December 2015

International Financial Reporting Standards

Business combinations under common control ('BCUCC')

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Objective

- Our objective is to better understand how BCUCC are accounted for in practice today and which method, or methods, provide most useful information and why.

- We will discuss:
  - Background
  - Project update
  - Illustrative scenarios
    - Which accounting method should be applied in BCUCC?
    - How should the predecessor method be applied?

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Background

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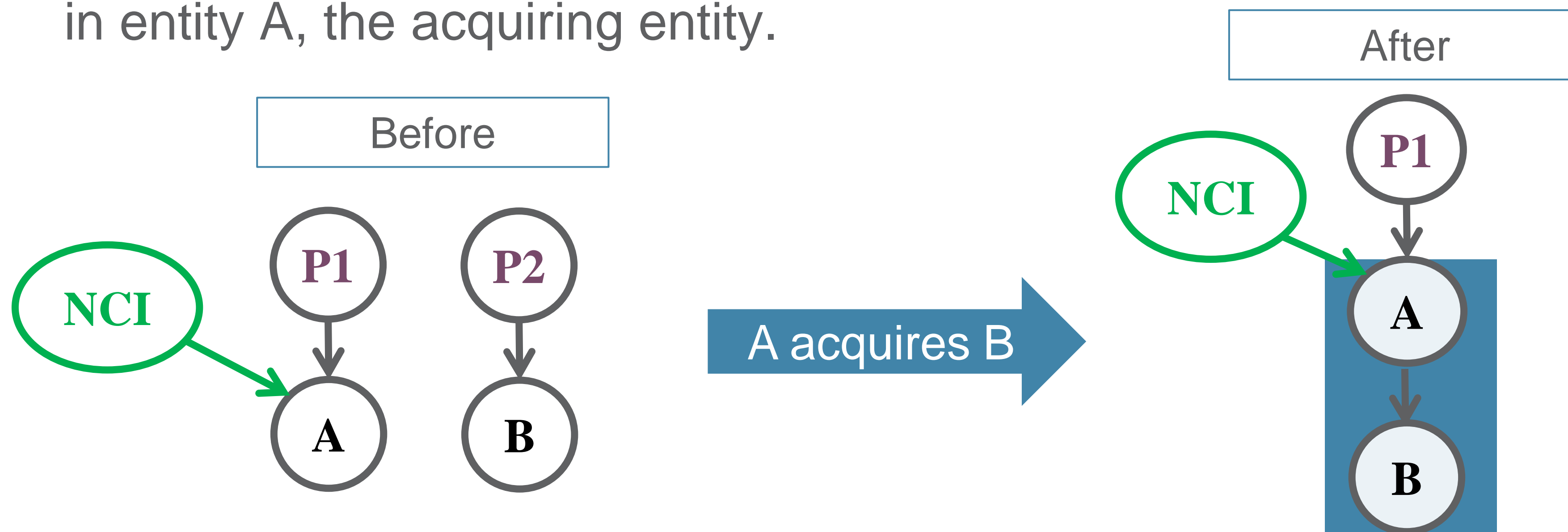
Project background

- IFRS 3 *Business Combinations* requires use of acquisition method in accounting for business combinations
- However, IFRS 3 excludes business combinations under common control (BCUCC) from its scope
- Interested parties expressed concerns about diversity in practice in accounting for BCUCC
- Respondents to the IASB's 2011 Agenda Consultation identified BCUCC as a high priority project
- Group restructurings in preparation for an initial public offering (IPO) is an area of concern of securities regulators

Business combination under IFRS 3

- Entity A acquires Entity B. Entity A and Entity B are controlled by *different* parties P1 and P2. There are non-controlling shareholders in entity A, the acquiring entity.



- Under IFRS 3, Entity A ***must*** apply the **acquisition method** and show in its consolidated financial statements:
  - Identifiable assets and liabilities of Entity B **at fair value**, and
  - Any resulting goodwill (or a gain on a bargain purchase)

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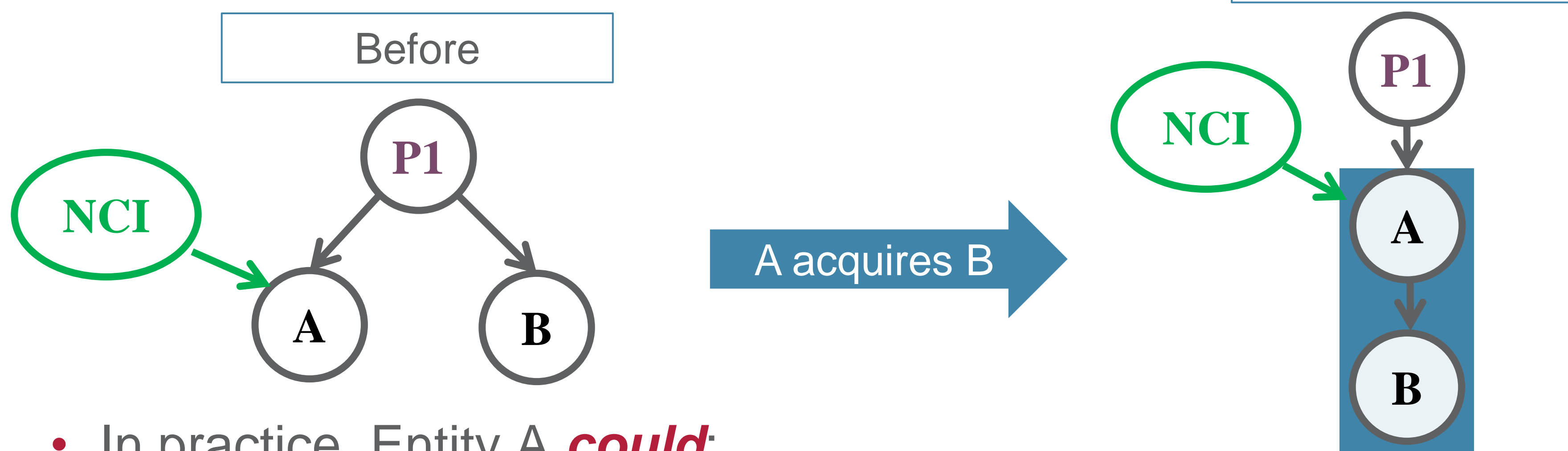
BCUCC excluded from scope of IFRS 3

- Entity A acquires Entity B. Entities A and B are controlled by the *same* party P1. There are non-controlling shareholders in Entity A, the acquiring entity.



- In practice, Entity A ***could***:
  - apply the **predecessor method** and show assets and liabilities of Entity B **at historical carrying amount**; or
  - apply the **acquisition method** and show assets and liabilities of Entity B **at fair value** and any resulting goodwill (or a gain on a bargain purchase).

Project update

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Tentative IASB decisions – scope

- The scope of the project includes:
  - BCUCC that are excluded from the scope of IFRS 3,
  - Group restructurings, and
  - The need to clarify the meaning of ‘common control’
- Initial focus on transactions that:
  - Involve existing non-controlling shareholders
  - Are undertaken in preparation for an IPO

Research and outreach

- We seek to identify whether and when the acquisition method or the predecessor method should be applied in a BCUCC
  - Ie whether and when net assets of the acquiree should be reflected at fair values or historical carrying amounts
- Targeted outreach with users, prepares, regulators, standard-setters and accounting firms
- Research of accounting literature and existing practice

Staff preliminary view: the predecessor method is most appropriate for most BCUCC (ie historical carrying amounts)

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Next steps

- IASB deliberations are expected to continue in 2016
- The next due process document is a Discussion Paper expected in 2016
- Eventual outcome could be a Standard on BCUCC or an amendment to IFRS 3

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Illustrative scenarios

Which accounting method should be applied in BCUCC?

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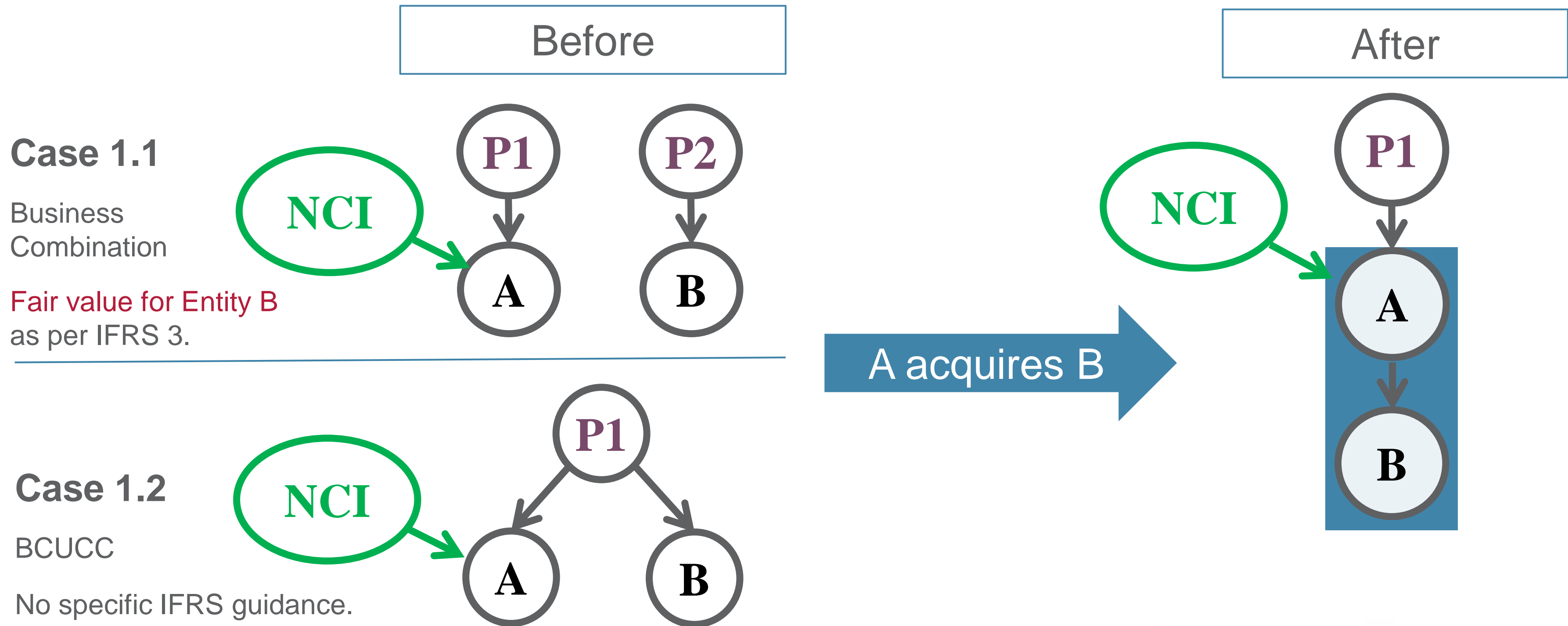
Scenario 1: NCI

Entity A is listed. 70% is held by P1, 30% is held by public shareholders. P1 controls Entity A.

- In Case 1.1, Entity A acquires Entity B from an external party P2.
- In Case 1.2, Entity A acquires Entity B from P1 that controls both Entity A and Entity B.

As a result, in both cases NCI hold an interest in both Entity A (directly) and Entity B (indirectly) as a result of the transaction.



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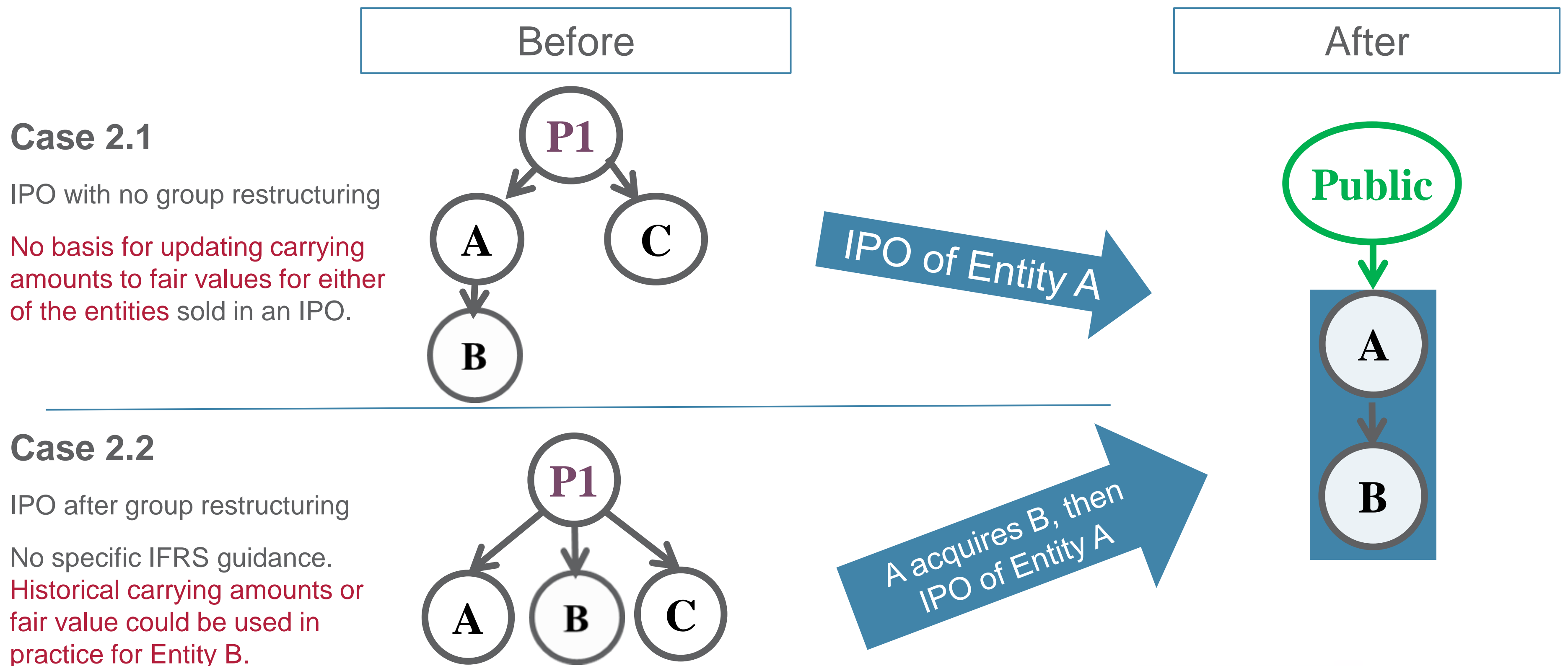
Scenario 2: IPO

- Entities A, B and C are wholly privately held and controlled by P1.
- P1 decides to sell 100% of Entities A and B in an IPO.
- Depending on the legal structure pre-IPO, the accounting outcome could differ.



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Discussion questions

1. Are BCUCC common in your jurisdiction? Do they typically involve existing NCI or are they undertaken in preparation for an IPO? Are there any common features of BCUCC in your jurisdiction?
2. Which accounting method, or methods, are typically applied in your jurisdiction by an acquirer in a BCUCC?
3. In your view, is the acquisition method or the predecessor method most appropriate for financial statements of the acquirer [Entity A], in a BCUCC that:
   – involves existing NCI (case 1.2)?
   – is undertaken in preparation for an IPO (case 2.2)?
   Why?

Illustrative scenarios

How should the predecessor method be applied?

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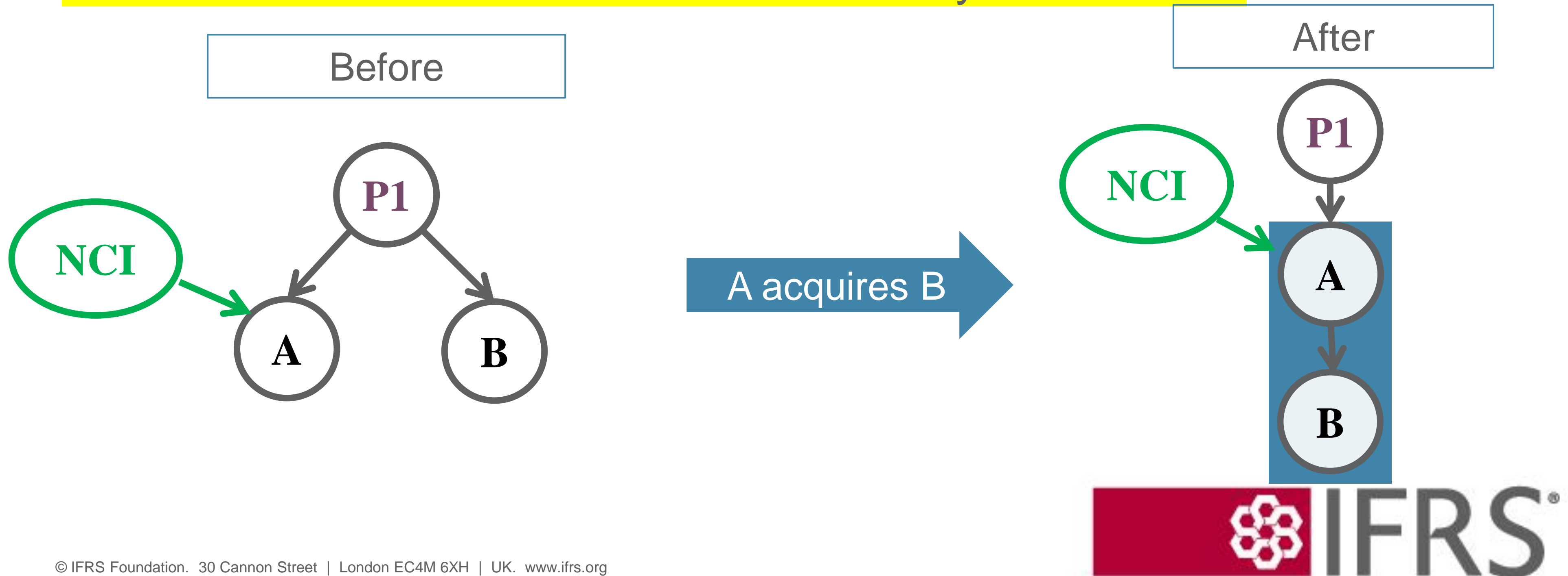
Base scenario

- Building on Scenario 1
- Entities A and B are controlled by Entity P1. Entity A is a listed entity. 30% of Entity A is owned by public shareholders.
- Entity A acquires 100% of Entity B by issuing shares to Entity P1. Fair value of issued shares is CU120, nominal value is CU20.
- Fair value of assets and liabilities of Entity B is CU118.



Base scenario (continued)

- The following information is available immediately before the transaction:

	Entity P1	Entity A	Entity B	Cons A	Cons B	P1 group
Sub A	130			(130)		0
Sub B	100				(100)	0
Other net assets	200	150	110			460
Total net assets	430	150	110	(130)	(100)	460
Share capital	100	50	20	(50)	(20)	100
Retained earnings	330	100	90	(80)	(80)	360
Total equity	430	150	110	(130)	(100)	460

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If the acquisition method is applied

Under IFRS 3:

- The difference between the consideration transferred and the acquired assets and liabilities is recognised as goodwill (or a gain on a bargain purchase)
- Consideration transferred is measured at fair value
- Acquired assets and liabilities are recognised at fair value
- Entities are combined from the date of the transaction and comparative information is not restated

If the acquisition method is applied

- In consolidated financial statements of Entity A:

	Entity A	Entity B	Cons B	A group
Sub B	120		(120)	0
Goodwill			2	2
Other net assets	150	110	8*	268
Total net assets	270	110	(110)	270
Share capital	170	20	(20)	170
Retained earnings	100	90	(90)	100
Total equity	270	110	(110)	270

*Per slide 16, fair value of acquired assets and liabilities is CU118.

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If the predecessor method is applied

1. Where in equity to recognise the difference between the consideration and the acquired assets and liabilities?
   – Share capital or retained earnings and reserves
2. How to measure consideration in the form of shares?
   – Fair value or nominal value of the shares transferred as consideration
3. Which historical carrying amounts to use?
   – Transferee [Entity B] or its parent before the transaction [Entity P1]
4. From what date to combine the entities and how to present comparative information?
   – Always combined with restated comparatives or from the date of transaction with no restatement

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If the predecessor method is applied

1. Where in equity to recognise the difference between the consideration and the acquired assets and liabilities?
   - Share capital or retained earnings and reserves
2. How to measure consideration in the form of shares?
   - Fair value or nominal value of the shares transferred as consideration
3. Which historical carrying amounts to use?
   - Transferee [Entity B] or its parent before the transaction [Entity P1]
4. From what date to combine the entities and how to present comparative information?
   - Always combined with restated comparatives or from the date of transaction with no restatement

Where to recognise the difference? Alternative 1

- The difference could be recognised in share capital:

	Entity A	Entity B	Cons B	A group
Sub B	120		(120)	0
Other net assets	150	110		260
Total net assets	270	110	(120)	260
Share capital	170	20	(30)*	160
Retained earnings	100	90	(90)	100
Total equity	270	110	(120)	260

* CU30 is an aggregate of CU20 share capital of Entity B and CU10 the difference between consideration transferred and acquired assets and liabilities.

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Where to recognise the difference? Alternative 2

- The difference could be recognised in retained earnings:

	Entity A	Entity B	Cons B	A group
Sub B	120		(120)	0
Other net assets	150	110		260
Total net assets	270	110	(120)	260
Share capital	170	20	(20)	170
Retained earnings	100	90	(100)*	90
Total equity	270	110	(120)	260

* CU100 is an aggregate of CU90 retained earnings of Entity B and CU10 the difference between consideration transferred and acquired assets and liabilities.

Where to recognise the difference? Alternative 3

- The difference could be recognised in reserves:

	Entity A	Entity B	Cons B	A group
Sub B	120		(120)	0
Other net assets	150	110		260
Total net assets	270	110	(120)	260
Share capital	170	20	(20)	170
Retained earnings	100	90	(90)	100
Other reserve			(10)	(10)
Total equity	270	110	(120)	260

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Where to recognise the difference? Discussion questions

In your jurisdiction, where do entities tend to recognise the difference between the consideration transferred and the acquired assets and liabilities:

– Share capital?

– Retained earnings?

– Reserves, eg other reserve?

Staff preliminary view: require that the difference is recognised in equity but do not prescribe where in equity

If the predecessor method is applied

1. Where in equity to recognise the difference between the consideration and the acquired assets and liabilities?
   - Share capital or retained earnings and reserves
2. How to measure consideration in the form of shares?
   - Fair value or nominal value of the shares transferred as consideration
3. Which historical carrying amounts to use?
   - Transferee [Entity B] or its parent before the transaction [Entity P1]
4. From what date to combine the entities and how to present comparative information?
   - Always combined with restated comparatives or from the date of transaction with no restatement

How to measure consideration? Alternative 1

- Measure at the fair value of transferred shares:

	Entity A	Entity B	Cons B	A group
Sub B	120		(120)	0
Other net assets	150	110		260
Total net assets	270	110	(120)	260
Share capital	170	20	(20)	170
Retained earnings	100	90	(90)	100
Other reserve			(10)	(10)
Total equity	270	110	(120)	260

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How to measure consideration? Alternative 2

- Measure at the nominal value of transferred shares:

	Entity A	Entity B	Cons B	A group
Sub B	20		(20)	0
Other net assets	150	110		260
Total net assets	170	110	(20)	260
Share capital	70	20	(20)	70
Retained earnings	100	90	(90)	100
Other reserve			90	90
Total equity	170	110	(20)	260

How to measure consideration? Discussion questions

1. What forms of consideration do you most frequently observe in BCUCC transactions (eg cash, share issue, no consideration)?
2. In your jurisdiction, how do entities tend to measure shares transferred as consideration in a BCUCC?
3. In your view, how should consideration in the form of shares in a BCUCC be measured, and why?

Staff preliminary view: consideration in the form of shares should be measured at fair value. However, that would not affect the net amount recognised in equity nor recognised assets, liabilities, income and expenses

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If the predecessor method is applied

1. Where in equity to recognise the difference between the consideration and the acquired assets and liabilities?
   - Share capital or retained earnings and reserves
2. How to measure consideration in the form of shares?
   - Fair value or nominal value of the shares transferred as consideration
3. Which historical carrying amounts to use?
   - Transferee [Entity B] or its parent before the transaction [Entity P1]
4. From what date to combine the entities and how to present comparative information?
   - Always combined with restated comparatives or from the date of transaction with no restatement

Which carrying amounts to use? Variation to the base scenario

- Suppose Entity P1 acquired Entity B from a third party a few years ago and reflected assets and liabilities of Entity B at their then fair values in accordance with IFRS 3.
- Carrying amounts of assets and liabilities of Entity B in Entity P1's consolidated financial statements just before the BCUCC reflect that fair value step up [CU5].

	Entity P1	Entity A	Entity B	Cons A	Cons B	P1 group
Sub A	130			(130)		0
Sub B	100				(100)	0
Other net assets	200	150	110		5	465
Total net assets	430	150	110	(130)	(95)	465
Share capital	100	50	20	(50)	(20)	100
Retained earnings	330	100	90	(80)	(75)	365
Total equity	430	150	110	(130)	(95)	465

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Which carrying amounts to use? Alternative 1

- Carrying amounts in the financial statements of the transferred entity [Entity B]:

	Entity A	Entity B	Cons B	A group
Sub B	120		(120)	0
Other net assets	150	110		260
Total net assets	270	110	(120)	260
Share capital	170	20	(20)	170
Retained earnings	100	90	(90)	100
Other reserve			(10)	(10)
Total equity	270	110	(120)	260

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Which carrying amounts to use? Alternative 2

- Carrying amounts in the financial statements of the parent of the transferred entity [Entity P1]:

	Entity A	Entity B	Cons B	A group
Sub B	120		(120)	0
Other net assets	150	110	5	265
Total net assets	270	110	(115)	265
Share capital	170	20	(20)	170
Retained earnings	100	90	(90)	100
Other reserve			(5)	(5)
Total equity	270	110	(115)	265

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Which carrying amounts to use? Discussion questions

1. In your jurisdiction, which carrying amounts do entities tend to use in applying the predecessor method?
2. In your view, which carrying amounts should be used in applying the predecessor method, and why?

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If the predecessor method is applied

1. Where in equity to recognise the difference between the consideration and the acquired assets and liabilities?
   – Share capital or retained earnings and reserves
2. How to measure consideration in the form of shares?
   – Fair value or nominal value of the shares transferred as consideration
3. Which historical carrying amounts to use?
   – Transferee [Entity B] or its parent before the transaction [Entity P1]
4. From what date to combine the entities and how to present comparative information?
   – Always combined with restated comparatives or from the date of transaction with no restatement

Date of combination and comparatives Base scenario – additional information

- Suppose Entity A acquired Entity B at the end of the reporting year.
- The following information is available about the current and preceding reporting years.

	Comparative year			Reporting year	
	Entity A	Entity B		Entity A	Entity B
Sub B				120	
Other net assets	135	100		150	110
Total net assets	135	100		270	110
Share capital	50	20		170	20
Retained earnings	85	80		100	90
Total equity	135	100		270	110
Profit or loss	8	3		15	10

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Date of combination and comparatives Alternative 1

- Account for the newly created group from the date of transaction. Do not restate comparative information.

	Comparative year		Reporting year			
	Entity A		Entity A	Entity B	Cons B	A group
Sub B			120		(120)	0
Other net assets	135		150	110		260
Total net assets	135		270	110	(120)	260
Share capital	50		170	20	(20)	170
Retained earnings	85		100	90	(90)	100
Other reserve					(10)	(10)
Total equity	135		270	110	(120)	260
Profit or loss	8		15	10	(10)	15

Date of combination and comparatives Alternative 2

- Account for the newly created group as if it has always existed (or since first under common control, if later). Restate comparative information.

	Comparative year					Reporting year			
	Entity A	Entity B	Cons B	A group		Entity A	Entity B	Cons B	A group
Sub B	120		(120)	0		120		(120)	0
Other net assets	135	100		235		150	110		260
Total net assets	255	100	(120)	235		270	110	(120)	260
Share capital	170	20	(20)	170		170	20	(20)	170
Retained earnings	85	80		165		100	90		190
Other reserve			(100)	(100)				(100)	(100)
Total equity	255	100	(120)	235		270	110	(120)	260
Profit or loss	8	3		11		15	10		25

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Date of combination and comparatives Alternative 2 – a variation

- Account for the newly created group as if it has always existed (or since first under common control, if later). Restate comparative information. Measure transferred shares at the nominal value.

	Comparative year					Reporting year			
	Entity A	Entity B	Cons B	A group		Entity A	Entity B	Cons B	A group
Sub B	20		(20)	0		20		(20)	0
Other net assets	135	100		235		150	110		260
Total net assets	155	100	(20)	235		170	110	(20)	260
Share capital	70	20	(20)	70		70	20	(20)	70
Retained earnings	85	80		165		100	90		190
Total equity	155	100	(20)	235		170	110	(20)	260
Profit or loss	8	3		11		15	10		25

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Date of combination and comparatives Discussion questions

1. In your jurisdiction, from which date do entities tend to account for a BCUCC and how do they tend to present comparative information?
2. In your view, from which date should the entities be combined in a BCUCC and how should comparative information be presented, and why?

Staff preliminary view: entities should be combined from the date of the transaction and comparative information should not be restated. However, selected information on a proforma basis could be disclosed.

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Thank you

We welcome your feedback

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