STAFF PAPER

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Prepared for the Global Preparers Forum Meeting

Project	**Business Combinations under Common Control**		
Paper topic	Accounting for business combinations under common control		
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The purpose of the session

1. The purpose of this session is to:
   (a) provide an update on the project to GPF members;
   (b) obtain feedback from GPF members on the accounting approach being considered by the staff for particular types of business combinations under common control ('BCUCC'); and
   (c) identify any further issues related to such BCUCC that need to be considered by the staff.
2. Questions for GPF members are set out after paragraph 31.

Background

3. Accounting requirements for business combinations (Illustration 1) are set out in IFRS 3 *Business Combinations*. IFRS 3 requires the acquisition method of accounting for a business combination in the consolidated financial statements of the acquirer. Under the acquisition method, the acquirer recognises:
   (a) identifiable assets and liabilities of the acquired business at their acquisition-date fair values, and
   (b) goodwill or a gain on a bargain purchase, if applicable.

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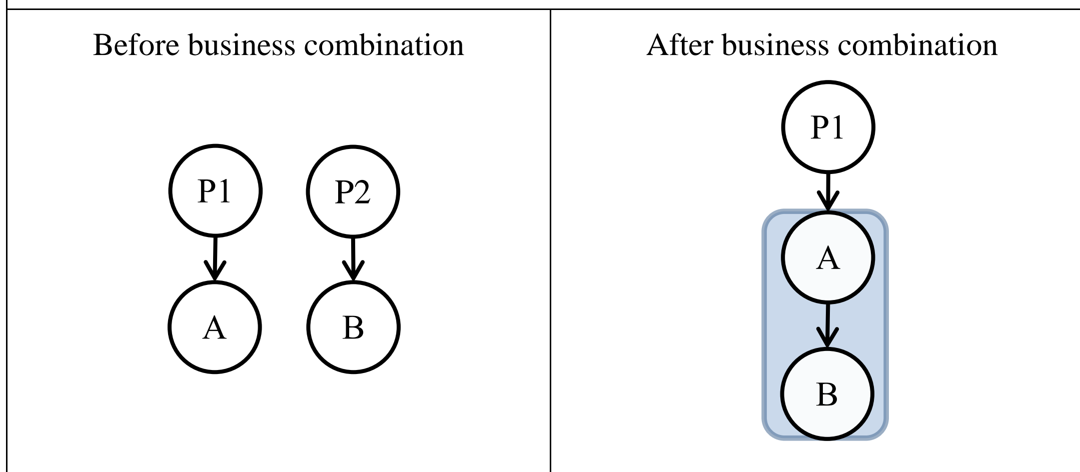
4. IFRS 3 also requires disclosure of information that enables users of financial statements to evaluate the nature and financial effect of a business combination.

Illustration 1—business combination

Entity A and Entity B are controlled by different parties, P1 and P2, respectively. Entity A acquires Entity B. In accordance with IFRS 3, the consolidated financial statements of Entity A will show assets and liabilities of Entity B at fair values and goodwill (or a gain on a bargain purchase).

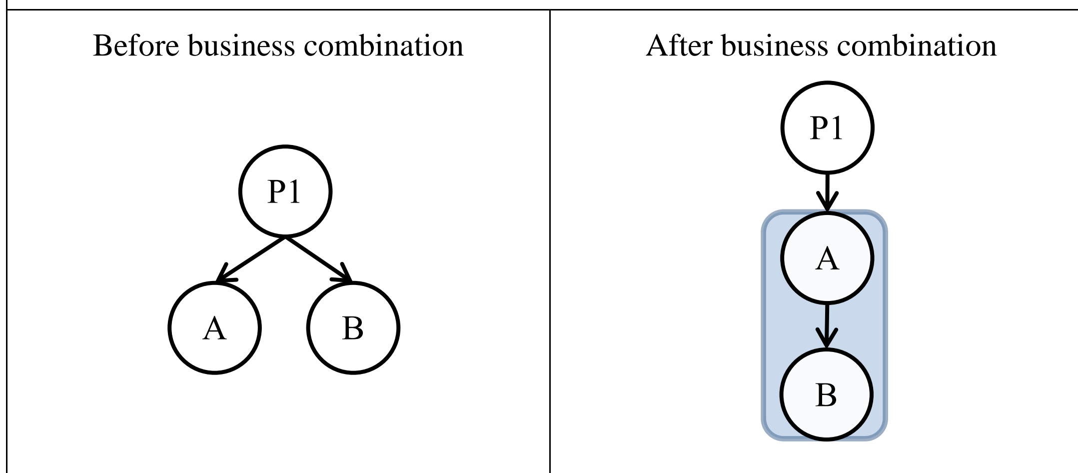


5. However, BCUCC (Illustration 2) are excluded from the scope of IFRS 3. Paragraph B1 of IFRS 3 describes a BCUCC as ‘a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and the control is not transitory’. There is no specific guidance in IFRS on how to account for such business combinations.

6. In practice, entities typically account for BCUCC using the acquisition method set out in IFRS 3 or the predecessor method. Under the predecessor method, assets and liabilities of all combining entities or businesses are reflected in consolidated financial statements at their carrying amounts immediately prior to the business combination (ie at their predecessor carrying amounts).

Illustration 2—BCUCC

Entity A and Entity B are controlled by the same party, P1. Entity A acquires Entity B. The consolidated financial statements of Entity A *could* show assets and liabilities of Entity B at their fair values (acquisition method) or the carrying amounts (predecessor method).



Research project

7. Interested parties, including respondents to the IASB's 2011 Agenda Consultation, have expressed concerns about the absence of specific accounting requirements for BCUCC in IFRS and the resulting diversity in practice.

8. As a result, the IASB added BCUCC to its research agenda. In June 2014, the IASB 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'.

9. The IASB tentatively decided to give priority to considering BCUCC that involve third parties or are related to third party transactions, for example those undertaken in preparation for an initial public offering (IPO). That is an area of particular concern for securities regulators.

10. In July 2014, the staff requested regional and national standard-setters to provide information about the current requirements in their jurisdictions regarding the

financial information to be presented by an entity that is undertaking an IPO, including when there is a group restructuring in preparation for the IPO.

11. In October 2014, the staff commenced targeted outreach with investors to understand their information needs in a BCUCC. In Q1 2015, the staff extended their outreach efforts to preparers, accounting firms and standard-setters in order to identify all relevant issues and to obtain preliminary views on accounting alternatives.

12. The staff plan to present to the IASB the results of the outreach and an analysis of accounting alternatives in Q2 2015.

Scope

13. In the light of the priorities set by the IASB, the staff are initially focusing on BCUCC that involve—or are related to transactions with—third-party equity investors and considering the key aspects of accounting for such BCUCC in the consolidated financial statements of the acquirer. That is, whether using fair values or predecessor carrying amounts in consolidated financial statements is more appropriate for such BCUCC.

14. The staff will next consider other types of transactions within the scope of the project, specifically:
    (a) BCUCC that involve other types of interested third parties (for example, debt investors in the combining entities); and
    (b) group restructurings that do not meet the definition of a business combination (for example, a transfer of an operating business to a new holding company under common control).

15. The staff will also explore detailed questions related to the application of the relevant accounting method, or methods, of accounting for BCUCC and group restructurings in consolidated financial statements. For example, if the staff decide to recommend the use of the predecessor method, the staff will consider:
    (a) which predecessor carrying amounts should be used; and
    (b) how comparative information should be provided.

16. The staff will also consider what disclosures should be required to provide additional relevant information to users of financial statements.

17. Finally, the staff will assess whether there is a need to address accounting and disclosure:

    (a) in separate or individual financial statements of the acquirer; or

    (b) by other parties in a BCUCC or a group restructuring.

Staff discussion and analysis

18. The staff have identified two types of BCUCC that involve—or are related to transactions with—third-party equity investors:

    (a) a combination of wholly owned businesses or entities in preparation for a planned sale, including a sale through an IPO (Illustration 3); and

    (b) a combination that involves an existing non-controlling interest (NCI) in the acquirer (Illustration 4).

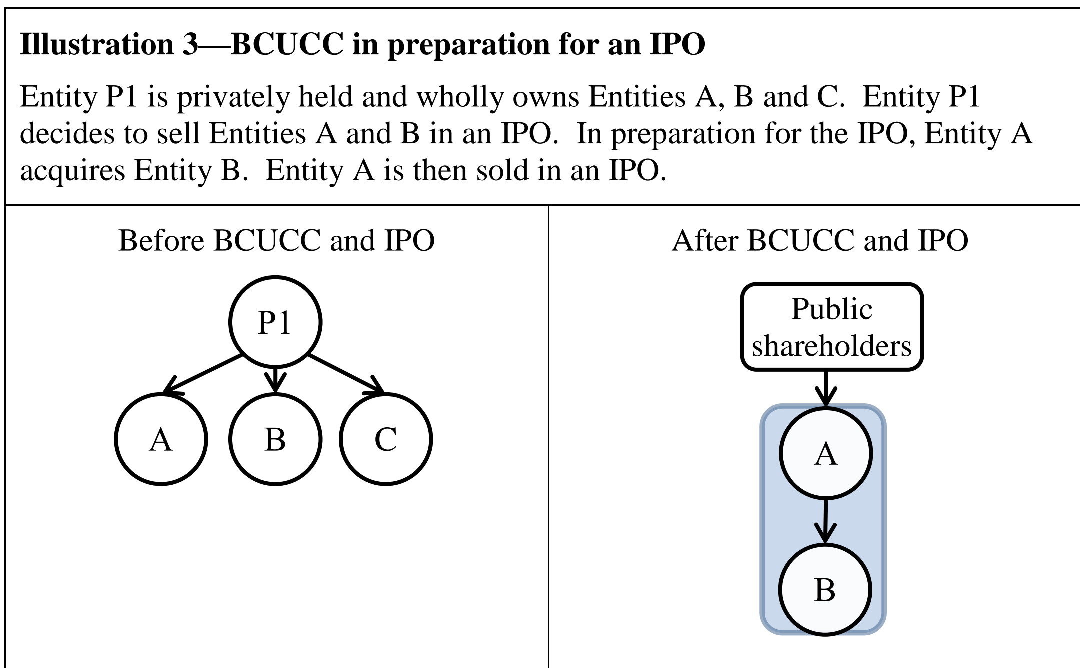
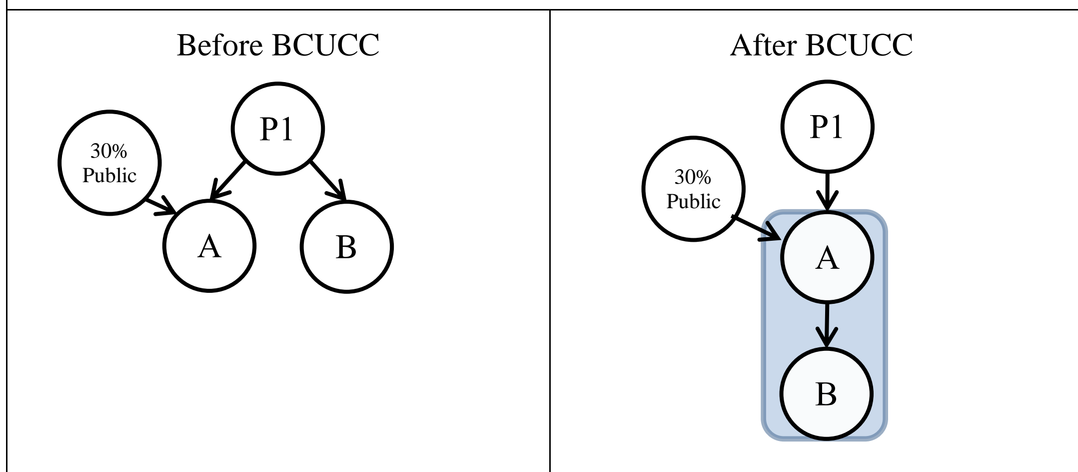


Illustration 3—BCUCC in preparation for an IPO

Entity P1 is privately held and wholly owns Entities A, B and C. Entity P1 decides to sell Entities A and B in an IPO. In preparation for the IPO, Entity A acquires Entity B. Entity A is then sold in an IPO.

Illustration 4—BCUCC that involves an existing NCI

Entity A and Entity B are controlled by Entity P1. Entity B is wholly owned by Entity P1. Entity A is 70 per cent owned by Entity P1. The remainder is held by public shareholders. Entity A acquires Entity B.



19. In the staff's view, these two types of BCUCC are sufficiently different to merit separate consideration. This is because in the sale/IPO scenario (shown in Illustration 3), third-party equity investors—the new shareholders—are *not* affected by the BCUCC. Instead, they acquire an interest in the business as it stands after the BCUCC. In contrast, in the NCI scenario (shown in Illustration 4), third-party equity investors—the existing NCI—*are* affected by the BCUCC. This is because the assets and liabilities in which they hold an interest change as a result of the BCUCC.

BCUCC in preparation for an IPO[1]

20. The staff think that there is no *economic* difference between:

    (a) selling existing businesses in an IPO without undertaking a BCUCC in preparation for the IPO (Illustration 5a); and

    (b) combining existing businesses under common control in preparation for an IPO and then selling them in an IPO (Illustration 5b).

21. This is because in both cases third-party equity investors newly acquire an interest in the existing businesses (Entities A and B in Illustrations 5a and 5b), which were

[1] This section of the paper focuses on the IPO scenario. However, the analysis would be the same for a BCUCC in preparation for a planned private sale.

previously wholly owned by the controlling party in the group (P1 in Illustrations 5a and 5b).

Illustration 5a—IPO without BCUCC

Entity P1 is privately held and wholly owns Entities A, B and C. Entity P1 decides to sell Entities A and B in an IPO.

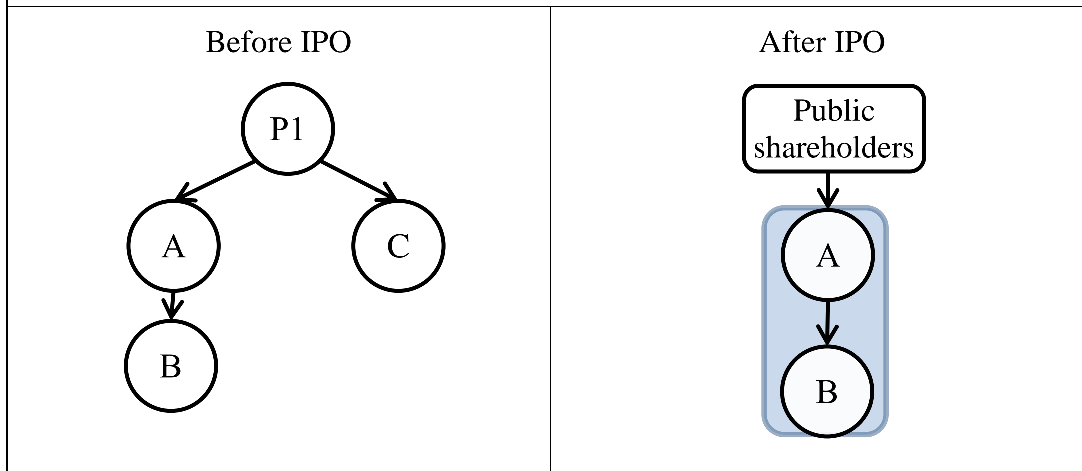
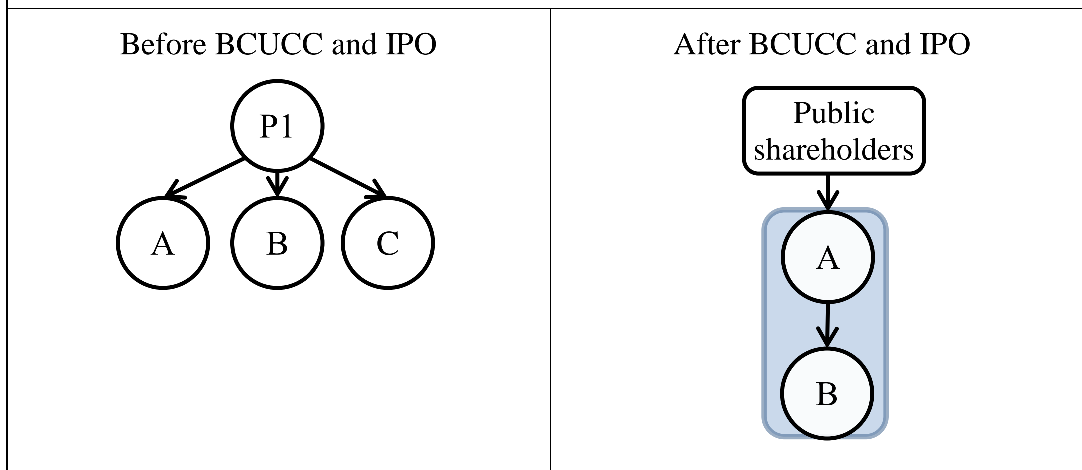


Illustration 5b—IPO *with* BCUCC

Entity P1 is privately held and wholly owns Entities A, B and C. Entity P1 decides to sell Entities A and B in an IPO. In preparation for the IPO, Entity A acquires Entity B.



22. Consequently, the staff think that IFRS financial statements[2] provided in connection with an IPO should be prepared on a consistent basis, regardless of whether there is a BCUCC in preparation for the IPO. Specifically, a consistent basis should be applied both:

[2] A local regulator may require additional information, such as fair values, to be provided in the prospectus.

(a) within an IPO scenario, that is to *all* the assets and liabilities that are being sold in the IPO; and

(b) across IPO scenarios.

23. Accordingly, it seems inappropriate to apply the acquisition method set out in IFRS 3 to a BCUCC undertaken in preparation for an IPO. This is because that would result in uplifting some—but not all—assets and liabilities being sold in an IPO to their fair values. Instead, all the assets and liabilities being sold in an IPO should be reflected at their fair values or all those assets and liabilities should be reflected at their carrying amounts regardless of whether there is a BCUCC in preparation for an IPO.

24. Applying IFRS 3 to a BCUCC undertaken in preparation for an IPO also has the disadvantage of creating accounting arbitrage. That is, entities could structure a BCUCC to achieve uplifting particular assets and liabilities to their fair values.

25. If no BCUCC takes place in preparation for an IPO (Illustration 5a), there is no basis in IFRS for updating the carrying amounts of the assets and liabilities that are being sold to their fair values. Instead, those assets and liabilities will be reflected at their carrying amounts.[3] If the assets and liabilities that are being sold in an IPO should be accounted for consistently, regardless of whether there is a BCUCC in preparation for the IPO, it follows that the predecessor method should be applied to a BCUCC undertaken in preparation for the IPO. That is, the assets and liabilities of the combining businesses will be reflected at their predecessor carrying amounts. Additional information could be provided via disclosure.

26. The staff note that fair value information could also be relevant to investors in an IPO. The feedback received from users of financial statements to date is inconclusive. The staff will continue outreach with users of financial statements and will consider the feedback received in developing recommendations for the IASB.

[3] An entity that presents its first IFRS financial statements would apply IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

BCUCC that involves an existing NCI

27. In a BCUCC that involves an existing NCI in the acquirer, the NCI is affected by the BCUCC (Illustration 6b). Arguably, this is similar to a scenario in which the acquirer acquires a business from a third party (Illustration 6a). In both cases, the assets and liabilities in which the NCI holds a share change as a result of the business combination. That is, instead of only holding a direct interest in Entity A, the NCI obtains an indirect interest in Entity B as a result of the business combination (Illustrations 6a and 6b).

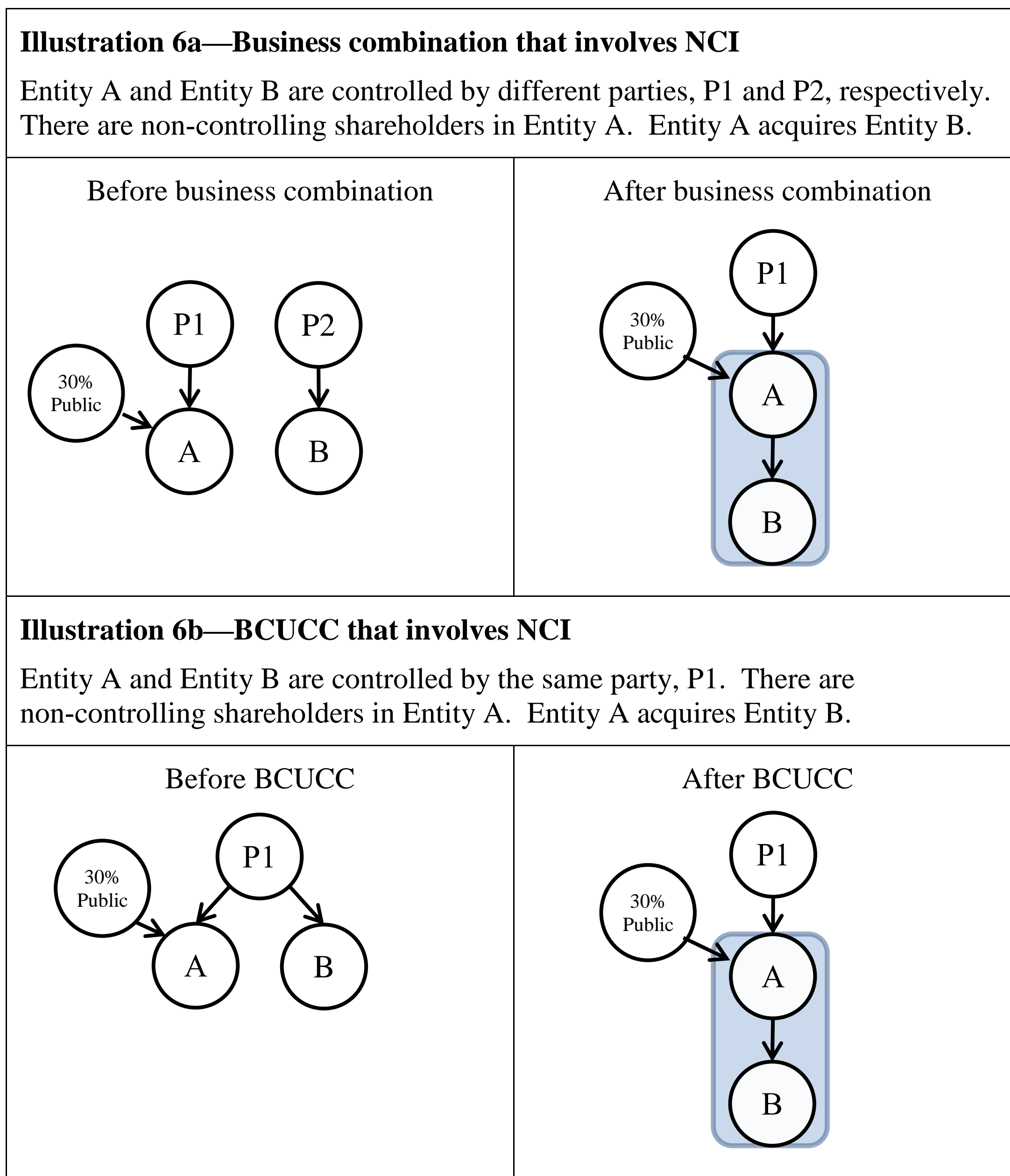


Illustration 6a—Business combination that involves NCI

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

Illustration 6b—BCUCC that involves NCI

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

28. In Illustration 6a, Entity A will apply the acquisition method set out in IFRS 3 to account for the business combination with Entity B in its consolidated financial statements. That is, the consolidated financial statements of Entity A will reflect the identifiable assets and liabilities of Entity B at their acquisition-date fair values and any goodwill (or a gain on a bargain purchase).

29. Economically, from the NCI perspective, the BCUCC in Illustration 6b is similar to the business combination in Illustration 6a. Consequently, applying the acquisition method set out in IFRS 3 to BCUCC in Illustration 6b in the consolidated financial statements of Entity A would provide comparable information. Applying the acquisition method to such BCUCC would also provide greater transparency about values exchanged in a BCUCC.

30. However, applying IFRS 3 to such BCUCC—but not to BCUCC undertaken in preparation for an IPO—involves the following disadvantages:

    (a) recognition of goodwill (or a gain on a bargain purchase) in BCUCC may not be appropriate, because the consideration transferred may not be representative of the fair value of the acquired business;

    (b) applying different accounting treatments to different types of BCUCC:

        (i) would increase accounting complexity;

        (ii) would create the need to define those populations; and

        (iii) could create an opportunity for structuring transactions with the aim of achieving the desired accounting outcome. For example, the controlling party could choose to create an insignificant NCI in one of the group operating entities and then, by transferring another group business into that entity, achieve uplifting assets and liabilities of the transferred business to their fair values and recognising goodwill generated within the group.

31. The staff find the arguments in paragraph 30 more compelling and are therefore on balance leaning towards the use of the predecessor method for all types of BCUCC that involve—or are related to transactions with—third-party equity investors. Additional information, such as fair value information, could be provided via disclosure.

Questions for GPF members

Questions 1-3
1. Do you have any comments on the approach set out in this paper? 2. Should any types of BCUCC that involve—or are related to transactions with—third-party equity investors be accounted under the acquisition method as set out in IFRS 3, and if so, why? 3. Should the staff consider any additional issues related to such BCUCC?