STAFF PAPER

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Prepared for Capital Markets Advisory Committee Meeting

Project	**Business combinations under common control**		
Paper topic	Information needs of investors for business combinations under common control		

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Background

1. IFRS 3 *Business Combinations* governs the accounting for the acquisition of a business. IFRS 3 requires acquisition method of accounting for a business combination. Under that method identifiable assets and liabilities of the acquired business are recognised in the consolidated financial statements of the acquirer at their acquisition-date fair values.

2. IFRS 3 excludes business combinations of entities under common control (herein referred to as BCUCC) from its scope. Paragraph B1 of IFRS 3 defines BCUCC as 'business combination[s] 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'. Arguably, these are different from other business combinations because:

   (a) they are transactions directed by the controlling party rather than arm's-length exchanges between unrelated parties and therefore the transaction price might not be representative of the fair value of the transferred business; and

   (b) the reason for such transactions could be different from the reason for entering into business combinations that are not under common control.

3. In light of the feedback received on the 2011 Agenda Consultation, the IASB identified BCUCC as a priority research project. The respondents to the 2011 Agenda Consultation expressed concerns about the absence of specific guidance on accounting for BCUCC under IFRS and diversity in practice.

4. At its June 2014 meeting, the IASB discussed the scope of the research project. It tentatively decided that the project should consider:

   (a) BCUCC that are currently excluded from the scope of IFRS 3;

   (b) group restructurings; and

   (c) the need to clarify the description of BCUCC, including the meaning of ‘common control’.

5. The IASB also tentatively decided to give priority to considering transactions that involve third parties , for example those undertaken in preparation for an initial public offering or those that involve non-controlling interests. This is an area of particular concern for securities regulators.

6. In July 2014 we started asking regional and national standard-setters and large firms for information about the current requirements in various jurisdictions regarding the financial information to be presented by an entity that is undertaking an initial public offering (IPO) of its securities, and especially when there is a group restructuring in preparation for the IPO. We are not seeking their views on what the requirements *should* be—it is simply helping us diagnose the problem. We will present the results of this outreach to the IASB during Q4 2014.

Objective of this meeting

7. In this meeting, we would like to better understand how investors assess and think about a new group that has been created as a consequence of a BCUCC. We will consider the feedback from this meeting when assessing the various alternatives to account for a BCUCC.

Scenarios for discussion

8. We have identified two general BCUCC scenarios that involve third parties, and have compared those with similar transactions that are not under common control. We would like to understand whether the information needs of investors are the same or different for each comparative scenario, and why.

Scenario 1

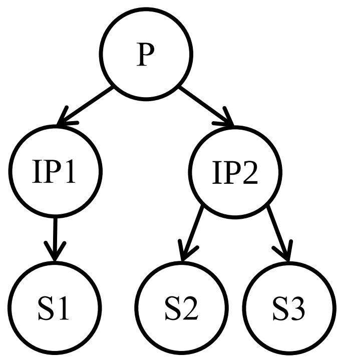
	Category of BCUCC	*Compared with*
Scenario 1	A group restructuring in preparation for an IPO of a group entity.[1]	An IPO of a group entity without any group restructuring.

9. Consider the following fact pattern. Entity P is the ultimate controlling party and entities IP1 and IP2 are the intermediate parent entities. Entity P is planning to sell some of its ownership interest in Entity IP1 through a listing in a public market. Entity IP1 has to file its financial statements (as part of the offer document) with the securities commission for the purpose of issuing its securities in the public market and getting its securities listed on the stock exchange.

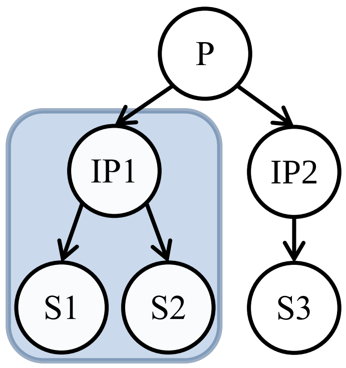
[1] In this paper, the term 'group entity' means an entity within a group controlled by an ultimate controlling party.

10. The group structures are as follows:

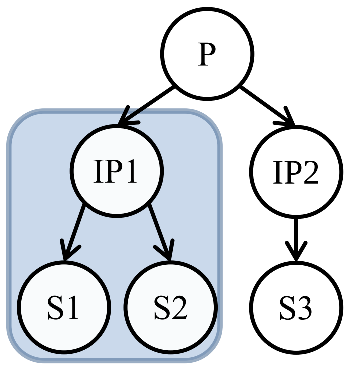
<table>
<tr>
<td>Scenario 1A
A group restructuring in preparation for an IPO of a group entity.</td>
<td>Scenario 1B
An IPO of a group entity <u>without</u> any group restructuring.</td>
</tr>
<tr>
<td>Before restructuring



</td>
<td rowspan="2">No restructuring



</td>
</tr>
<tr>
<td>After restructuring



</td>
</tr>
</table>

11. In Scenario 1A Entity P transfers one of Entity IP2's subsidiaries, Entity S2, to Entity IP1 prior to the IPO. In Scenario 1B, Entity IP1 is ready for the IPO in its current form and there is no need for any restructuring.

12. Assume that Entity IP1 has always prepared consolidated financial statements. In Scenario 1B, historical financial information of Entity IP1's group is readily available for inclusion in the offer document.

13. In Scenario 1A, historical financial information of the restructured Entity IP1's new group is not available because Entity S2 was not part of Entity IP1's group. Rather, it was acquired by Entity IP1 as part of the group restructuring. Accounting for such transactions is not specifically addressed by IFRS. Entity

IP1 could present the historical financial information of its new group using one of two approaches:

(i) as if Entity S2 had always been a part of Entity IP1's group, ie as if the new group of Entity IP1 had always existed; or

(ii) include Entity S2 from the date of acquisition of Entity S2 by Entity IP1.

Questions to the CMAC

1. In Scenario 1A, what information about Entity IP1's new group do investors need to be provided in Entity's IP1's consolidated financial statements?[2] Specifically, should the consolidated financial statements of Entity IP1 be prepared:

    a. as if Entity S2 had always been a part of Entity IP1's group; or

    b. including Entity S2 only from the date it was acquired by Entity IP1?

    Why?

2. If you believe Entity S2 should be included in the consolidated financial statements of Entity IP1 only from the date it was acquired, would the fair value of the assets and liabilities in Entity S2 provide useful information? Why or why not? If yes, would you want those fair values:

    a. to be recognised in the consolidated financial statements of Entity IP1; or

    b. to be disclosed in the notes?

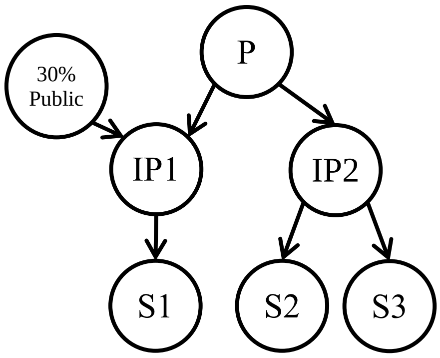
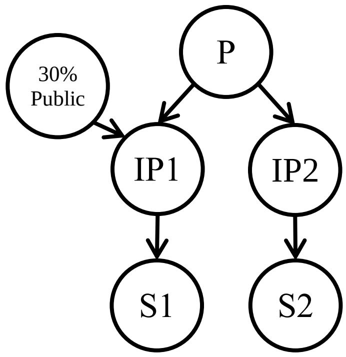
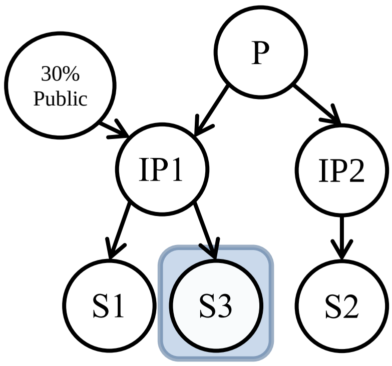
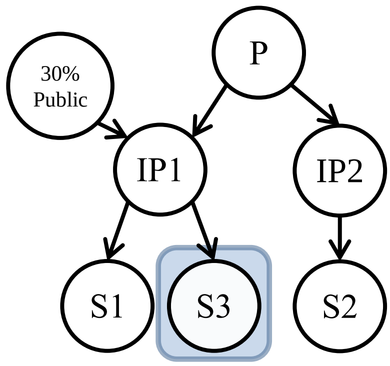
[2] In some cases, there might be combined financial statements that may have to be prepared.

Scenario 2

	Category of BCUCC	*Compared with*
Scenario 2	A group entity whose securities are traded in a public market acquires a business from another group entity.	A group entity whose securities are traded in a public market acquires a business from an unrelated entity.

14. Consider the following fact pattern. Entity P is the ultimate controlling party and Entities IP1 and IP2 are the intermediate parent entities. Entity IP1's ordinary shares are traded in a public market. There is a public shareholding of 30 per cent in Entity IP1, the rest being held by Entity P.

15. The group structure and the sub-scenarios are as follows:

<table>
<tr><td>Scenario 2A
A group entity whose securities are traded in a public market acquires business from another group entity.</td><td>Scenario 2B
A group entity whose securities are traded in a public market acquires business from an <u>unrelated entity</u>.</td></tr>
<tr><td>Before BCUCC
</td><td>Before acquisition
</td></tr>
<tr><td>After BCUCC
</td><td>After acquisition
</td></tr>
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16. In Scenario 2A, Entity IP1 acquires Entity S3 from a co-subsidiary, Entity IP2. In Scenario 2B Entity IP1 acquires Entity S3 from an unrelated entity.

17. In Scenario 2B, Entity IP1 will apply IFRS 3 and account for the acquisition of Entity S3 using the acquisition method, ie recognise the assets and liabilities of Entity S3 at their fair value on the date of acquisition.

18. However, in Scenario 2A, because BCUCC are excluded from the scope of IFRS 3, the acquisition of Entity S3 may be accounted for in different ways[3]. The staff

[3] Accounting for BCUCC is a matter of an accounting policy choice. Accordingly, an entity must apply the chosen accounting policy consistently.

are aware of the following methods that are commonly used in practice to account for a BCUCC:

(a) *Acquisition method*. If Entity IP1 uses this method, the accounting for the acquisition of Entity S3 will be similar to Scenario 2B, ie assets and liabilities of Entity S3 will be recognised in the consolidated financial statements of Entity IP1 at fair values.

(b) *Predecessor carrying values*. If Entity IP1 uses this method, the assets and liabilities of Entity S3 are accounted for using their carrying values.

Questions to the CMAC
Are the information needs of the investors in Entity IP1 for a business combination the same or different, depending on whether the business was acquired from an entity under common control or from an unrelated party? Why or why not?