STAFF PAPER

December 2017

IASB Meeting

Project	**Business Combinations under Common Control**
Paper topic	Review of related projects

CONTACT(S)	Satenik Vanyan	svanyan@ifrs.org	+44 (0)20 7246 6924
	Yulia Feygina	yfeygina@ifrs.org	+44 (0)20 7332 2743

Purpose of the paper

1. This paper provides an overview of the issues related to the scope of the Business Combinations under Common Control (BCUCC) research project that the staff have identified in other projects of the International Accounting Standards Board (Board) and the IFRS Interpretation Committee (Committee).

2. This paper is for information only and there are no questions for the Board. Agenda Paper 23B *Scope of the project* for this month's meeting discusses whether issues that remain unresolved should be within the scope of the BCUCC project and asks the Board for decisions.

3. This paper should be read together with Agenda Paper 23 *Cover note* and Agenda Paper 23B *Scope of the project*.

Structure of the paper

4. The paper is structured as follows:

   (a) review performed by the staff (paragraphs 5–8);

   (b) overview of the issues raised (paragraphs 9–32):

      (i) transfers of businesses under common control involving the formation of a new entity, Newco; and

(ii) application of the scope exclusion in IFRS 3 *Business Combinations* to other common control transactions.

Review performed by the staff

5. The staff have reviewed the following sources to identify issues related to the scope of BCUCC project:

   (a) submissions received by the Committee, related Agenda Papers and IFRIC *Updates*;

   (b) feedback received on the 2011 and 2015 Agenda Consultations;

   (c) feedback received on the Post-implementation Review of IFRS 3 *Business Combinations*; and

   (d) feedback received on the Exposure Draft *Definition of a Business and Accounting for Previously Held Interests*.

6. The staff have identified several issues related to the scope of BCUCC project in submissions received by the Committee. Some of these issues remained unresolved and have also been raised subsequently by a securities regulator. The issues raised with the Committee are discussed in paragraphs 9–32.

7. Respondents to both the 2011 and 2015 Agenda Consultations identified BCUCC as an important and urgent project. Some respondents asked the Board to consider related party transactions more broadly. The Board considered such suggestions in making its tentative decision on the scope of the project but decided that the project should only address transactions under common control involving transfers of businesses or entities (see Agenda Paper 14 *Scope of the research project*, June 2014 and Agenda Paper 23 *Scope of the project*, October 2017).

8. The staff for this project have not identified any issues related to the scope of the BCUCC project in the Post-implementation Review of IFRS 3 and in the project on Definition of a Business.

Overview of the issues raised

9. The issues raised with the Committee that are related to the scope of the BCUCC project fall into two broad categories:

   (a) transfers of businesses under common control involving the formation of a Newco (paragraphs 10–26); and

   (b) application of the scope exclusion in IFRS 3 to other transactions under common control (paragraphs 27–32).

Transfers of businesses under common control involving the formation of a Newco

10. The staff have identified three submissions discussed by the Committee over 2005–2011 that describe formation of a Newco to acquire a business or businesses controlled by the same party (or parties). The fact patterns discussed vary, for example:

    (a) Newco can be formed by the controlling party (for example, to facilitate subsequent disposal of the newly created group through an initial public offering—IPO—or a spin off) or by a third-party acquirer (for example, to raise funds to effect the acquisition);

    (b) Newco can pay cash or shares to effect the acquisition; and

    (c) Newco can be formed to acquire just one business or more than one business.

11. Specific questions raised in the submissions also vary. However, the common question that arises from those submissions is whether Newco can be identified as the acquirer and apply the acquisition method set out in IFRS 3—recognise acquired identifiable net assets at fair value as well as any goodwill or a gain on a bargain purchase arising from the transaction. The submitters, including a securities regulator, have reported diversity in practice in accounting by Newco.

12. The staff have identified two aspects of the fact patterns described in the submissions that are relevant to the scope of the BCUCC project:

    (a) the transaction meets the definition of a business combination but it is not clear whether the combination is under common control and thus whether the scope exclusion in IFRS 3[1] applies (Issue 1 and Issue 2 below); and

    (b) the transaction is under common control but does not meet the definition of a business combination (Issue 3 below).

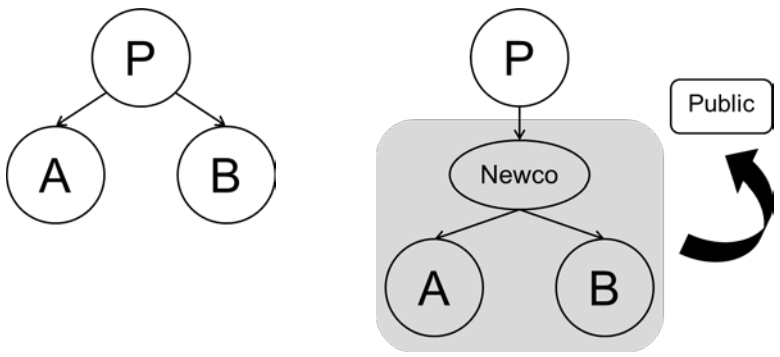
Issue 1. Is control by the same party 'transitory'?

13. This issue arises in a scenario where a Newco is formed by the controlling party to acquire businesses controlled by that party. Newco is subsequently sold in an IPO. An illustrative example of such a transaction is presented in **Figure 1**.

Figure 1

Entity A and Entity B are controlled by Entity P. Entity P forms a Newco and transfers Entity A and Entity B to that Newco. Both Entity A and Entity B are businesses. Newco is not a business.

The reporting entity is Newco.



[1] Business combinations under common control are excluded from the scope of IFRS 3 *Business Combinations* (paragraph 2(c) of IFRS 3).

14. The question arises as to whether Entity P's control over Newco is 'transitory'[2] and thus whether the scope exclusion in IFRS 3 applies to the acquisition of Entity A and Entity B by Newco.

15. The following views have been expressed:

(a) **control over Newco is 'transitory'—**some constituents argue that Entity P's control over Newco is 'transitory' because Newco is subsequently sold in an IPO. Accordingly, the acquisition of Entity A and Entity B by Newco is *not* a business combination under common control (paragraph B1 of IFRS 3) and the scope exclusion in IFRS 3 does not apply. Therefore, one of the combining entities must be identified as the acquirer and must recognise acquired identifiable net assets at fair value as well as any goodwill or a gain on a bargain purchase arising from the transaction. Some constituents further note that if Newco issues shares to effect a business combination, it cannot be identified as the acquirer and one of the combining entities that existed before the combination shall be identified as the acquirer (paragraph B18 of IFRS 3).

(b) **control over Newco is 'not transitory'—**some constituents argue that Newco's IPO is irrelevant to the analysis. In their view, Entity P's control over Newco is 'not transitory'. Accordingly, the acquisition of Entity A and Entity B by Newco *is* a business combination under common control and the scope exclusion in IFRS 3 applies. Consequently, Newco must develop and apply an accounting policy in accordance with the hierarchy set out in paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

16. In its September 2011 Agenda Decision, the Committee noted that transactions involving formation of a Newco are complex and would be better considered in a broader project on common control transactions. Therefore, the Committee decided not to add the issue to its agenda.

[2] The description of business combination under common control in paragraph B1 of IFRS 3 requires that 'all 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].

17. The staff have considered the issue of transitory control in Agenda Paper 23B *Scope of the project* for this month's meeting.

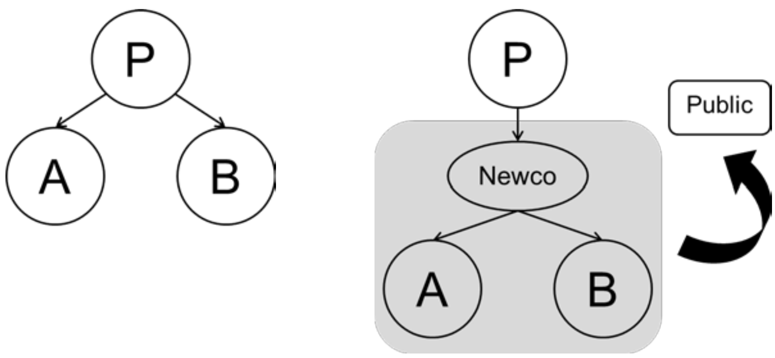
Issue 2. Is a business combination conditional on an IPO a combination under common control?

18. Like Issue 1, Issue 2 arises in a scenario where a Newco is formed by the controlling party to acquire businesses controlled by that party (see **Figure 2**). However, in Issue 2, the acquisition of the businesses by Newco is conditional upon the success of Newco's IPO. Newco is formed with a nominal equity and issues a prospectus offering shares for cash to raise funds to acquire businesses from the controlling party. If Newco's IPO is successful, the controlling party loses control over Newco and Newco uses the cash raised in the IPO to acquire the businesses from that party. If Newco's IPO does not occur, the acquisition of the businesses by Newco does not occur either.

Figure 2

Entity A and Entity B are controlled by Entity P. Entity P forms a Newco. Newco acquires Entity A and Entity B from Entity P *only on condition* of the occurrence of Newco's IPO. Both Entity A and Entity B are businesses. Newco is not a business.

The reporting entity is Newco.



19. The question arises as to whether the acquisition of the Entity A and Entity B by Newco is a business combination under common control and thus whether the scope exclusion in IFRS 3 applies.

20. The following views have been expressed:

    (a) **the combination is under common control—**some argue that the condition imposed on the acquisition is not relevant to the analysis. In their view, the important factors in the analysis are which party has formed Newco and which party has initiated the transaction. In this scenario, Newco has been formed by Entity P to facilitate a disposal of the existing businesses by means of an IPO of Newco. The new shareholders are investing in the combining entities rather than Newco in its own right. Moreover, they further argue that Entity P's control over the combining entities is 'not transitory'. Accordingly, the combination is under common control and the scope exclusion in IFRS 3 applies. Newco must develop and apply an accounting policy in accordance with the hierarchy set out in paragraphs 10–12 of IAS 8.

    (b) **the combination is not under common control—**some argue that the condition imposed on the business combination is the decisive factor in the analysis. In their view, the business combination cannot be considered complete until Newco's IPO takes place and the condition is hence satisfied. Entity P loses control over Newco in the IPO. Accordingly, in acquiring Entity A and Entity B from Entity P, Newco represents new shareholders and the business combination is *not* under common control. Others argue that condition imposed on the acquisition is not relevant to the analysis, but the combination is still *not* under common control because Entity P's control over Newco is 'transitory'. Under both views, the scope exclusion in IFRS 3 does not apply. In accordance with IFRS 3, Newco, that pays cash to effect the acquisition, can be identified as the acquirer and thus recognises the acquired identifiable net assets at fair value as well as any goodwill or a gain on a bargain purchase arising from the transaction.

21. In its September 2011 Agenda Decision, the Committee observed that transactions involving formation of a Newco are complex and would be better considered in a broader project on common control transactions. Therefore, the Committee decided not to add the issue to its agenda.

22. The staff have considered the issue of business combinations conditional on an IPO in Agenda Paper 23B *Scope of the project* for this month's meeting.

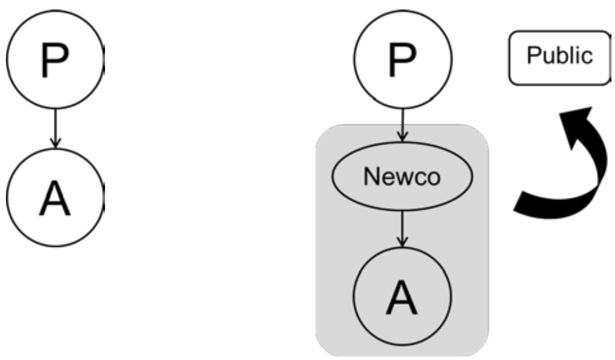
Issue 3. Transfer of a business in a transaction that is not a business combination

23. This issue arises in a scenario where a Newco is formed by a party to acquire a single business controlled by the same party. An illustrative example of such a transaction is presented in **Figure 3**. Newco may, or may not, be subsequently sold in an IPO.

Figure 3

Entity A is controlled by Entity P. Entity P forms a Newco) and transfers Entity A to that Newco. Entity A is a business. Newco is not a business.

The reporting entity is Newco.



24. The transaction does not meet the definition of a business combination because neither of the combining entities can be identified as the acquirer. Newco that issues shares is not an acquirer applying paragraph B18 of IFRS 3. The acquired business cannot be identified as the acquirer because Newco is not a business. The question arises how Newco should account for the transaction.

25. In its September 2011 Agenda Decision, the Committee observed that transactions involving formation of a Newco are complex and would be better considered in a broader project on common control transactions. The Committee decided not to add the issue to its agenda.

26. In October 2017, the Board discussed the scope of the BCUCC project and tentatively decided that the scope of the project will include transactions under common control in which a reporting entity obtains control of one or more businesses, regardless of whether IFRS 3 would identify the reporting entity as the acquirer, if IFRS 3 were applied to the transaction. Accordingly, the transaction outlined in paragraph 23 is included in the scope of the BCUCC project.

Application of the scope exclusion in IFRS 3 to other common control transactions

27. In June and September 2017 the Committee discussed two submissions that asked the Committee to clarify whether the scope exclusion in IFRS 3 applies to other transactions under common control.

28. One submission raised a general question as to whether IFRS Standards provide a general exception or exemption from applying the requirements in a particular Standard to common control transactions. The following views have been expressed:

    (a) some argued that entities must apply the requirements in the relevant IFRS Standards to common control transactions unless a specific scope exception or exemption applies; and

    (b) others argued that entities can apply the scope exclusion in IFRS 3 to other common control transactions by analogy.

29. The Committee issued a tentative Agenda Decision where it noted that unless a Standard specifically excludes common control transactions from its scope, an entity applies the applicable requirements in the Standard to common control transactions. The comment period for this tentative Agenda Decision ended on 20 November 2017. The Committee will discuss the comments received on the tentative Agenda Decision at a future meeting.

30. Another submission asked whether the scope exclusion in IFRS 3 applies to an acquisition of an associate from an entity under common control. The submitter presented the following views:

(a) some argue that IAS 28 *Investments in Associates and Joint Ventures* does not include a scope exclusion for acquisition of associates from entities under common control. Accordingly, an entity applies IAS 28 to an acquisition of an associate from an entity under common control and calculates its share in the fair value of the identifiable net assets of the associate applying paragraph 32 of IAS 28.

(b) others refer to paragraph 26 of IAS 28 that states that 'the *concepts underlying the procedures used in accounting for the acquisition of a subsidiary* are also adopted in accounting for the acquisition of an investment in an associate or a joint venture' [emphasis added]. They argue that, because IFRS 3 excludes from its scope business combinations under common control and the 'concepts' applied to accounting for acquisitions of associates are similar to those applied to acquisitions of subsidiaries, an entity can apply the scope exclusion in paragraph 2(c) of IFRS 3 to acquisitions of associates from an entity under common control. As a result, the entity does not remeasure identifiable net assets of the associate to fair value and recognises the investment in the associate at its share of the carrying amount of the associate's net assets.

31. The Committee discussed the issue at its June and September 2017 meetings but did not issue an Agenda Decision. Some members argued that it may be premature for the Committee to issue an Agenda Decision pending developments in the BCUCC project.

32. As discussed in Agenda Paper 23 *Scope of the Project* (October 2017), the Board acknowledged that there is an interaction between accounting for transactions in the scope of the project and accounting for other transactions under common control or related party transactions more broadly. As explained in that paper, the staff will consider this interaction as the BCUCC project progresses.