IFRS

STAFF PAPER

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IASB meeting

Project	**Business Combinations under Common Control**
Paper topic	Method(s) of accounting for BCUCC

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Purpose of this paper

1. The purpose of this paper is to present to the International Accounting Standards Board® ('the Board') the results of research and outreach on the method(s) that:
   (a) *are* applied in practice to account for BCUCC, and
   (b) stakeholders think *should be* applied to provide useful information about BCUCC.
2. This paper is for information only and there are no questions for the Board.

Structure of the paper

3. This paper discusses:
   (a) key messages (paragraph 4),
   (b) feedback received from the request for information to national standard-setters (paragraphs 5-13),
   (c) feedback received in other outreach activities (paragraphs 14-52), and
   (d) findings in the review of relevant publications (paragraphs 53-58).

Key messages

4. The feedback received by the staff from various interested parties indicates that:

   (a) BCUCC are common in many jurisdictions, especially BCUCC in connection with an IPO;

   (b) in practice, BCUCC are typically accounted for using the predecessor method; however, the acquisition method is also used in some jurisdictions;

   (c) users of financial statements have different views on whether the predecessor method or the acquisition method would provide most useful information about BCUCC, and why;

   (d) many interested parties other than users of financial statements support using the predecessor method as a default method of accounting for BCUCC; and

   (e) many interested parties, including users of financial statements, believe that the Board should provide guidance for BCUCC.

Request for information to national standard-setters

5. In July 2014, the staff asked regional and national standard-setters to provide information about the reporting requirements in their jurisdictions for an entity that is undertaking an initial public offering (IPO).

6. The staff request contained two illustrative scenarios:

   (a) IPO of an existing intermediate parent with its existing subsidiaries, and

   (b) a group restructuring involving transfer of subsidiaries either to an existing intermediate parent or to a newly incorporated entity (NewCo) in connection with an IPO of that existing parent or of the NewCo.

7. The staff request contained the following questions about the local reporting requirements for the issuing entity in an IPO:

   (a) what basis is required in the special purpose consolidated financial statements of the issuing entity included in the offer document;

(b) what disclosures about group restructuring are required to be provided by the issuing entity in its special purpose consolidated financial statements;

(c) what other financial information in addition to the special purpose consolidated financial statements (for example, prospective financial information) is required to be provided by the issuing entity; and

(d) what basis is required in the general purpose consolidated financial statements of the issuing entity.

8. The staff request asked respondents to specify whether the reporting requirements depend on:

(a) whether control over the issuing entity is lost in the IPO; and

(b) whether the group restructuring takes place before or after the IPO.

9. The staff received 15 responses to this request, mostly from Asia-Oceania and Europe but also from Middle East, North America and Africa. Those responses focussed on different aspects of the staff request. Some responses focussed on reporting requirements in an IPO in general and the additional disclosures about group restructuring, while others also discussed the requirements or the practice in accounting for BCUCC.

10. Most respondents stated that the issuing entity is required to provide consolidated financial statements in the offer document. In most cases, but not all, those consolidated financial statements are required to be prepared in accordance with International Financial Reporting Standards®. In addition, particular jurisdictions have additional disclosure requirements for an IPO, such as disclosure of prospective or historical financial information. Some jurisdictions also reported specific disclosure requirements for group restructuring; for example, pro forma financial information for the issuing entity and its subsidiaries or financial statements of individual entities transferred in the restructuring.

11. Many respondents commented on how BCUCC are accounted for. All those respondents stated that the predecessor method is used in their jurisdictions and a few respondents stated that the predecessor method is either most commonly

used or even required in their jurisdictions. Some respondents stated that the acquisition method in accordance with IFRS 3 *Business Combinations* is also used in their jurisdictions.

12. Some respondents commented on loss of control over the issuing entity by the group in an IPO and whether that affects the accounting for the group restructuring in connection with an IPO. Most of those respondents noted that there are different views on whether a group restructuring in connection with an IPO is considered a BCUCC if control over the issuing entity is lost in the IPO:

    (a) under one view, control by the group over the issuing entity would be considered transitory and the group restructuring would not be considered a BCUCC;[1]

    (b) under the other view, control by the group of the issuing entity would not be considered transitory and the group restructuring would be considered a BCUCC.

13. A few respondents asked the Board to clarify the meaning of 'transitory control'.

Other outreach

14. As stated in Agenda Paper 23, the Board tentatively decided to give priority to considering transactions that could affect third parties. Accordingly, in its discussions with interested parties, the staff focussed on two illustrative sets of comparative scenarios:

    (a) the NCI scenario—a business combination that involves an existing non-controlling interest (NCI) in the acquirer/transferee (Illustrations 1a and 1b), and

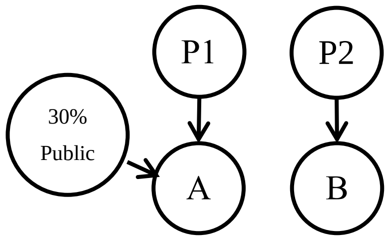
    (b) the IPO scenario—an IPO of wholly owned businesses or entities with and without BCUCC in preparation for an IPO (Illustrations 2a and 2b).

[1] IFRS 3 paragraph B1 described 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 that control is not transitory.

Illustration 1a—NCI in the acquirer in a business combination

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.

Before business combination



After business combination

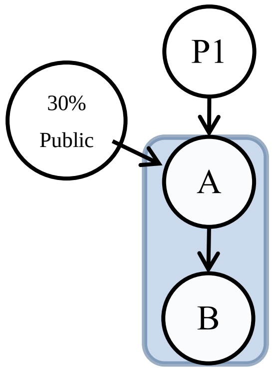
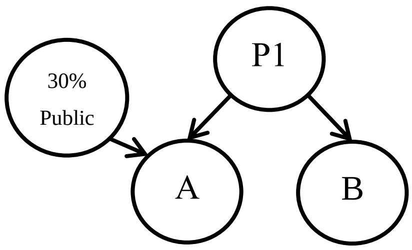


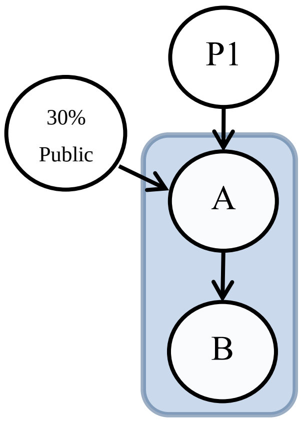
Illustration 1b—NCI in the transferee in a BCUCC

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.

Before BCUCC



After BCUCC

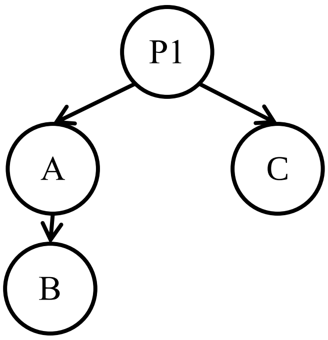


15. In presenting the NCI scenario, the staff emphasised that a business combination that is not under common control will be accounted for in accordance with IFRS 3 at the acquisition-date fair values and raised the question of whether a different approach is warranted for BCUCC, and why.

Illustration 2a—IPO without BCUCC

Entity P1 is privately held and wholly owns Entities A, B and C. Entity P1 decides to sell Entity A and Entity B in an IPO. There is no BCUCC in preparation for the IPO.

Before IPO



After IPO

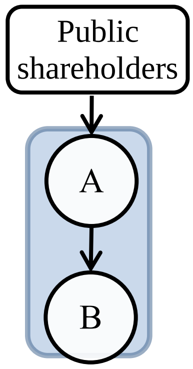
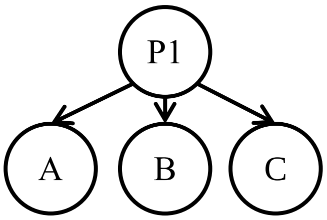


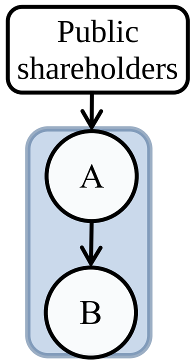
Illustration 2b—IPO accompanied by a BCUCC

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

Before BCUCC and IPO



After BCUCC and IPO



16. In presenting the IPO scenario, that staff emphasised that in accordance with IFRS Standards there is no basis for revising the carrying amounts of assets and liabilities of either Entity A or Entity B if there is no BCUCC in preparation for the IPO. The staff then raised the question of whether the financial reporting outcome should be the same regardless of whether a BCUCC occurs in connection with the IPO.

17. In the discussions with users of financial statements and preparers, the staff focussed on which accounting method(s) those stakeholders thought *should be* applied in BCUCC in the NCI and IPO scenarios, and why. In the discussions with standard-setters and regulators, the staff typically discussed both which method(s) *are applied* in practice in those scenarios and which method(s) they thought *should be applied*, and why.

18. Except for the discussions with users of financial statements, the staff typically discussed their preliminary view that the predecessor method should be applied in all, or most, BCUCC and sought feedback on that preliminary view.

Feedback from users of financial statements

19. As stated in Agenda Paper 23, Board members and the staff discussed BCUCC in 14 meetings and calls with individual users of financial statements and user representative groups from various jurisdictions.

20. The users of financial statements who participated in the outreach had different levels of experience with BCUCC. Some have come across such transactions in practice and others have not. Overall, a BCUCC that involves privately held entities and is undertaken in connection with an IPO was a more familiar scenario than a BCUCC that involves listed entities.

General comments from users on accounting for BCUCC

21. The users who participated in the outreach expressed diverse views on what information would be most useful in a BCUCC, and why. Some advocated the use of fair values for all types of BCUCC, whereas others advocated the use of the predecessor carrying amounts for all such transactions. Some users would make a distinction between different types of BCUCC and expressed the view that different accounting methods may be more appropriate in different circumstances. Many users also stated that business combinations are generally difficult to analyse and that they always disrupt trend information.

22. Users who supported the use of fair values provided the following arguments:

(a) fair value information, including information about goodwill, is generally most relevant for investors and BCUCC is an opportunity to provide investors with an updated valuation;

(b) fair value is the only relevant measurement basis in a related party transaction because it provides transparency and enables investors to assess whether the transaction has taken place on market terms;

(c) fair value information is particularly relevant for assessing performance of the new combined entity going forward;

(d) recognition of goodwill holds management accountable because they would need to deliver value if a premium has been paid in a BCUCC;

(e) whether the transaction has taken place on market terms is a corporate governance issue rather than an accounting issue; accounting consequences should be the same for all types of business combinations;

(f) investor information needs in a BCUCC are the same as for any business combination;

(g) the acquisition method set out in IFRS 3 is well tested and familiar to investors and works well in practice.

23. Users who advocated the use of the predecessor carrying amounts provided the following arguments:

(a) predecessor carrying amounts assist in preserving trend information; in contrast, the use of fair values disrupts trend information and is therefore not most relevant to investors who perform their own valuation;

(b) predecessor carrying amounts are more reliable; in contrast, fair values determined in a related party transaction are open to management discretion and may lead to manipulating future profits;

(c) unlike a business combination at arms' length, a BCUCC is not freely negotiated but is directed by the controlling party; consequently, the use of fair values, and especially recognition of goodwill or gain in such a transaction, is not meaningful and may create an incentive to artificially shift values within the group to achieve desired results;

(d) predecessor carrying amounts are more relevant for assessing management's stewardship of the entity's resources entrusted to it;

(e) predecessor carrying amounts would enable investors to assess return on capital employed;

(f) predecessor carrying amounts are more relevant for debt analysts, who focus on cash flows rather than valuation; and

(g) a requirement to use fair values in a BCUCC would cause management to provide more non-GAAP information to explain the effects of the transaction.

24. Users who would make a distinction between different types of BCUCC tended to broadly focus on whether the transaction has economic substance or whether it took place on market terms. They suggested that the following aspects of the transaction may indicate that it has economic substance or is undertaken on market terms:

(a) the transaction is settled in cash rather than shares;

(b) the transaction involves publicly held entities;

(c) there is NCI in the transferee; and/or

(d) the transaction generates economic value and synergies for the combining entities.

25. In contrast, they argued that a transaction that involves privately held entities and is settled in shares is likely to lack economic substance and will not necessarily have taken place on market terms. Those users advocated the use of fair values for BCUCC that have economic substance or are undertaken on market terms and the use of predecessor values for other BCUCC.

Specific comments from users on the NCI and IPO scenarios

26. Users who specifically commented on the NCI scenario expressed different views on whether the presence of NCI would likely affect the terms of the transaction. As stated above, some thought that NCI, especially in a listed

entity, will likely be protected by law and that a BCUCC that involves NCI in the transferee will likely take place on market terms. Accordingly, they thought that such transactions should be comparable with business combinations that are not under common control.

27. Others argued that in a common control situation NCI would be a passive investment, the terms of the transaction would be determined by the controlling party and the interests of the non-controlling shareholders would not necessarily be protected in many jurisdictions. Accordingly, they thought that BCUCC are different from business combinations that are not under common control.

28. Many users who specifically commented on the IPO scenario agreed that it is important for all assets and liabilities being offered in the IPO to be measured on a consistent basis, ie either all assets and liabilities should be measured at fair values or all should be measured at the predecessor carrying amounts. They stated that measuring assets and liabilities transferred in a BCUCC in connection with an IPO at fair values, but measuring all other assets and liabilities at predecessor values, would not provide useful information.

29. Some users who specifically commented on the IPO scenario also stated that the amounts reported in the statement of financial position are generally not so important for valuation in an IPO (except for IPOs in the financial services industry, where price to book ratios are used). Instead, in an IPO investors focus on forecast cash flows and profitability.

30. Overall, there was more support for the use of fair values in the NCI scenario and more support for the use of the predecessor carrying amounts in the IPO scenario.

Other comments from users

31. Some users stated that depending on which accounting method is required for BCUCC, additional information can be provided via disclosures. For example, if the predecessor method is required, fair value information can be disclosed and vice versa.

32. Some users emphasised the need for disclosure regardless of which accounting method is required for BCUCC. Typically users wanted the following disclosures to be provided:

    (a) how fair values have been determined;

    (b) transaction price; and

    (c) historical information about the newly created entity as if that entity had existed in the past.

33. Many users also emphasised that comparability between similar transactions is important. Many users, including those who had not come across BCUCC in their work, stated that it is important for the Board to provide accounting requirements for BCUCC. Some users even stated that it is not that important which particular method is required, but that the Board should eliminate the accounting policy choice that is currently available to entities.

Feedback from preparers

34. The staff discussed accounting for BCUCC in the NCI and IPO scenarios at the March 2015 meeting of the Global Preparers Forum (GPF) and expressed the staff's preliminary view that the predecessor method should be applied in all or most BCUCC.

35. Some GPF members agreed that the predecessor method should be applied in both the NCI and the IPO scenarios. Some other GPF members supported using that method in the IPO scenario but expressed concerns about using it in the NCI scenario. For example, one GPF member expressed a concern that the predecessor method would not reflect the values exchanged in the BCUCC transaction and could result in an understatement of the transferee's equity, which in turn would result in inflated indicators for return of equity in subsequent years. That GPF member expressed a view that information needs of NCI in a BCUCC are the same as in a business combination with a third party.

36. A few GPF members asked the Board to broaden the scope of the project. Some of them suggested that the project should consider accounting in the separate financial statements of the transferee. One member suggested that the project

should consider other transactions under common control and the interaction with the broader issue of measuring related party transactions.

Feedback from standard-setters

37. The staff discussed BCUCC:

    (a) at the March and December 2015 meetings of the Accounting Standards Advisory Forum (ASAF),

    (b) at the June 2015 Asia-Oceania IFRS workshop for Standard-setters, and

    (c) at the December 2015 meeting of the Emerging Economies Group (EEG).

Feedback on which method should be applied for BCUCC

38. There was support from all those groups for using the predecessor method to account for BCUCC. Some participants supported using that method for all BCUCC. Some supported using that method as a default method of accounting for BCUCC but suggested that the Board should consider whether and when exceptions to using that method may be appropriate.

39. Some ASAF members and workshop participants suggested that different methods may be most appropriate in different circumstances. Overall, there was more support for using the acquisition method in the NCI scenario. There was little support for using the acquisition method in the IPO scenario. Some suggested the use of the so-called ‘fresh start’ accounting in the IPO scenario (ie measuring all assets and liabilities of all combining entities at fair values), but there was little support for that approach.

40. A few ASAF members, as well as participants in the Asia-Oceania workshop, emphasised that it is important for the Board to establish a clear objective for accounting for BCUCC and to develop a conceptual basis for why a particular method should be applied for BCUCC.

41. Suggestions for how the Board could approach developing such a conceptual basis and for making a distinction between different types of BCUCC included:

(a) consider whether the ultimate controlling party or the reporting entity perspective is most important for a BCUCC;

(b) consider why a set of financial statements is prepared and what information is most useful to users of those financial statements;

(c) consider whether the transaction has economic substance;

(d) consider whether the transaction is conditional on a successful IPO;

(e) consider whether the transaction is settled in cash or shares;

(f) consider whether the transaction involves a formation of a NewCo;

(g) consider whether there is NCI in the transferee and whether their profile of risks and rewards changes as a result of the transaction; and

(h) develop principles for when each accounting method is most appropriate and require preparers to apply judgement in deciding which method is more appropriate for a particular transaction.

Feedback on which method is applied in practice for BCUCC

42. The ASAF discussed papers presented by the staff of the Canadian Accounting Standards Board (AcSB) and the Hong Kong Institute of Certified Public Accountants (HKICPA) that discussed the practice for accounting for BCUCC in Canada and in Hong Kong.

43. The AcSB staff paper stated that BCUCC are common in Canada. The paper noted that both the acquisition method and the predecessor method are used in Canada to account for BCUCC, with the predecessor method being more frequently used.

44. The HKICPA staff paper focussed on BCUCC undertaken in connection with an IPO. It stated that BCUCC in preparation for an IPO are common in Hong Kong and that most, if not all, those transactions are accounted for by using the predecessor method.

45. A few ASAF members commented on those papers that the predecessor method is also common, or even required, in their jurisdictions.

46. All participants at the 2015 EEG meeting who commented on the method of accounting for BCUCC used in their jurisdictions stated that the predecessor method was either typically used or was even required.

Other comments from standard-setters

47. Some participants at the Asia-Oceania workshop and the EEG meeting as well as some ASAF members commented on the scope of the project. A few standard-setters emphasised that the Board should consider a wide range of BCUCC, including transactions undertaken for internal purposes or transactions that are conditional on a successful IPO. A few standard-setters suggested that the Board should also consider accounting in separate financial statements, or accounting for transactions under common control more broadly, or consider the implications of any proposals for carve-out financial statements. However, a few others expressed little appetite for broadening the scope of the project.

Feedback from regulators

48. Board members and the staff discussed BCUCC with the International Organization of Securities Commissions Committee 1 (IOSCO C1), the European Securities and Markets Authority and the European Enforcers Coordination Session (EECS).

49. Most members of IOSCO C1 who commented on BCUCC stated that BCUCC are typically accounted for under the predecessor method in their jurisdictions, and generally supported the use of that method. One member of IOSCO C1 who commented on the topic did not think that the predecessor method would provide useful information about BCUCC, especially in an IPO scenario.

50. Participants at the EECS meeting also stated that BCUCC are typically accounted for under the predecessor method in their jurisdictions. They noted that they typically see BCUCC in preparation for an IPO but not so many transactions involving existing listed entities.

51. Some participants at the EECS meeting stated that they have come across BCUCC accounted for in accordance with the acquisition method when:

(a) the BCUCC transaction was settled in cash;

(b) there was an existing NCI in a listed entity; or

(c) the issuing entity wanted to report higher equity.

52. The participants at the EECS meeting generally supported the staff's preliminary view that the predecessor method should be applied in BCUCC. A few noted that using different methods for different transactions could create structuring opportunities. A few asked the Board to consider whether the acquisition method may be more appropriate in particular circumstances, for example when a transaction is settled in cash, or whether fresh start accounting may be appropriate in some cases.

Research

53. The staff reviewed accounting requirements for BCUCC in a sample of national GAAPs, recent publications on BCUCC by standard-setters and guidance published by accounting firms.

54. The national GAAPs reviewed by the staff required the predecessor method for all or particular types of BCUCC. In some national GAAPs the predecessor method is not permitted, for example, if the transaction has economic substance and has a significant effect on future cash flows or if there is a change in the NCI in the net assets of the group.

55. The staff reviewed the findings discussed in the research report No. 33 *Critical Perspectives in Accounting for Business Combinations Under Common Control* published by the Korea Accounting Standards Board in April 2013. In developing the report, the KASB sought input from standard-setters from various jurisdictions on accounting for BCUCC based on an illustrative example. Most respondents who commented on the example stated that the predecessor method should either be required or permitted.

56. The staff reviewed Exposure Draft 60 *Public Sector Combinations*, published by the International Public Sector Accounting Standards Board in January 2016. The Exposure Draft proposes that a so-called 'modified pooling of interests method' is applied to public sector combinations that do not meet the proposed definition of an acquisition. One circumstance in which the public sector

combination may not meet the definition of an acquisition is when the transaction is imposed by a third party without any party to the combination being involved in the decision-making process. Under the proposed modified pooling of interests method, the predecessor carrying amounts are used to account for the combination.

57. The staff reviewed a sample of guidance published by accounting firms. Some of those publications suggest that BCUCC can generally be accounted for using the predecessor method or the acquisition method set out in IFRS 3. One publication suggests that the acquisition method can be used only if the transaction has economic substance from the perspective of the reporting entity. It further suggests a number of factors that could be considered in determining whether the transaction has substance: for example, the purpose of the transaction, whether the transaction is conducted at fair value or whether there is a significant change in ownership as a result of the transaction.

58. Some guidance emphasises that if the acquisition method is applied, it should normally be applied in its entirety as set out in IFRS 3. However, if the acquisition method gives rise to an apparent gain on a bargain purchase, such a gain should be recognised in equity as a capital contribution from the shareholders acting in their capacity as such.