Project **New items for consideration**

Topic **IFRS 3 *Business combinations*—identification of the acquirer**

Introduction

1. In January 2011, the IFRS Interpretations Committee (the Committee) received a request for guidance on the circumstances or factors that are relevant when identifying an acquirer in a business combination under IFRS 3 *Business Combinations*.

2. More specifically, the submission describes a fact pattern in which a group spins-off its business in an initial public offering (IPO) by incorporating a new entity (referred to as 'Newco'). Newco will only acquire that part of the group being spun-off at the time the IPO occurs. The submitter asks whether, in the identification of the acquirer in a business combination under IFRS 3, the following factors are relevant in this identification:

   (a) the existence of a condition imposed to effect the acquisition (in this case, the IPO); and

   (b) the identity of the party that formed the new entity to effect a business combination.

3. The submitter requests the Committee to add this issue to its agenda because they consider the issue to be widespread and that significant different interpretations exist in practice regarding the circumstances under which a newly formed entity is regarded as the acquirer. The submitter has provided an

assessment of the Committee's agenda criteria which can be found in Appendix B of this paper.

4. We performed outreach with national standard-setters on this topic in order to find out whether the issue raised by the submitter is widespread and whether diversity in practice exists. The results of this outreach are included as part of the staff's analysis of this issue.

Objective

5. The objective of this paper is to:

   (a) provide background information for the issue raised in the submission;

   (b) provide an analysis of the issue, including a summary of the outreach responses received from national standard setters;

   (c) present an assessment of the issue against the Committee's agenda criteria;

   (d) make a recommendation to the Committee; and

   (e) ask the Committee whether they agree with the staff recommendation.

Issue raised

Main features identified

6. The submission (reproduced in Appendix B) describes a fact pattern in which a group spins-off part of its business by the incorporation of a Newco. This arrangement has the following main features:

   (a) The group comprises Entity A (the parent company), which owns 100 per cent of two subsidiaries (Sub 1 and Sub 2).

   (b) Entity A incorporates a Newco with nominal equity.

   (c) Newco signs an agreement establishing that Newco will acquire Sub 1 and Sub 2 from Entity A conditional on the Newco IPO occurring. The prospectus offering will allow Newco to issue shares in exchange for cash to give effect to the acquisition.

(d) When the IPO occurs, Entity A will lose control of Newco.

7. An illustration of the structure of the group before and after the IPO occurs is illustrated in Appendix B.

Views in identifying the acquirer

8. The submitter identifies two views in determining who the acquirer is and whether the fact pattern described is or is not a business combination. These views are:

(a) **View 1**—The fact that the acquisition is conditional on the IPO is a critical feature and therefore Newco is the acquirer and the transaction is a business combination.

(b) **View 2**—The fact that the acquisition is conditional on the IPO is not a critical feature and therefore Newco is not the acquirer and the transaction is a business combination under common control.

Description of View 1

9. Proponents of View 1 believe that the IPO is an integral part of the transaction as a whole, because there would not have been a combination of Newco with the subsidiaries if the IPO had not occurred.

10. In their view, the IPO creates a change in the ownership of the subsidiaries, because Newco's new shareholders obtain control of Sub 1 and Sub 2 in an arm's length transaction, while Entity A retains only a nominal interest in the Newco.

11. Consequently, those who support this view think that that this transaction would be considered a business combination under IFRS 3 and that Newco should be identified as the acquirer when the IPO occurs.

Description of View 2

12. Under View 2, the fact that the acquisition is conditional upon the IPO is not relevant. The critical feature in identifying the acquirer is: who established Newco? This is determined by taking into consideration the following factors:

    (a) who made the strategic and operational decisions to create the Newco; and

    (b) who initiated the transaction.

13. Those who advocate this view think that this transaction would be considered a business combination under common control and either Entity A or one of the subsidiaries (ie Sub 1 or Sub 2) could be considered to be the acquirer.

Staff analysis

14. The submission questions whether the following factors are relevant when identifying the acquirer:

    (a) a conditional event such an IPO, and

    (b) the identity of the party that formed the Newco.

    These factors will be discussed in subsequent paragraphs.

Is an IPO relevant for identifying the acquirer?

Transfer of cash by a new entity

15. Paragraph B18 of IFRS 3 states that a newly formed entity could be regarded as the acquirer when it transfers cash as consideration in the acquisition. This paragraph states that (emphasis added):

    > B18 A new entity formed to effect a business combination is not necessarily the acquirer. If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in paragraphs B13–B17. In contrast, **a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.**

16. In the fact pattern presented, Newco's acquisition of the subsidiaries (Sub 1 and Sub 2) is conditional upon the successful completion of the IPO, because in the absence of an IPO, there will not be any combination to account for. Through the IPO, Newco raises cash from the public (ie an unrelated party to the former controlling party) and is able to acquire the subsidiaries for cash. Consequently, we agree with the conclusion in View 1 that the IPO is an integral part of the transaction and that its completion is relevant for identifying the acquirer because it triggers a change in control as discussed in the paragraphs below.

Is Newco the acquirer?

Change in control

17. The obtaining of 'control' in paragraph 7 of IFRS 3 is, in our view, the fundamental concept for identifying the acquirer. Paragraph 7 defines the acquirer as 'the entity that obtains control of the acquiree'. In determining whether an entity has control over another entity, the guidance in IAS 27 *Consolidated and Separate Financial Statements*[1], should be followed. 'Control' is defined in paragraph 4 of IAS 27 as the 'power to govern the financial and operating policies of an entity so as to obtain benefits from its activities'.

18. In the fact pattern presented, the acquisition of the subsidiaries by Newco will result in a change of control of the subsidiaries when the transfer occurs because:

    (a) Entity A will lose control of virtually 100 per cent ownership in Newco and will maintain only a nominal ownership interest in the Newco; and

[1]For annual periods beginning on or after 1 January 2013 the guidance in IFRS 10 *Consolidated Financial Statements* should be followed. **'Control of an investee'** is defined in Appendix A of IFRS 10 as follows: 'An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee'.

(b) Newco's new shareholders will obtain control of the subsidiaries using the cash raised through the IPO.

19. We think that the transaction described in the fact pattern is, in substance, no different from an arm's length transaction in which Newco's new controlling shareholders directly acquire, for cash, Sub 1 and Sub 2 from Entity A.

20. In addition, in our opinion this fact pattern does not reflect a situation of a business combination under common control as defined in paragraph B1 of IFRS 3, where '…all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory', because before the completion of the IPO, Entity A controlled the subsidiaries and after the IPO, Newco's new controlling shareholders acquire control.

21. Consequently, we think that, in line with View 1, it could reasonably be concluded that Newco becomes the acquirer in this business combination[2] because Newco:

(a) independently raised necessary cash to fund the acquisition of the subsidiaries (Sub 1 and Sub 2) through the successful completion of an IPO; and

(b) obtains control in the subsidiaries acquired and it is not controlled by the former shareholders of the acquired subsidiaries.

[2] Our conclusion is similar to the one in EIC-145, *Basis of accounting for assets acquired upon the formation of an income trust* (issued in March 19, 2004) by the Canadian Institute of Chartered Accountants (CICA), which describes a similar fact pattern to the submission received. This Interpretation describes the transfer of a business to an income trust that is conditional on the income trust IPO's completion. The Interpretation concludes that (a) the acquisition results in a *substantive change* in the ownership interests of the subsidiary; and (b) the IPO provides independent evidence of the exchange amount for the ownership interest in the subsidiary as a result of the participation of unrelated parties in determining the exchange amount.

22. In our opinion, because Newco would be identified as the acquirer, it would account for the acquired businesses as a business combination using the acquisition method as described in paragraph 4 of IFRS 3.

Is the identity of the party that formed the Newco relevant?

23. Proponents of View 2 argue that because Entity A initiated the combination, Entity A should be considered the acquirer in accordance with paragraph B17 of IFRS 3, which states that (emphasis added):

> B17 In a business combination involving more than two entities, **determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination**, as well as the relative size of the combining entities.

24. We do not agree. In accordance with paragraph 7 of IFRS 3, it is who obtains control, (and not who incorporates the new entity), the main feature that determines who the acquirer is in a business combination.

Outreach request to national standard-setters

25. We asked a group of standard-setters in different countries to provide us with feedback on whether the issue raised in the submission:

    (a) is widespread and has practical relevance.

    (b) indicates that there are significant divergent interpretations (either emerging or existing in practice).

26. In our request we included the information we are reproducing in Appendix A of this paper. We asked the national standard-setters the following two questions:

    (a) What in your experience is the prevalence of the transactions described in the submission? This is, how common the transactions described therein are within your jurisdiction, and if they do occur, if you could provide us with information that the Committee could use to assess how widespread the issues that have been raised are; and

    (b) In your view, is there diversity in practice in the accounting for the transactions described in the submission? Please describe the predominant accounting approach (or approaches) that you observe in your jurisdiction?

27. We received 18 responses. Only 4 of them considered the issue to be prevalent in practice and 2 noted significant divergent interpretations (either emerging or existing in practice).

Is the transaction prevalent?

28. Four national standard-setters considered the issue to be prevalent in practice. One respondent states that these transactions are common in group restructurings (eg spin-offs, disposals) or when refinancing a new business. Another respondent expects that the transaction referred in the submission will become more prevalent as the economy recovers. Another one noted that while in the majority of cases 100 per cent of the shares are sold to third parties, it is also common for the original parent company (Entity A in the submission) to retain a controlling interest in Newco.

29. A total of 14 national standard-setters do not consider the issue to be prevalent because of the following reasons:

    (a) some jurisdictions have strict local requirements to give effect to an IPO (eg a Newco has to be established for 3 years before an IPO can occur);

    (b) the Newco normally acquires the business before the IPO occurs; and

    (c) it is not common for a parent company (eg Entity A) to maintain a nominal interest in Newco; normally, Entity A will keep control of the Newco after the IPO occurs.

Feedback received on the existence of diversity in practice

30. One national standard-setter notes differing views in practice on whether or not the transaction is a business combination under common control and that a clarification on how ‘conditionality’ should be regarded in transactions similar to the one that is described in the fact pattern might help to bring about a convergence of the views.

31. Another respondent noted that the acquisition method and the pooling of interests method are the most prevalent methods in accounting for such a transaction.

Agenda criteria assessment

32. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *The issue is widespread and has practical relevance.*

    No.

    Based on our outreach on this issue, we understand that the specific structure of the transaction described by the submitter is not widespread.

    (b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

    No.

    Based on our outreach on this issue, we do not expect divergent interpretations in practice, because the transaction described by the submitter is not common in practice.

    (c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

    No.

    On the basis of our outreach on this issue, most of the respondents agree with View 1, described in paragraph 8(a) of this agenda paper (ie that the IPO is a critical feature).

    (d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

    We do not believe that there is a need to incorporate additional guidance to clarify the requirements in IFRS 3 on the identification of the acquirer.

    (e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Not applicable. In our opinion, no formal interpretation is needed for this issue.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

Not applicable. We do not believe that the IASB should add this issue into its agenda.

Staff recommendation

33. On the basis of our technical analysis (described in paragraphs above), and of our assessment of the Committee's criteria, where we noted that the issue is not prevalent and that there is not significant diversity in practice, we do not recommend that the Committee should take this issue onto its agenda. We think that IFRS 3 already provides sufficient guidance for the identification of the acquirer in paragraph 7, and in paragraphs B13–B18.

Questions for the Committee
1. Does the Committee agree that an acquisition that is conditional on the completion of an initial public offering is a critical feature of the transaction, and consequently that Newco is considered to be the acquirer and that the transaction is a business combination? 2. Does the Committee agree with the staff's recommendation that the Committee should not add this issue to its agenda? 3. Does the Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A—Proposed wording for tentative agenda decision

A1 The staff propose the following wording for the tentative agenda decision:

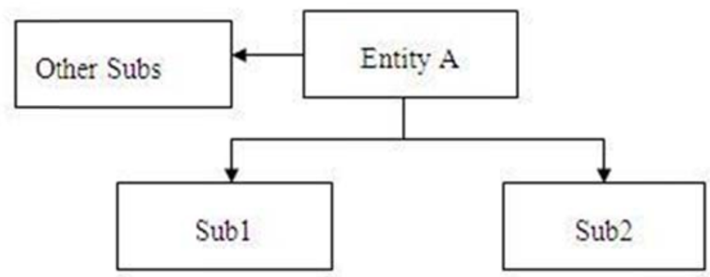
> **IFRS 3 *Business Combinations*—identification of the acquirer**
>
> The Interpretations Committee received a request for guidance on the circumstances or factors that are relevant when identifying an acquirer in a business combination under IFRS 3 *Business Combinations.* More specifically, the submitter requested the Committee to clarify whether the existence of a condition (for example, an initial public offering) that is imposed to effect the acquisition of subsidiaries by a new entity that has been formed to effect a business combination (and the identity of the party that formed this new entity), is relevant in this identification.
>
> The Committee observed that paragraphs 7 and B13-B18 in IFRS 3 provide sufficient guidance for the identification of the acquirer in a business combination. In addition, the Committee noted that the issue is not prevalent and that there is not (current or emerging) significant diversity in practice.
>
> Consequently, the Interpretations Committee [decided] not to add the issue to its agenda.

Appendix B

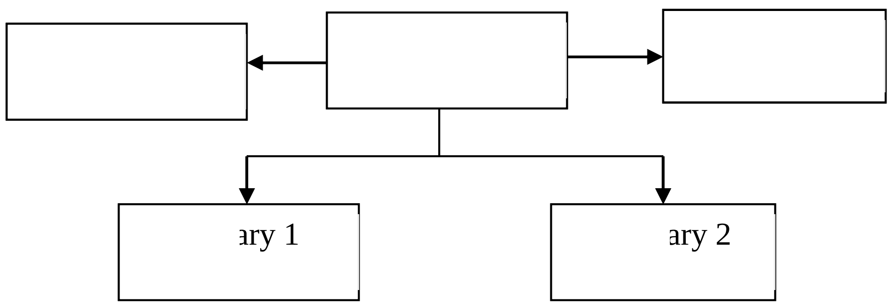
IFRIC AGENDA ITEM REQUEST

<u>The issue:</u> Newco entering into a conditional acquisition. Application of IFRS 3 *Business Combinations* where a newly formed entity (Newco) is established to acquire another entity, where the acquisition is conditional on the occurrence of another event that results in a loss of control of Newco.

It is common practice for a group to spin-off a part of its business in an Initial Public Offering (IPO). In some jurisdictions, this is done via the group establishing a Newco, which will be the listing entity. However, Newco will only acquire that part of the group being spun-off at the time that the IPO occurs – the same time that there is a change in ownership of Newco and therefore a change in control. The typical arrangement is set out below:

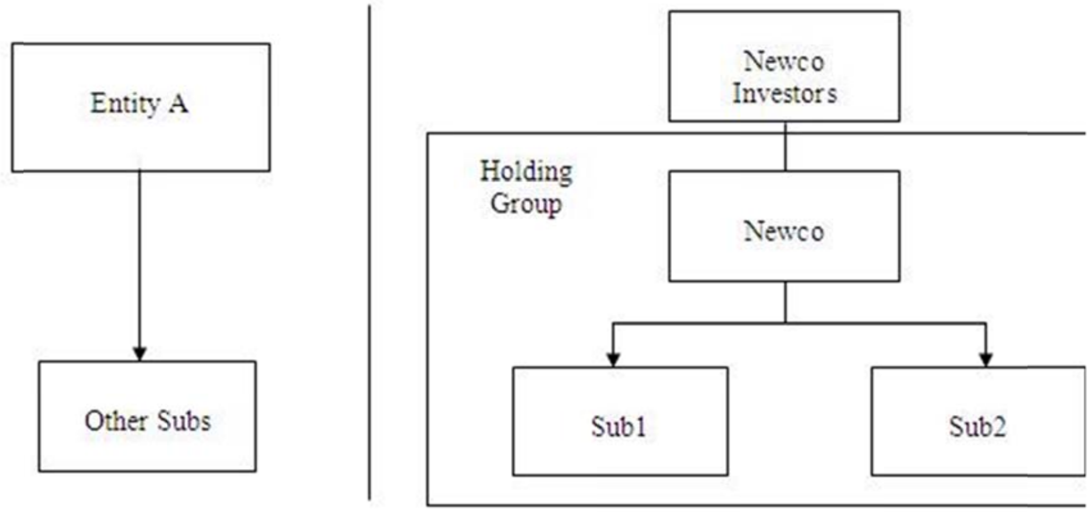


- To facilitate the spin-off, Entity A incorporates a new company (Newco) with nominal equity and appoints independent directors to the Board of Newco.



- Newco signs an agreement to acquire Sub1 and Sub2 from Entity A conditional **upon** on the IPO occurring. If the IPO does not occur the transaction is dissolved.
- Newco issues a prospectus offering to issue shares for cash to provide Newco with funds to acquire Sub1 and Sub2.
- The IPO occurs and Newco acquires Sub1 and Sub2 for cash.
- Because Entity A holds only nominal equity, virtually 100% ownership in Newco is held by the new investors.
- After the IPO occurs, the respective group structures of Entity A and Newco

appear as follows:



Paragraph B18 of Appendix B to IFRS 3 states that a newly formed entity (Newco) that transfers cash or other assets as consideration **may be** the acquirer in a business combination. Whenever a newly formed entity (Newco) is formed to effect a business combination other than through the issuance of shares, Newco can be considered an extension of one of the transacting parties.

What role does the conditionality of the acquisition have in determining who the acquirer is?

Current practice:
Different views exist as to the role that the conditionality of the acquisition has as to whether or not this is a business combination under common control.

View 1: Conditionality is a critical feature and Newco is representative of the new shareholders

The conditionality of the transaction means that the transaction cannot be considered complete until all conditions have been removed. That is, as the whole transaction dissolves if the IPO does not proceed, it cannot be accounted for as occurred until this possibility is resolved. Because the condition relates to the IPO, upon which the change in shareholders occurs, the change in ownership and control must be considered an integral element of the transaction.

However, this is only relevant when the establishment of Newco creates a new reporting unit/group that previously did not exist. Thus, Newco has a purpose for the new shareholders and can be considered to represent them even though the existing Parent (Entity A) establishes Newco.

View 2: Conditionality is not a critical feature and Newco is an extension of the party that formed Newco

Which party establishes Newco is the critical feature in assessing whether Newco is the acquirer, and the fact that the acquisition is conditional on another event is not relevant. Determining who establishes the Newco is also dependent on who initiated the transaction.

Therefore, in most cases where the conditionality is the occurrence of an IPO, the Parent (Entity A) made the strategic and operational decisions to create the Newco and structure the arrangement to facilitate the disposal, which will be considered for the Parent's (Entity A's) benefit and not that of the new shareholders. In such cases the Newco is considered to represent the existing owners and further assessment is then needed to determine whether it is an extension of the Parent (Entity A) or one of the subsidiaries involved in the spin-off (in the scenario noted).

<u>Reasons for the IFRIC to address the issue:</u>

Our assessment of the agenda criteria is as follows:

(a) *The issue is widespread and has practical relevance.*

This issue is widespread, and has a significant impact on the financial statements of the newly formed entity, because when view 1 is taken, the acquisition method is applied by Newco and both Sub1 and Sub 2 are recognised at fair value; however, when view 2 is taken, only Sub 1 or Sub 2 would be recognised at fair value.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

There are diverse views regarding the circumstances under which a newly formed entity is regarded as the acquirer. We are aware of preparers, auditors, and regulators that hold each of the views above.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Yes, given the significant divergence in practice, and the significant impact on the financial statements, as noted in (a) and (b), financial reporting would be improved through elimination of one of the views.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

Yes, we believe that the process can be resolved efficiently within the confines of IFRS 3.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Yes, we believe that the process can be resolved efficiently within the confines of IFRS 3.

(f) *If the issue relates to a current or planned IASB project, there is a need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

While the Board has stated that it intends to perform a post-implementation review of IFRS 3, work on this project has not yet commenced and is not expected to commence until three years after IFRS 3 became effective (or 1 July 2012). This issue is currently arising in practice and is expected to increase as the number of IPOs increases as the economy strengthens. Therefore, there is a need to address this issue before the Board will otherwise address it.

Specifically, we request that the Committee address the following questions:

What circumstances or factors are relevant when assessing whether a newly formed entity is the acquirer in a business combination? In particular:

- When a transaction is conditional upon an event occurring, is the conditionality relevant to the assessment of identifying the acquirer?
- When a new entity is formed, is the identity of the party that formed the new entity relevant?