Project	**New items for consideration**
Topic	**IFRS 3 *Business combinations*—business combinations under common control**

Introduction

1. In April 2011, the IFRS Interpretations Committee (the Committee) received a request for guidance on business combinations under common control (BCUCC). More specifically, the submitter provides a fact pattern that illustrates a type of a common control transaction in which an entity transfers a business into a new entity (referred to as 'Newco'). The submission requests clarification on the following issues:
   - (a) the accounting at the time of the transfer of the business to a Newco;
   - (b) whether an imminent initial public offering (IPO) that might occur after the formation of Newco is considered relevant in analysing the transaction in accordance with IFRS 3; and
   - (c) whether a business that is not a legal entity could be considered the acquirer in a reverse acquisition under IFRS 3.
2. In the submitter's view, the lack of accounting guidance in IFRSs for BCUCC causes divergent and inconsistent accounting for transactions that are similar in nature. The submitter suggests that the Committee should add BCUCC to its agenda.
3. The submission is reproduced in full in Appendix B.

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.

Objective

5. The objective of this paper is to:

   (a) provide background information for the issues 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 issues 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.

Structure of the paper

6. This agenda paper is organised as follows:

   (a) **Issue 1:** discusses whether IFRS 3 can be applied to account for the transfer of a business to a Newco;

   (b) **Issue 2:** discusses whether an imminent initial public offering that might occur after the formation of Newco is considered relevant in identifying the acquirer under IFRS 3; and

   (c) **Issue 3:** discusses whether a business that is not a legal entity can be considered the acquirer in a reverse acquisition under IFRS 3.

Issue 1: Application of IFRS 3 to the transfer of Business A to a Newco

Description of the issue

7. The submission describes a fact pattern in which the parent company (Entity A), which is 100 per cent owned by Shareholder A, transfers a business (Business A) to a new entity (Newco) formed by Shareholder A.

8. An illustration of the structure of the group before and after the transfer of Business A to Newco is shown in Appendix B.

9. The submitter states that the fact pattern described in the submission is a business combination between entities under common control and that IFRS 3 does not apply to this fact pattern because:

   (a) paragraph 2(c) excludes business combinations under common control from its scope;

   (b) paragraph B1 of IFRS 3 excludes business combinations that are under common control and in which control is not transitory;

   (c) none of the combining entities in the fact pattern can be identified as the acquirer, for the following reasons:

      (i) none of the factors included in paragraphs B13-B18 of IFRS 3 would apply to Newco so that it can be identified as the acquirer.

      (ii) Newco is not considered a business (as defined in Appendix A of IFRS 3); and consequently Business A cannot be the acquirer in a business combination.

10. Consequently the submitter identifies the following alternative accounting treatments for recognising the transfer of Business A into Newco:

    (a) **Acquisition method—**Newco would apply IFRS 3's guidance by analogy to account for the transaction.

    (b) **Pooling of interests method—**assets and liabilities of both commonly controlled entities are not to be remeasured. Instead, they are presented at book values as if the entities had always been combined from the beginning of the earliest period presented. Comparative information includes the combined results of both Business A and Newco.

(c) **Reverse recapitalisation accounting—**the accounting is similar to that resulting from a reverse acquisition, except that no goodwill is recorded.

11. The submitter asks for the Committee's views on which accounting treatment should be followed.

Staff analysis of Issue 1

12. We think that in the fact pattern described by the submitter, there is no change of control as a result of the transfer of Business A to Newco, because it is the same party (Shareholder A) that controls the combining entities both before and after the transfer of Business A (this is, prior to an IPO occurring).

13. Consequently, we think that in line with paragraph B1 of IFRS 3 (quoted below), this transaction can effectively be described as a business combination under common control, as follows:

> B1 This IFRS does not apply to a business combination of entities or businesses under common control. **A business combination involving entities or businesses under common control is a business combination in which 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.

14. Business combinations under common control are specifically excluded from the scope of IFRS 3 as stated in paragraph B1 (above) and in paragraph 2(c) of IFRS 3. In the absence of specific guidance to account for business combinations under common control, entities should select an appropriate accounting policy using the hierarchy described in paragraphs 10 to 12 of IAS 8, *Changes in Accounting Estimates and Errors.*

15. Under this process, accounting policies are developed by judging all the sources that are included in the IAS 8 hierarchy, including:

(a) making **analogies** for similar transactions when appropriate as stated in paragraph 11(a) of IAS 8; or

(b) considering the **most recent pronouncements of other standard-setting bodies** that use a similar conceptual framework to develop accounting standards, as stated in paragraph 12 of IAS 8.

Application of IFRS 3 by analogy

16. As we concluded in our meeting with the Committee in January 2011, regarding the application of IFRSs by analogy in accordance with IAS 8 (refer to Agenda Paper 5), when management develops an accounting policy by analogy to an IFRS dealing with similar and related matters, it needs to use its judgement and apply all aspects of the IFRS that are relevant to the particular issue.

17. Application by analogy of IFRS 3 to the fact pattern described in the submission involves considering and understanding the scope exclusions in that standard. In our view, if a transaction has been excluded from the scope of a particular standard, then the reason for this scope exclusion should be identified. This reason might prevent application by analogy, or might require some modification of the accounting policy to take account of the reason for the scope exclusion.

18. We think that the Board decided to exclude BCUCC from the scope of IFRS 3 as a provisional measure to avoid a delay in the issue of IFRS 3 (2008) and because it is the Board's intention to address BCUCC at a later stage. An extract of paragraphs BC59 of IFRS 3 and of the IASB Update (September 2004) sets out these facts, as follows:

[IASB Update September 2004]

....

> **The Board also noted that some of the business combinations are excluded from the scope of IFRS 3 as an interim measure**, because the Board is considering issues relating to accounting for those combinations in phase II of its Business Combinations project. (*See also* Business Combinations (phase I) *above*.)

[IFRS 3 – 2008]

BC 59 Formations of joint ventures and combinations of entities under common control are excluded from the scope of the revised standards. Those transactions were also excluded from the scope of both IFRS 3 and SFAS 141, and the boards continue to believe that issues related to such combinations are appropriately excluded from the scope of this project. **The boards are aware of nothing that has happened since IFRS 3 and SFAS 141 were issued to suggest that the revised standards should be delayed to address the accounting for those events**.

19. Despite business combinations under common control being excluded from the scope of IFRS 3, it is our view that management can still look at IFRS 3 for guidance in developing an accounting policy. We found evidence of a situation in which the Board has permitted the application of an IFRS for transactions that have been excluded from its scope. When addressing combinations by contract alone or involving mutual entities (as referenced in the IASB Update of September 2004), the Board stated:

> (...)
>
> In accordance with IAS 8, an entity is precluded from applying a superseded Standard, such as the guidance in IAS 22 Business Combinations that was withdrawn in March 2004, when accounting for combinations involving mutual entities or by contract alone without the obtaining of an ownership interest. **However, entities would be permitted to look to IFRS 3 for guidance.**

20. However, we think that applying IFRS 3 by analogy might be subject to different interpretations. When accounting for a BCUCC, some might interpret it as applying only some aspects of the guidance in IFRS 3.

21. In the fact pattern presented, if only *some* aspects of IFRS 3 were to be considered, management might choose to designate the newly formed entity as being the acquirer despite it not fulfilling the requirements relating to the identification of the acquirer in IFRS 3; ie, in the fact pattern, Newco does not obtain control of Business A because all of the combining entities are ultimately controlled by the same party (Shareholder A) both before and after the combination. All other aspects of the acquisition method of accounting

contained in IFRS 3 would be applied, because they are considered to provide relevant and reliable information.

Application of pronouncements of other standard-setting bodies

22. As we discussed above, combinations between entities or businesses under common control are excluded from the scope of IFRS 3 and there is no other IFRS or interpretation providing specific guidance on the accounting for those transactions. In accordance with IAS 8, preparers may consider the pronouncements of other standard-setting bodies and other accounting literature to find guidance on the accounting for BCUCC.

23. For example, a preparer could refer to the existing guidance in US GAAP in Topic 805-30-05 *Transactions Between Entities Under Common Control* in the *FASB Accounting Standards Codification®* which contains limited guidance on the accounting for those transactions[1]. This paragraph requires the entity in a BCUCC to recognise assets acquired and liabilities assumed in the transaction at their carrying amounts in the accounts of the transferring entity at the date of transfer, as follows (emphasis added):

> 30-5 **When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer.** If the carrying amounts of the assets and liabilities transferred differ from the historical cost of the parent of the entities under common control, for example, because pushdown accounting had not been applied, then the financial statements of the receiving entity shall reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control.

24. We are aware that other standard-setters and professional bodies have issued national accounting guidance to account for combinations between entities or businesses under common control, but the accounting treatment might not be the

[1] Topic 805-10-15- 4 *Business Combinations (Scope and scope exceptions)* in the US *FASB Accounting Standards Codification®* **excludes** BCUCC in paragraph (c): 'a combination between entities, businesses, or nonprofit activities under common control'.

same. For example, based on our outreach with national standard-setters, it seems that for some the ‘pooling of interest method’ is the most commonly used to account for BCUCC in some jurisdictions, but some others prefer the acquisition method, because they believe that the application of this method results in more relevant and reliable information. Some even cautioned that the fact that the pooling of interest method might be contradictory to the guidance in IFRSs, because IFRSs do not prescribe the use of carrying amounts at initial recognition.

25. In addition, there are different interpretations of what the ‘pooling of interests method’ means. Based on our outreach:

(a) some interpret the pooling of interests method in the way in which IAS 22 *Business Combinations* described it (IAS 22 was replaced by IFRS 3 in 2004 and the latter was subsequently updated in 2008); other jurisdictions use a variation on the ‘pooling-of-interests’ method and call it ‘predecessor’s value method’.

(b) some would restate comparative financial statements for the new reporting group whereas others would not restate them.

(c) it is not clear which amounts should be carried over when applying the pooling of interests method (ie whether they should be the carrying amounts in the financial statements of the entity that transfers the business; the carrying amounts in the individual financial statements of the entity transferred; the carrying amounts in the consolidated financial statements of the ultimate parent or the carrying amounts in the consolidated financial statements of any intermediate parent).

26. On the other hand, the submitter refers to the use of ‘reverse recapitalisation accounting’ for accounting for BCUCC. This accounting method is similar to the one that is applied to a reverse acquisition (paragraphs B19 – B22 in IFRS 3 contain guidance in this respect), except that goodwill cannot be recognised.

Based on our outreach with national standard-setters, this accounting method is not applied in practice.

27. We think that the Committee should not give an interpretation as to which accounting method should be used to account for a BCUCC, for the following reasons:

    (a) the Board has explicitly excluded BCUCC from the scope of IFRS 3 because it plans to deal with the accounting for this type of combinations at a later stage; and

    (b) the issue regarding the accounting for BCUCC is too broad to be addressed by an interpretation.

28. Our conclusion is based on previous tentative decisions made by the Committee when it has been asked to provide guidance for issues that have been excluded from the scope of IFRSs. For example, in March 2006, the Committee was asked to consider a request to provide guidance on how to apply IFRS 3 to reorganisations in which control remains within the original group. However, the Committee declined to add this topic to its agenda. The following extract from the IFRIC Update (from March 2006) reflects the reasons why the Committee made this decision (emphasis added):

> ...
>
> The IFRIC also considered a request for guidance on how to apply IFRS 3 to reorganisations in which control remains within the original group. **The IFRIC decided not to add this topic to the agenda, since it was unlikely that it would reach agreement in a reasonable period, in the light of existing diversity in practice and the explicit exclusion of common control transactions from the scope of IFRS 3**.

29. In December 2007 (refer to Agenda Paper 5C) the Board decided to add to its active agenda a project on common control transactions. The Board tentatively decided that the scope of the common control transactions project should include:

(a) the accounting in the acquirer's consolidated and separate financial statements,

(b) the definition of what a common control transaction is, and

(c) the accounting for demergers and spin-offs.

30. The Board paused the project in 2009, but the project could be restarted. In order to encourage the Board to take the project forward, the European Financial Reporting Advisory Group (EFRAG) has established a proactive project on business combination under common control. The EFRAG's project will result in a Discussion Paper that is scheduled to be published in the next few months. In addition, we are aware that the Korean Accounting Standards Board (KASB) is also performing some research work on the accounting for BCUCC.

31. On the basis of the factors mentioned above, we think that the Committee should avoid giving interpretations on the accounting for BCUCC because the Board has deliberately excluded these combinations from the scope of IFRS 3 as it plans to deal with them at a later stage.

Issue 2: Effect of an imminent public offering on the identification of the acquirer

Description of the issue

Newco is substantive (ie could be identified as the acquirer)

32. The submitter describes a situation in which an IPO might occur after the transfer of Business A to Newco takes place and asks whether this situation might affect the identification of the acquirer.

33. In the submitter's view, a public offering of Newco's shares that might occur after the transfer of Business A to Newco, could cause either:

(a) a loss of control from Shareholder A of Newco and Business A; or

(b) a significant change of ownership interests in Newco, even when control is maintained by Shareholder A.

34. In the submitter's view, in any of the circumstances described above, Newco should be considered a 'substantive' entity and should be identified as the acquirer. The submitter requests the Committee's views on this.

Is control transitory?

35. The submitter asks whether common control of Newco and Business A could be considered transitory as a result of the IPO (ie Newco would be temporarily controlled by Shareholder A). As a consequence, the submitter asks whether this transaction would still be considered a business combination under common control.

Staff analysis of Issue 2

36. In our view, the transfer of Business A to Newco should be accounted for by considering the facts that happened at the date of the transfer and not the facts that have not happened yet. In our view, at the date of the transfer:

(a) there is no change in control of Shareholder A over Newco and Business A; and

(b) the outcome of the IPO is unknown, as it will depend on future capital market conditions.

37. Consequently, we think that the possibility of an IPO occurring should not impact the categorisation of this transfer as a BCUCC.

38. The submitter also asks whether common control of Newco and Business A could be considered 'transitory' because of an imminent IPO and, consequently, whether the transaction would no longer be considered a BCUCC in accordance with paragraph B1 of IFRS 3, which states that (emphasis added):

> B1 This IFRS does not apply to a business combination of entities or businesses under common control. A business combination involving entities or businesses under common control is a business combination in which 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**.

39. We observe that the meaning of ‘transitory’ is not explained in IFRS 3. However, we believe that it was intended to ensure that the acquisition method could not be avoided by structuring ‘grooming transactions’ as explained in paragraph BC 28 of IFRS 3 issued in 2004 (emphasis added):

> BC 28 The Board noted the concern expressed by some that **business combinations between parties acting at arm’s length could be structured through the use of ‘grooming’ transactions so that, for a brief period immediately before the combination, the combining entities or businesses are under common control. In this way, it might be possible for combinations that would otherwise be accounted for in accordance with the IFRS using the purchase method to be accounted for using some other method.** Thus, the Board decided that for a business combination to be excluded from the scope of the IFRS as one involving entities or businesses under common control, the combining entities or businesses should be controlled by the same party or parties both before and after the combination, and that control should not be transitory.

40. We think that the rationale behind the paragraph above mentioned is still valid in IFRS 3 (2008), in spite of the Board having decided not to address BCUCC as explained in paragraph BC59. Consequently, in our view, in the fact pattern presented, the combining entities or businesses, both before and after the transfer of Business A to Newco, are ultimately controlled by the same shareholder and control is not ‘transitory’.

Issue 3: Can a business that is not a legal entity be considered the acquirer in a reverse acquisition?

Description of the issue

41. The submitter asks for clarification on whether IFRS 3 allows a business that is not a legal entity to be the acquirer, in the case in which a reverse acquisition has taken place and a business combination is accounted for under that basis. In this regard, the submitter identifies two alternative views, as follows:

    (a) View 1—a business can be an acquirer in a reverse acquisition because it would be inconsistent to have (in substance) different outcomes for the same transaction depending upon whether a legal entity exists.

(b) View 2—a business cannot be an acquirer in a reverse acquisition because the guidance in IFRS 3 states that an acquirer can only be 'an entity' (presuming this means a 'legal entity').

Staff analysis of Issue 3

42. IFRS 3 describes an acquirer as an 'entity' and an acquiree as a 'business', as follows:

(a) In accordance with paragraph 7 of IFRS 3: the acquirer is '**the entity** that obtains *control* of the acquiree' (emphasis added).

(b) In accordance with Appendix A of IFRS 3: the acquiree is '**The business or businesses** that the **acquirer** obtains control of in a **business combination**' (emphasis added).

(c) The reverse acquisition guidance in paragraph B19 of IFRS 3 also requires that the acquirer must be 'an entity', as follows: '...**the entity whose equity interests are acquired (the legal acquiree) must be the acquirer** for accounting purposes for the transaction to be considered a reverse acquisition' (emphasis added).

43. We think that an acquirer in a reverse acquisition does not need to be a 'legal entity'. We think that in accordance with the guidance in IFRS 3, as long as a 'business' is a 'reporting entity' it can be considered the acquirer in a reverse acquisition. This is because in our view, the notion of an 'entity' in IFRS 3 refers to the concept of the 'reporting entity' notion as defined in the exposure draft *Conceptual Framework for Financial Reporting: The Reporting Entity*, as follows:

> RE2 A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.

44. The *Framework for the Preparation and Presentation of Financial Statements* (replaced by the first edition of the *Conceptual Framework for Financial Reporting* issued in September 2010) defined a 'reporting entity'[2] in paragraph 8 as follows (emphasis added):

> 8 The Framework applies to the financial statements of all commercial, industrial and business reporting entities, whether in the public or the private sectors. **A reporting entity is an entity for which there are users who rely on the financial statements as their major source of financial information about the entity.**

Outreach request to national standard-setters

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

    (a) are widespread and have practical relevance.

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

46. In our request, we included the information that we are reproducing in Appendix B 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?

[2] The Board has plans to add *Chapter 2: the Reporting Entity* to the IASB's *Conceptual Framework for Financial Reporting*.

Feedback received

47. We received 18 responses from national standard-setters. The respondents consider the fact pattern described in the submission to be a BCUCC. Also, a great majority think that the issue about the accounting for a BCUCC is prevalent in practice and note significant divergent interpretations in practice.

Prevalence of the issues raised in the submission

48. Fourteen respondents consider the issue of how to account for BCUCC as being a prevalent issue. However, some respondents note that in the fact pattern described:

    (a) the specific structure of the transaction might differ. For example, it is more common to transfer a business to an existing entity within the group rather than to a new entity (Newco) prior to an IPO;

    (b) the parent company (in the fact pattern, Entity A) usually retains a controlling interest in the new entity <u>after</u> the IPO; and

    (c) the transfer of business to a new entity (Newco) is more common in financial institutions.

Existence of diversity in practice

49. Differing views in practice have been observed by 13 respondents when accounting for a BCUCC. The main comments received are the following:

    (a) entities account for BCUCC using either the acquisition method or the pooling of interests method, for example:

        (i) some apply the acquisition method to account for the BCUCC to ‘synchronise the accounting values of the assets and liabilities acquired with the tax values’;

        (ii) others apply the pooling of interests method because they say that they ‘do not want to introduce volatility to their future earnings’.

(b) the pooling of interests method seems to be the most used in practice because it does not regard Newco as the acquirer. However, diversity in practice exists in the application of the pooling of interests method.

(c) the reverse recapitalisation accounting method is not used in practice.

50. There are differing views on whether the Committee should take the issue on common control transactions onto its agenda. Some think that:

(a) the Committee should at least provide some relevant guidance on the accounting for BCUCC; and

(b) the accounting for BCUCC cannot be resolved within the boundaries of an interpretation, so the IASB should undertake a full review of common control transactions.

51. Two respondents mentioned that they have accounting guidance on business combinations under common control in their local GAAP.

52. Only few national standard setters made comments on Issue 3 (ie whether a business, that is not a legal entity, can be an acquirer in a reverse acquisition). The main comments received are the following:

(a) a business can be an acquirer 'depending on particular facts and circumstances';

(b) 'the current guidance, according to which the acquirer must be an entity is reasonable and helps to avoid definition problems'.

53. None of the respondents identified this issue as widespread or having practical relevance.

54. In summary, on the basis of the responses received, we learned that:

(a) the issue on how to account for BCUCCs is widespread and divergence in practice exists on the application of accounting methods to account for the transaction illustrated in the fact pattern;

(b) the pooling of interests method and acquisition method are widely used in practice to account for BCUCC;

(c) divergence exists in the application of the pooling of interests method; and

(d) Issue 3 (ie whether a business, that is not a legal entity, could be considered the acquirer in a reverse acquisition) is not widespread.

Agenda criteria assessment

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

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

Yes.

On the basis of our outreach on this issue, we understand that the existence of divergent accounting treatments to account for BCUCC (ie the fact patterns described in Issue 1 and Issue 2) is widespread. However, the issue on whether, in a reverse acquisition, a business that is not a legal entity could be considered to be the acquirer does not seem to be a widespread issue.

(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.

Yes.

Based on our outreach, we understand that:

- it is sufficiently clear that the transaction is a BCUCC;
- both the pooling of interest method and the acquisition method are widely used in practice to account for BCUCCs;
- diversity in practice exists in the application of the pooling of interests method; and
- a reverse acquisition in which a business that is not a legal entity can be considered the acquirer is not a common issue that occurs

in practice. Consequently, we do not expect significant diversity in practice.

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

Yes.

The acquisition method and the pooling of interests method produce very different accounting results, which impairs the comparability of financial statements. In addition, the absence of guidance on the accounting for BCUCCs might cause users to make suboptimal investment decisions.

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

No.

We believe that the issue regarding the accounting for a BCUCC is too broad to be addressed by an interpretation. On the other hand, Issue 3 (ie whether a business that is not a legal entity can be considered to be the acquirer in a reverse acquisition) could be resolved efficiently within the confines of existing IFRSs.

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

No.

In our opinion, the issue regarding the accounting for a BCUCC is too broad. In addition, conflicting views exist in practice on the accounting for these transactions. Accordingly, we think that it is unlikely that the Committee could reach a consensus on this issue on a timely basis. However, we think that the Committee will be able to reach a consensus on a timely basis on Issue 3.

(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.*

No. We believe that the best approach to resolve this issue regarding the accounting for BCUCC would be for the IASB to reactivate the project on common control transactions.

Staff recommendation

Issue 1

56. On the basis of our analysis, and of our assessment of the Committee's criteria, we think that the issue regarding the accounting for a BCUCC:

    (a) is too broad to be addressed by an interpretation. We think that the Committee should avoid giving interpretations on the accounting for BCUCC because the Board has deliberately excluded these combinations from the scope of IFRS 3 as it plans to deal with them at a later stage.

    (b) should not be undertaken as a research project on behalf of the Board because it is our understanding that other organisations have established projects on business combination under common control (eg the EFRAG); and

    (c) should not be addressed by the Committee as a narrow scope project (ie which amounts should be carried over when applying the pooling of interests method) as we understand that preparers are applying in practice either the acquisition method under IFRS 3 or the pooling of interests method. We think that the main issue that the Board should address is which method is adequate to account for BCUCC.

57. Consequently, we do not recommend that the Committee should take this issue onto its agenda. In addition, we think that the Committee should encourage the IASB to reactivate its project on common control transactions because we noted that the issue on the accounting for BCUCC is widespread, there is significant diversity in practice and it is a regular topic in the submissions that the Committee receives.

Issue 2

58. We think that the fact pattern described in the submission is a BCUCC, despite the expectation that an imminent IPO will occur after the transfer of Business A to Newco. Accordingly, we do not recommend that the Committee should take this issue onto its agenda.

Issue 3

59. We think that in accordance with the guidance in IFRS 3, a 'business' that is a 'reporting entity' can be the acquirer in a reverse acquisition. However, we do not recommend that the Committee should take this issue onto its agenda because this issue is not widespread.

Questions for the Committee
1. Does the Committee agree that the issue regarding the accounting for BCUCC is too broad to be addressed by an interpretation? 2. Does the Committee agree that the transaction (ie the transfer of a business to a Newco) is a BCUCC despite the expectation that an imminent IPO will occur after the transfer of Business A to Newco? 3. Does the Committee agree that a business that is not a 'legal entity' can be the acquirer in a reverse acquisition? 4. Does the Committee agree with the staff's recommendation that the Committee should not add Issues 1, 2 and 3 to its agenda? 5. 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*—business combinations under common control**
>
> The Interpretations Committee received a request for guidance on business combinations under common control. More specifically, the submission provides a fact pattern that illustrates a type of a common control transaction in which an entity transfers a business into a new entity (referred to as 'Newco').
>
> The submission requests clarification on (a) the accounting at the time of the transfer of the business to Newco; (b) whether an imminent initial public offering (IPO) that might occur after the formation of Newco is considered relevant in analysing the transaction under IFRS 3 *Business Combinations* and (c) whether a business that is not a legal entity could be considered to be the acquirer in a reverse acquisition under IFRS 3.
>
> The Committee observed that for issues (a) and (b), IFRS 3 explicitly excludes business combinations under common control from its scope. The Committee noted that these two issues are widespread and that diversity in practice exists. However, the Committee also observed that the issue regarding the accounting for these transactions is too broad to be addressed by an interpretation and that the Board has planned to address the accounting for business combinations under common control at a later stage.
>
> In addition, for issue (c) the Committee observed that this issue is not widespread.
>
> Consequently, the Committee [decided] not to add these issues to its agenda.

Appendix B

IFRIC AGENDA ITEM REQUEST

Re: Potential agenda item– business combinations and common control transactions

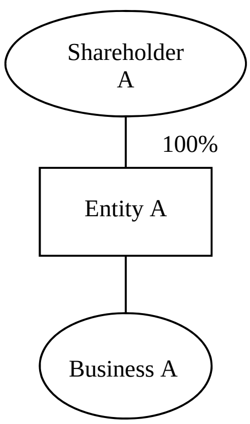
We are providing this letter to express our concerns with divergent accounting treatments under IFRS relating to common control transactions. IFRS does not provide guidance on accounting for common control transactions, and situations such as those outlined in this letter are not treated consistently by the large accounting firms and are also not treated consistently by securities regulators. The result is that the application of IFRS does not produce consistent financial reporting for similar transactions of this nature. We are aware that some of these issues have been considered in the past by the IFRS Interpretations Committee as well as by the International Accounting Standards Board (IASB or the Board) in considering a project for common control transactions. However, we ask the IFRS Interpretations Committee to consider these issues and determine if it should contemplate adding these as potential agenda items, or whether the Board could resolve some of these concerns through its annual improvements. We note that these issues are becoming more prevalent as additional countries adopt IFRS and believe that some form of additional guidance should be issued.

<u>Example transaction</u>

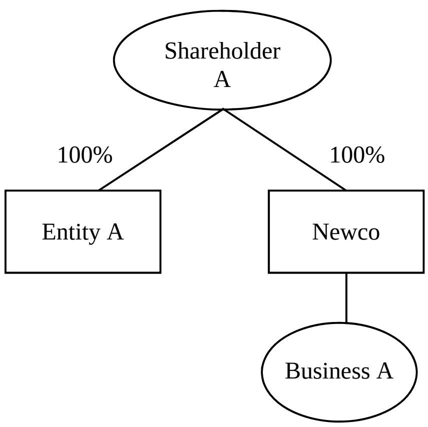
The following is an example of one type of common control transaction that results in inconsistent treatment:

Entity A, owned 100% by Shareholder A, transfers a business (Business A) into a Newco that has been formed for the purpose of acquiring Business A. Eventually Newco will raise new capital from public shareholders; however a period of several months may lapse before a prospectus offering may occur.

<u>Prior to transaction</u>



<u>After transaction</u>



Issue 1 – What is the accounting by Newco?

It would appear as though this transaction does not result in a change in substance or ultimate ownership of Business A and we have observed inconsistent accounting treatment for this type of transaction.

IFRS 3 *Business Combinations* provides guidance on accounting for the acquisition of a business. However, the above transaction is not in the scope of IFRS 3 as:

- The guidance in IFRS 3 paragraphs B13-B18 indicates that Newco cannot be the acquirer.
- Business A cannot be the acquirer in a business combination as Newco is not a business.
- The guidance in IFRS 3 paragraph B1 indicates that IFRS 3 does not apply to a business combination of entities or businesses under common control.

Given that IFRS is silent on the appropriate accounting treatment, an entity is required to apply IAS 8 *Accounting Policies, Changes in Estimates, and Errors* to determine an appropriate accounting policy. The large accounting firms have some discussion in their IFRS accounting publications and there is a divergence of opinions on this issue.[3] Commonly used accounting policies are:

(a) **Acquisition Method**– Assets and liabilities of Business A are accounted for at fair value from the date of the acquisition through analogy to IFRS 3. Comparative information includes only the results of Newco. The results of Business A are included from the date of acquisition.

(b) **Pooling Method of Accounting or Uniting of Interests Method of Accounting**: – Assets and liabilities of both commonly controlled entities are presented at book values as if the entities had always been combined from the beginning of the earliest period presented. Comparative information includes the combined results of both Business A and Newco.

(c) **Reverse recapitalization accounting:** Other standard setting bodies or securities regulators have issued guidance to reflect the substance of similar transactions as a recapitalization of Business A, equivalent to the issuance of stock by Business A for the net monetary assets of Newco. [4] The accounting is similar to that resulting from a reverse acquisition, except that no goodwill or other intangible assets are recorded.

Although we recognize the above accounting treatments are the most widely used, it has been observed that inconsistencies exist between these accounting approaches and IFRS standards. Additionally, we have noted use of other accounting policies identified as potential alternatives in accounting literature, such as the use of book values of the acquired business accounted for from the date of the transaction.

[3] Appendix A contains short extracts from the Large accounting firm publications on this issue.

[2] Topic 12 *Reverse Acquisitions and Reverse Recapitalizations,* US Securities and Exchange Commission, Division of Corporation Finance Financial Reporting Manual and Emerging Issues Abstract 10 *Reverse Takeover Accounting*, Canadian Accounting Standards Board

Issue 1 concern

In substance, Business A has not changed other than the transaction may have resulted in a change to its capital structure. In option (a) above, the accounting results in an omission of the results of operations prior to the acquisition by Newco, and also results in an omission of comparative information. For purposes of a prospectus, securities regulators often require financial statements for several years of Business A, however on an ongoing basis there is incomplete information in the financial statements of Newco.

We note that, in May 2006, the IFRS Interpretations Committee considered a request for guidance on how to apply IFRS 3 to reorganisations in which control remains within the original group. The IFRIC decided not to add this topic to the agenda, since it was unlikely that it would reach agreement in a reasonable period, existing diversity in practice, and the explicit exclusion of common control transactions from the scope of IFRS 3. We are concerned with this decision, given diversity continues and securities regulators differ on how to approach financial reporting for these transactions.

Issue 2 - What impact does an imminent public offering have on the accounting for Newco?

We understand that some conclude on the appropriate accounting in these situations by considering, among other factors, whether Newco is substantive, and/or whether Shareholder A's control over Newco is transitory in nature.

a) Is Newco substantive?

It is common for transactions such as the one in the example to precede a public offering of Newco shares. Some are of the view that a subsequent transaction resulting in a change of control over Newco and Business A that occurs shortly after the formation of Newco suggests that Newco is a substantive entity that should be considered to be the acquirer of Business A in a business combination. Other are of the view that Newco is a substantive entity when the subsequent transaction results in a *significant* change of ownership interests in Newco, even when control is still maintained by Shareholder A. Accordingly, we believe that clarification regarding if, and when, a Newco can be considered an acquirer is necessary.

b) Is the transitory nature of control of Newco by Shareholder A relevant?

If, in the circumstances described in part a), there is a change of control as a result of a public offering or similar transaction, we believe it should also be made clear whether the 'transitory' nature of control of Newco by Shareholder A may be relevant in determining whether the transaction is in the scope of IFRS 3.

We note that IFRS 3 *Business Combinations* does not apply to a business combination of entities or businesses under common control. Paragraph B1 of IFRS 3 provides the following definition:

> "a business combination in which 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" (emphasis added).

In paragraph BC28 of IFRS 3 (2004) the Board explained that business combination accounting should not be avoided simply because an unrelated entity is temporarily placed under the control of a parent before it is combined with an entity under existing control of the parent. However, there are differing views on whether common control of Newco and Business A should also be considered transitory where Newco is only temporarily controlled by Shareholder A for the purposes of facilitating a public offering.

We have noted that there is significant diversity in practice with respect to the accounting for these transactions and believe that clarification on whether, and how, a subsequent public offering can or should impact the accounting for the business combination would reduce this diversity.

Issue 3 – Can a 'business' be an acquirer?

We also believe the Interpretations Committee should address a question regarding reverse acquisitions. Note we have previously raised this issue in our comment letter for the 2009 annual improvements cycle, and have included it in this submission in order to obtain clarification on the subject. Specifically, an entity may legally acquire the business of another entity or the business segment of another group of entities. An acquired business segment might include businesses extracted from parts of entities within a larger vendor group. An acquired business segment could also include some legal entities in their entirety. If a business (including a business segment) as well as an "entity" (presuming this means a legal entity) can be treated as an acquirer, this will affect which assets are recognized at fair value and the amount of goodwill recognized in the transaction.

We understand that there are some accounting practitioners that hold the view that IFRS 3 was intended to allow a business (that is, not a legal "entity") as an acquirer in a reverse acquisition, and to account for business combinations on this basis. However, IFRS 3 describes an acquirer as an entity and an acquiree as a business. The reverse acquisition provisions also require the selection of an entity as the acquirer. These provisions would seem to preclude the possibility of a business that is not an entity being the acquirer in a reverse acquisition.

Those who believe that a business can be an acquirer in a reverse acquisition offer the logic that it would be inconsistent to have different outcomes for the substance of a transaction depending upon whether a legal entity exists. They believe that there are errors in the standards, and that the wording of the standards should be disregarded. Some of the practitioners who support the view that a business may be an acquirer argue that the term "entity" includes a business, but this view seems inconsistent with the construction of the standards.

Other practitioners believe that a business cannot be an acquirer in a reverse acquisition given the wording of IFRS 3 that an acquirer is "an entity." Further, most of the transactions in which debate is occurring involve cash acquisitions but as the reverse acquisition accounting provisions and the notion behind a reverse acquisition only refer to exchanges of equity interests, it would not seem possible that a reverse acquisition can occur in a cash exchange. IFRS 3 also specifically contemplates the situation where one of several legal entities from a larger group can be treated as the acquirer, with the assets of the other entities being recognized at fair value. Practical issues would include when to choose a business rather than an entity as the acquirer (particularly as businesses and entities can overlap) and how to determine the share capital and reserves attributable to a business.

If the IASB is of the view that a business can be the acquirer in a reverse acquisition, IFRS 3 would need to be amended to address the current uncertainty and diversity.

Brief Survey of Accounting Literature

The following extracts on this issue are noted in various publications:

Deloitte

"*There is currently no specific guidance on accounting for common control transactions under IFRSs. In the absence of specific guidance, entities involved in common control transactions should select an appropriate accounting policy using the 'hierarchy' described in paragraphs 10-12 of IAS 8…*

(Source: Deloitte iGAAP IFRS for Canada 2nd edition 38.2.2.2)

KPMG

"In our view, the acquirer in a common control transaction has a choice of applying either book value accounting or IFRS 3 accounting in its consolidated financial statements"

(Source: KPMG Insights into IFRS 2010-11 5.13)

"In our view, in its consolidated financial statements the acquirer is permitted, but not required, to restate its comparatives and adjust its current year prior to the date of the transaction as if the combination had occurred prior to the start of the earliest period presented. However, this restatement should not, in our view, extend to periods during which the entities were not under common control"

(Source: KPMG Insights into IFRS 2010-11 5.13.60.30)

"*In our experience usually it is appropriate to conclude that [where newco formations are used in a restructuring] no business combination has occurred...*

… accordingly, we believe that Newco should use book value accounting in its consolidated financial statements on the basis that there has been no business combination and in substance nothing has occurred".

(Source: KPMG Insights into IFRS 2010-11 Extracts, 5.13.200.10; 5.13.200.50)

E&Y

"in the absence of specific guidance in IFRS, management shall use its judgement in developing and applying an accounting policy that is relevant and reliable...management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, to the extent that these do not conflict with the Framework or any other IFRS or Interpretation. Several such bodies have issued guidance and some allow or require the pooling of interests method (or predecessor accounting or merger accounting as its known in some jurisdictions) in accounting for business

combinations involving entities under common control. Accordingly, until such time as the IASB finalises its conclusions under its project on common control transactions, we believe that entities should apply either the: (a) pooling of interests method; or (b) acquisition method (as in IFRS 3) in accounting for business combinations involving entities or businesses under common control."

(Source: E&Y International GAAP 2011 Chapter 10, 3.1)

"it would only be if the facts and circumstances meant that there was substance to the transaction [example 10.10] such that Newco could be regarded as the acquirer that the application of the acquisition method in IFRS 3 would result in fair values being attributed to the assets acquired and liability of the A group and the recognition of goodwill. For example, where the transaction was contingent on the completion of an IPO that resulted in a change in control of the A group"

(Source: E&Y International GAAP 2011 Chapter 10, 4.2)

PwC

"Business combinations involving entities under common control are excluded from IFRS 3's scope. However, management could refer to IFRS 3 in determining a policy for such transactions and decide to adopt the acquisition method as their accounting policy. IFRS 3 is the standard that applies to most business combinations. Business combinations between entities under common control are business combinations by definition, and it is legitimate to choose to apply IFRS 3 to such transactions. In that case, the requirements of IFRS 3 are applied in full.

Alternatively, as business combinations involving entities under common control are excluded from IFRS 3's scope, management could use predecessor accounting. This would be in line with some other GAAPs (for example, US and UK) that permit predecessor accounting to be used for group reconstructions and other common control transactions…

...The acquirer's financial statements can either:

(1) include the acquired entity's full year's results, even though the business combination may have occurred part of the way though the year; or
(2) include the acquired entity's results from the date of the business combination"…

… *Complications may arise where a common control transaction involves a new company set up by the group, in the case of an entity that adopts a policy of accounting for common control transactions under IFRS 3. In the context of IFRS 3, the combination of a new company and a single reporting entity is unlikely to meet the definition of a business combination: the new company will not be the acquirer, and the new company is not a business to allow the existing entity to be the acquirer in a reverse acquisition. As a result, the transaction would be accounted for as a capital reorganisation. Where a policy of predecessor accounting is used the transaction will qualify for the predecessor accounting method if it involves an entity acquiring a business."*

(Source: PwC Manual of Accounting, 2010, Extracts 25.403-25.407)