.

BC ED PROPOSALS

2. The BC ED proposes that business combinations that occur by contract alone or in the absence of a transaction involving the acquirer should be accounted for by applying the acquisition method.

3. Paragraph 54 of the BC ED proposes some guidance for applying the acquisition method to business combinations achieved by contract alone:

> In rare circumstances, an acquirer (a) obtains control of an acquiree by contract (b) transfers no consideration for control of the acquiree or for the net assets of the acquiree, and (c) obtains no equity interests in the acquiree, either on the acquisition date or previously. An example of such a business combination is one in which two businesses are brought together to form a dual listed corporation. This type of business combination is referred to as a business combination achieved by contract alone in this Statement. In such a business combination, the fair value of the acquiree shall be attributed to the noncontrolling interests of the acquiree (that is, the equity holders of the acquiree) in the consolidated financial statements of the acquirer.

CURRENT IFRS 3 REQUIREMENTS

4. IFRS 3 defines a business combination as “the bringing together of separate entities or businesses into one reporting entity.“ IFRS 3 currently requires business combinations in which control is obtained in the absence of a transaction involving the acquirer to be accounted for by the purchase method (for example, if control is obtained through the lapse of minority veto rights). However, IFRS 3 scopes out “business combinations in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest (for example, combinations in which separate entities are brought together by contract alone to form a dual listed corporation)” (paragraph 3(d)).

CURRENT STATEMENT 141 REQUIREMENTS

5. Paragraph 9 of Statement 141 states that "a *business combination* occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities. This Statement does not address transactions in which control is obtained through means other than an acquisition of net assets or equity interests" *(footnote reference omitted)*. Therefore, Statement 141 does not explicitly apply to business combinations achieved by contract alone or in the absence of a transaction involving the acquirer.

Business Combinations Achieved in the Absence of a Transaction Involving the Acquirer

6. Following are some examples of business combinations achieved in the absence of a transaction involving the acquirer. As discussed above, these business combinations are in the scope of IFRS 3, but are not in the scope of Statement 141.

Obtaining Control by a Lapse of Veto Rights Held by Minority Shareholders

7. An acquirer could obtain control of an acquiree through the lapse of minority veto rights that previously kept the acquirer from controlling the acquiree even though the acquirer held the majority voting interest in the acquiree. If the acquirer applied IFRSs, this event would be accounted for by the purchase method in IFRS 3. If the acquirer applied U.S. GAAP, no change in basis would be recognized. The basis for conclusion to Statement 141 provides guidance for initially consolidating an entity because of a lapse of minority veto rights. Paragraph B23 of Statement 141 states :

> . . . this Statement does not change current accounting practice with respect to [the lapse of minority veto rights]. For example, if a previously unconsolidated majority-owned entity is consolidated as a result of control being obtained by the lapse or elimination of participating veto rights that were held by minority stockholders, **a new basis for the investment's total carrying amount is not recognized**

> **under current practice**. **Instead, only the display of the majority-owned investment in the consolidated financial statements is changed. The majority-owned entity is consolidated rather than reported as a single investment accounted for by the equity method.** That treatment is consistent with the practice for accounting for step acquisitions, in which a parent obtains control of a subsidiary through two or more purchases of the investee-subsidiary's stock [**Emphasis** added.]

8. In accordance with the proposals in the BC ED, obtaining control of an entity through the lapse of minority veto rights would be accounted for using the acquisition method. That would be a change to current practice in the United States. The staff agrees with the Boards' initial reason for deciding to include those transactions in the scope of the BC ED—all changes of control in which an entity acquires a business are economically similar transactions or events that should be accounted for by applying the acquisition method. The staff believes that requiring the acquisition method to be used to account for an acquisition no matter how control is obtained will improve the consistency, relevance, and comparability of financial information.

Share Buy-Back (Repurchase) Arrangements That Result in a Change of Control

9. Paragraph 8 of IFRS 3 includes the following guidance:

> Included within the definition of a business combination, and therefore the scope of this IFRS, are business combinations in which one entity obtains control of another entity but for which the date of obtaining control (ie the acquisition date) does not coincide with the date or dates of acquiring an ownership interest (ie the date or dates of exchange). This situation may arise, for example, when an investee enters into share buy-back arrangements with some of its investors and, as a result, control of the investee changes.

10. In accordance with the proposals in the BC ED, such an event would be accounted for using the acquisition method. It is not clear how such an event would be accounted for under U.S. GAAP. As a result, it might be a change to current practice in the United States. The staff believes that such

an event is similar to obtaining control by the lapse of minority veto rights and also should be accounted for by applying the acquisition method.

Business Combinations Achieved by Contract Alone

11. Following are some examples of business combinations achieved by contract alone. As discussed above, those business combinations are not in the scope of IFRS 3 or Statement 141.

Contractual Arrangements between Physician Practice Management (PPM) Entities and Other Entities

12. EITF Issue No. 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements," addresses transactions that involve control by contract without necessarily obtaining an ownership or voting equity interest of the PPM. Issue 97-2 states:

> The Task Force reached a consensus that a transaction between a PPM and a physician practice in which the PPM executes a management agreement with the physician practice is considered to be a business combination to be accounted for under Opinion 16 [replaced by Statement 141, which requires using the purchase method for these types of transactions] if (1) based on the terms of the management agreement the PPM is required to consolidate the physician practice and (2) the physician practice is a business.

13. Resource group members stated that they rely on that consensus in other circumstances when an acquirer obtains control of an entity by contract alone. Therefore, although such a transaction may not meet the definition of a business combination in Statement 141, in current U.S. practice, business combinations achieved by contract alone are being accounted for by the purchase method.

Dual Listed Corporations (DLCs) and Stapling Arrangements

14. Transactions in which companies are brought together to form a DLC or a stapling arrangement occur infrequently. They seem to be most prevalent in Australia. There is no guidance in U.S. GAAP or IFRSs for accounting for such transactions. The only guidance that the staff is aware of for accounting for DLCs and stapling arrangements is guidance issued by the Australian Accounting Standards Board (AASB) Urgent Issues Group, which is summarized below. The guidance for both DLCs and stapling arrangements in the Urgent Issues Group Interpretations is based on the AASB 3 (and IFRS 3) definition of a business combination, which is defined as "the bringing together of separate entities or businesses into one reporting entity" even though AASB 3 (and IFRS 3) currently exclude from their scope business combinations achieved by contract alone.

DLCs

15. The AASB issued Urgent Issues Group Interpretation 1001 *Consolidated Financial Reports in Relation to Pre-Date-of-Transition Dual Listed Company Arrangements*[1] in July 2005. Interpretation 1001 describes a DLC as an arrangement between listed legal entities "under which their activities are managed as a single economic entity under contractual arrangements with another company, while retaining their separate legal identities. In these cases one entity has not acquired an ownership interest in the other entity and the individual legal entities have not been combined into a new legal entity. The securities of the entities comprising the DLC are normally quoted, traded, or transferred independently in different capital markets" (Interpretation 1001, paragraph 1). Interpretation 1001 requires that DLCs be accounted for as a pooling-of-interests rather than an acquisition and views that when "entities participating in a DLC arrangement act jointly as a single parent, consolidated general purpose financial reports are prepared

[1] Pre-date of transition refers to the period prior to the date of transition of Australian equivalents to IFRS.

on the basis of a combined income statement, combined balance sheet, combined cash flow statement, combined statement of changes in equity and notes thereto in respect of the entities in the DLC arrangement" (Interpretation 1001, paragraph 15). However, that interpretation notes that it does not apply to any DLC arrangements occurring on or after an entity's date of transition to Australian equivalents to IFRS.

16. Because DLCs are scoped out of IFRS 3, it is not clear what the appropriate guidance would be for those entities that apply IFRSs. Although a DLC would not meet the definition of a business combination in Statement 141, the SEC has required DLCs to be accounted for using the purchase method (see examples below).

Stapling Arrangements

17. The AASB issued Interpretation 1002 *Post-Date-of-Transition Stapling Arrangements* to provide guidance on business combinations created by stapling arrangements. Interpretation 1002 describes a stapled arrangement as a situation in which a legal entity has "issued equity securities that are combined with ("stapled" to) the securities issued by another legal entity by virtue of a contractual arrangement between the entities" (Interpretation 1002, paragraph 1). Those stapled securities are quoted at a single price and cannot be traded or transferred independently. Stapling arrangements often occur between a company and a trust. In that case, the company would normally obtain control of the trust and, therefore, would be identified as the acquirer.

18. Although, AASB 3 *Business Combinations* (equivalent to IFRS 3) currently excludes business combinations achieved by contract alone, the consensus reached in Interpretation 2 requires that the general principles in AASB 3 and AASB 127 *Consolidated and Separate Financial Statements* (equivalent to IAS 27) be applied to stapling arrangements. Therefore, one of the entities combined under the stapling arrangement is identified as the acquirer and the parent for the purpose of preparing consolidated financial

statements (Interpretation 1002, paragraph 7). Further, Interpretation 1002 requires a net asset approach and provides the following additional guidance:

a. The acquiree's identifiable assets, liabilities, and contingent liabilities that satisfy the recognition criteria are generally recognized and measured at their acquisition date fair values in the consolidated financial statements in accordance with AASB 3 (Interpretation 1002, paragraph 8).

b. No goodwill or excess of the acquirer's interest in the net fair value of an acquiree's identifiable assets, liabilities, and contingent liabilities over acquisition cost is recognized as part of the stapling arrangement (Interpretation 1002, paragraph 9).

c. Since the acquirer does not obtain any equity interests, the net assets of the consolidated acquiree under a stapling arrangement should be classified as minority interests and presented in the consolidated balance sheet within equity, separately from the parent equity holders' equity (Interpretation 1002, paragraph 10).

19. It is not clear how stapled security arrangements would be accounted for under IFRSs or U.S. GAAP. They are scoped out of IFRS 3 and do not meet the definition of a business combination under Statement 141. The staff is not aware of examples of these transactions that should be accounted for under IFRSs or U.S. GAAP.

Examples of Recent DLC Transactions and Stapling Arrangements

20. The following table summarizes some examples of DLCs and stapling arrangements and the basis of accounting for each transaction. The list is not comprehensive, but it illustrates how they were accounted for.

Description of Transaction	**International GAAP**	**U.S. GAAP**
In 2001, BHP Limited (an Australian company) and Billiton Plc (a British company) combined to form BHP Billiton, a DLC. (Source: 2006 BHP Billiton Form 20-F)	Accounted for as a pooling-of-interests under UK GAAP and AGAAP.	The SEC required this transaction to be accounted for as an acquisition of Billiton Plc by BHP Limited.
In 2003, Carnival Corporation (a U.S. company) and Carnival plc (a British company) combined to form Carnival Corporation & plc, a DLC. (Source: 2006 10-K)	N/A	The SEC required this transaction to be accounted for as an acquisition of Carnival plc by Carnival Corporation.
In 2001, Brambles Industries Limited (an Australian company) and Brambles Industries plc (a British company) combined to form Brambles Industries, a DLC. (Source: 2006 Annual Report)	Accounted for as a pooling-of-interests under UK GAAP and AGAAP. (The combined financial statements were prepared by applying accounting principles similar to those adopted under UIG Abstract 13: The Presentation of the Financial Report of Entities whose Securities are 'Stapled' (superseded by Interpretation 1013). The continuation of this consolidation basis under IFRS is in accordance with UIG Interpretation 1001: Consolidated Financial Reports in relation to Pre-Date-of-Transition Dual Listed Company Arrangements.)	N/A
In 2004, the Westfield Group was established by stapling the securities of Westfield Holdings Limited, Westfield Trust, and Westfield America Trust (Source: 2005 Annual Report)	Accounted for as an acquisition of Westfield Trust and Westfield America Trust by Westfield Holdings Limited under AIFRS by consolidating the fair value of the net assets of Westfield Trust and Westfield America Trust.	N/A

BACKGROUND AND INITIAL DELIBERATIONS

21. During their initial deliberations on the definition of a business combination the Boards decided to include transactions in which control of a business is obtained in the absence of a transaction involving the acquirer and achieved by contract alone in their separate February 2003, November 2004, and the IASB's December 2004 Board meetings. *[Footnote reference omitted]*

22. Shortly after IFRS 3 was issued, the IASB published an Exposure Draft of Proposed Amendments to IFRS 3 *Combinations by Contract Alone or Involving Mutual Entities* (Mutuals ED) as part of the first phase of its Business Combinations Project. The Exposure Draft proposed an interim approach for accounting for combinations achieved by contract alone until the IASB considered those issues as part of its second phase of the project. However, after reviewing the comment letters to that Exposure Draft, the IASB decided not to proceed with the proposals "primarily for reasons of timing and impending consideration of these issues in the second phase of this project" (IASB BC ED, paragraph BC185 footnote).

23. At its June 2004 meeting, the IASB tentatively concluded that combinations by contract alone should be accounted for by applying the purchase method, and considered whether any issues would arise from the application of the purchase method in its October 2004 meeting. As part of its analysis at that meeting, the IASB considered the comments received in response to the Mutuals ED, which were analyzed and presented at the IASB's September 2004 Board meeting. In its October 2004 meeting, the IASB decided to include business combinations achieved by contract alone in the scope of Phase II of the Business Combinations Project. Additionally, the IASB decided that in such business combinations:[2]

    a. The purchase method should be applied.

[2] Summary from the minutes of the IASB's October 2004 Board meeting.

b. Difficulties in identifying the acquirer are not a sufficient reason to justify a different accounting treatment and no further guidance is necessary for identifying the acquirer for combinations by contract.

c. The total amount to be recognized by the acquirer should be the fair value of the business acquired.

d. The accounting for goodwill should be the same as for combinations of other business entities.

e. The credit side of the entry should be recognized in equity.

24. The IASB BC ED summarizes why business combinations achieved by contract alone were included in Phase II of the Business Combinations Project:

> . . . issues relating to business combinations between mutual entities and combinations achieved by contract alone were not included in the original scope of the second phase of the project. The Board intended to deal with such business combinations as part of future phases of the project. However, the Board decided to address the accounting for such combinations as part of this joint project. The reason is that the FASB decided that decisions in the joint project should also apply to business combinations involving mutual entities and achieved by contract alone and, therefore, the scope of a single standard on business combinations became a convergence issue. (Paragraph BC 179)
>
> The current practice in the US is that such combinations are accounted for in accordance with SFAS 141. Therefore, they are accounted for by applying the SFAS 141 version of the acquisition method. (Paragraph BC 198)
>
> The Board notes that difficulties may arise in applying the acquisition method to combinations achieved by contract alone. In particular, such business combinations normally do not involve the payment of any readily measurable consideration and in rare circumstances it might be difficult to identify the acquirer. However, as for combinations between mutual entities and for the reasons discussed above, the Board concluded that the acquisition method can and should be applied in accounting for such business combinations. The Board concluded that in a business combination achieved by contract:

a. difficulties in identifying the acquirer are not a sufficient reason to justify a different accounting treatment, and no further guidance is necessary for identifying the acquirer for combinations by contract.

b. determining the fair value of the acquiree and calculating the related goodwill should be consistent with decisions reached in the second phase of the project. (Paragraph 199)

COMMENT LETTER RESPONSES AND STAFF ANALYSIS

25. Few respondents addressed whether the acquisition method should be applied to business combinations that occur in the absence of a transaction involving the acquirer possibly because they are already required to be accounted for by the purchase method under IFRSs and because they occur infrequently.

26. The Boards received a few comments related to business combinations achieved by contract alone. Those respondents generally apply IFRS and disagree with the proposal. Those respondents were accounting firms and associations and preparers. They disagreed for the following reasons:

    a. Identifying the acquirer is too difficult and would not reflect economic reality.

    b. There is no exchange of cash or other readily measurable consideration to measure the fair value of the acquiree.

27. The concerns expressed by respondents are generally the same concerns that the Boards considered in their separate deliberations for IFRS 3, including the IASB's Mutuals ED and Statement 141.

Difficulty in Identifying the Acquirer

28. Respondents that believe it will be difficult to identify the acquirer in such a transaction generally believe that "true mergers" or "mergers of equals" exist. Therefore, those respondents believe it is too difficult to identify an acquirer, and identifying an acquirer would not reflect economic reality. For example, EFRAG (CL #268) stated:

> As we explained when we commented on the ED 3 Business Combinations and the ED of proposed amendments to the scope of IFRS 3 we believe that in practice there are true mergers – particularly in the area of combinations involving two or more mutual entities or combinations achieved by contract alone – and we believe that, in those cases, the application of the acquisition method, involving the identification of the acquirer in all cases, will not reflect economic reality.

29. The staff acknowledges that it might often be difficult to identify an acquirer in a business combination achieved by contract alone. However, difficulties in identifying the acquirer are not unique to those types of transactions. For example, domestic legal, taxation, or economic factors can also make it difficult to identify an acquirer when business combinations occur between different types of entities. As noted in BC54 of IFRS 3, the IASB considered these concerns and whether the pooling-of-interests method should be permitted in such circumstances and whether applying the purchase method to combinations for which identifying the acquirer is difficult could result in an arbitrary selection of an acquirer and therefore decrease the comparability of financial information. The IASB concluded in paragraph BC55 of IFRS 3 that "in no circumstances does the pooling of interests method provide superior information to that provided by the purchase method, even if identifying the acquirer is problematic." Paragraphs 10–16 the BC ED provide guidance for identifying the acquirer. Also, the IASB's BC ED states:

> In developing SFAS 141 the FASB also considered the accounting for true mergers or mergers of equals and

concluded that all business combinations result in one entity obtaining control of another; that is, true mergers are very rare. Paragraph 42 of the Basis for Conclusions on SFAS 141 states:

> The [FASB] Board concluded that 'true mergers' or 'mergers of equals' are nonexistent or so rare as to be virtually nonexistent, and many respondents agreed. Other respondents stated that even if a true merger or merger of equals did occur, it would be so rare that a separate accounting treatment is not warranted. They also stated that developing the criteria necessary to identify those transactions simply would be a continuation of the same problems and potential for abuse evidenced by Opinion 16….The [FASB] Board further observed that respondents and other constituents were unable to suggest an unambiguous and nonarbitrary boundary for distinguishing true mergers or mergers of equals from other two-party business combinations and concluded that developing such an operational boundary would not be feasible. Moreover, even if those mergers could feasibly be distinguished from other combinations, the [FASB] Board concluded that it does not follow that such combinations should be accounted for on a carry-over basis. If they were to be accounted for using a method other than the purchase method, the [FASB] Board believes that a better method would be the fresh-start method. (Paragraph BC30)

The IASB agreed with the FASB's conclusion that true mergers, if they exist, would be very rare. The Board observed that almost all business combinations portrayed as mergers of equals by the combining entities resulted in one of the parties undoubtedly obtaining control over the other combining entity after the combination. Therefore, the Board agreed with the FASB's conclusion that virtually all business combinations result in one entity obtaining control of another entity (or entities) or business(es). As a result, the Board decided to adopt the FASB's definition of a business combination. (Paragraph BC31)

Even though the new definition focuses on control, all business combinations included in the scope of IFRS 3 are within the scope of the draft revised IFRS 3. Like IFRS 3 and SFAS 141, the proposed IFRS will continue to require the acquisition method to be applied to those rare combinations, if any, for which one of the combining entities does not

> obtain control of the other combining entity. However, the Board noted that it is committed to exploring in a future phase of its Business Combinations project whether the 'fresh start' method might be applied to these combinations. (Paragraph BC32)

30. *[Part of paragraph omitted from observer notes]* As the Boards indicated in their bases for conclusions, the staff believes that in virtually all business combinations, it is possible to identify one of the entities as obtaining control of another (and therefore be identified as an acquirer). The staff believes the proposals provide sufficient guidance for identifying the acquirer.

An Alternative Method Should Be Considered if an Acquirer Cannot Be Identified

31. Because of the concerns about identifying the acquirer in a business combination achieved by contract alone, some respondents suggested that the Board consider an alternative method of accounting such as the fresh-start method. For example, FAR (CL #142) stated:

> FAR is not convinced that applying one single method of accounting to all business combinations will necessarily enhance the relevance and reliability of the financial statements. FAR would have welcomed if the Board had addressed thoroughly the new basis of accounting (the fresh start method) as an alternative for true mergers as this method may more faithfully represent business combinations in which none of the combining entities obtains control of the other. FAR further believes that the Board should have investigated the new basis of accounting as an alternative for business combinations involving only mutual entities or achieved by contract alone.

32. CNC (CL #146 stated):

> As we had already indicated in our comment letter on ED 3, we still believe that the identification of an acquirer may be impossible in certain circumstances and that the application of the acquisition method in that case would clearly be inappropriate and would lead to an accounting treatment that does not reflect the economic reality. For those reasons, we strongly encourage the Board to complete its work on the fresh start method and the comparison with the pooling method to ascertain whether the fresh start method is a better method.

33. Allowing a second method such as the pooling-of-interests method or the fresh-start method to account for business combinations has the same disadvantages as those determined in Statement 141 and IFRS 3 when the Boards decided to eliminate the pooling-of-interests method in favor of adopting one method to account for business combinations—the purchase method. Some disadvantages are discussed in paragraph B27 of Statement 141, which states:

> . . . the Board was mindful of the disadvantages of having more than one method of accounting for business combinations, as evidenced by the experience with Opinion 16 over the past three decades. Among those disadvantages are the incentives for accounting arbitrage that inevitably exist when different methods produce dramatically different financial statement results for economically similar transactions. Another disadvantage is the difficulty in drawing unambiguous and nonarbitrary boundaries between the transactions to which the different accounting methods would apply. Still others include the difficulties and costs associated with applying, auditing, and enforcing the resulting standards. Yet others relate to the difficulties with analyzing the information provided by different methods because users commonly do not have the means available to convert from the information provided by one method to that provided by another.

The Fresh-Start Method

34. Respondents that believe “true mergers” or “mergers of equals” exist do not believe the acquisition method is appropriate because they do not believe any of the combining entities obtains control. The FASB noted in Statement 141 that another method such as the fresh-start method might be appropriate for business combinations that are not acquisitions as proposed by some respondents. Paragraph B81 of Statement 141 describes the fresh-start method as follows:

> Under the fresh-start method, none of the combining entities are viewed as having survived the combination as an independent reporting entity. Rather, the combination is viewed as the transfer of the net assets of the combining entities to a new entity that assumes control over them, and the history of that new entity, by definition begins with the combination.

35. The FASB noted that under the fresh-start method, the combined entity has no history against which to compare itself and comparability is decreased. Also, guidance would have to be developed to implement the fresh-start method, and many unsettled issues (such as the recognition and measurement of goodwill) would have to be addressed before it could be applied. Therefore, the FASB concluded in paragraph B84 of Statement 141 that:

> The advantages of using the fresh-start method . . . (primarily enhanced representational faithfulness) were outweighed by the disadvantages of having two methods of accounting (particularly the potential for accounting arbitrage but also the difficulties of drawing unambiguous and nonarbitrary boundaries between the methods). The Board further concluded that an alternative to the purchase method of accounting for those combinations was not needed because it is possible to apply the purchase method to them.

36. For the reasons noted in Statement 141, the staff believes that a second method of accounting would add complexity to the current model for accounting for business combinations.

Absence of Reliably Measurable Consideration

37. Some respondents expressed concern that there would be significant measurement issues related to determining the fair value of the acquired entity because no consideration is exchanged in a business combination achieved by contract alone. For example, Fitch Ratings (CL #16) stated:

> It is our view that combinations by contract alone should not be included at this time. We are concerned that without exchange of consideration, there would be significant measurement issues related to the determination of fair value of the acquired entity.

38. Business combinations achieved without an exchange of cash or other readily measurable consideration are not unique to business combinations achieved by contract alone. The same issues arise when two privately held companies combine or when two mutual entities combine. The BC ED proposes that when the fair value of the consideration given by the acquirer does not provide the best evidence for measuring the fair value of the acquirer's interest in the acquiree, the fair value of the acquired interest should be measured directly using valuation techniques. Therefore, even though consideration is not exchanged when a business combination is achieved by contract alone, the fair value of the acquired interest can be measured reliably. Therefore, the staff believes that the absence of reliably measurable consideration does not justify an accounting method other than the acquisition method.

The Definition of a Noncontrolling Interest Should Be Reconsidered

39. A couple of respondents questioned the appropriateness of the proposal in the BC ED that in a business combination achieved by contract alone, the fair value of the acquiree should be attributed to the noncontrolling interests of the acquiree (that is, the equity holders of the acquiree) in the

consolidated financial statements of the acquirer. The AASB (CL #261) stated:

> The proposed definition of non-controlling interest is premised on the parent owning an equity interest in the subsidiary. However, paragraph 6 of ED IFRS 3 envisages business combinations being achieved in several different ways, some of which do not involve the acquirer obtaining equity interests in the acquiree. This discrepancy has the potential to give rise to anomalous accounting treatments in circumstances where there is no ownership interest being acquired by one of the combining entities in another combining entity. For instance, application of the acquisition method to business combinations by contract alone, such as stapled security arrangements, can result in the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree being classified in the consolidated financial statements as minority interests. However, the economic substance of stapled security arrangements is that there is no 'minority' interest. Normally, the equity holders in the combining entities become equity holders in the combined entity and, therefore, have an interest in the results and net assets of all of the combined entities.
>
> The AASB recommends that the IASB reconsider the proposed definition of non-controlling interest as follows:
>
> > that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, of the *ownership group of the parent.*
>
> We note that this definition is consistent with the guidance in paragraphs A119-A120 for reverse acquisitions. We also note that this definition is similar to the definition of 'outside equity interest' as described in AASB 1024 *Consolidated Accounts* (Issued September 1991), which was superceded by AASB 3 *Business Combinations*. AASB 1024 defined outside equity interest as:
>
> > ". . .the equity in the economic entity other than that which can be attributed to the ownership group of the parent entity."
>
> In line with the scope of ED IFRS 3, the definition of non-controlling interest should focus on the equity holders that do not have an interest in the results and net assets of the parent and/or combined entity rather than the non-controlling

ownership interest in the subsidiary. This is likely to make consolidated financial statements more useful, particularly to equity holders in business combinations by contract alone such as stapled arrangements.

40. The staff is concerned that the proposal to attribute the fair value of the acquiree to the noncontrolling interests of the acquiree in the consolidated financial statements of the acquirer might not faithfully represent the economics of particular transactions achieved by contract alone such as stapling arrangements. It seems that the substance of a stapling transaction is similar to a business combination effected through a share-for-share exchange. In that case, the net assets of the acquiree would not be attributed to the noncontrolling interests. It seems like a more faithful representation might be to show the two classes of stapled shares in the consolidated financial statements. The staff is researching this issue in preparation for the upcoming December Board meetings. We welcome feedback from Board members on this issue.

STAFF RECOMMENDATION

41. Control of an entity can be achieved without the acquirer transferring consideration to a third party. The staff believes that the consequences of achieving control are more important than how control was achieved. Therefore, the staff recommends that the Boards affirm that the acquisition method be applied to business combinations achieved in the absence of a transaction involving the acquirer or by contract alone.

Do the Boards Agree?