IFRS

STAFF PAPER

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IASB® meeting

Project	**Business Combinations under Common Control**
Paper topic	Feedback on applying the acquisition method
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Purpose

1. This paper summarises feedback on the International Accounting Standards Board (IASB)'s preliminary views on how to apply the acquisition method to particular business combinations under common control (BCUCCs).

2. As explained in Agenda Paper 23, this paper does not ask for any decisions.

3. Disclosure requirements for BCUCCs accounted using the acquisition method are discussed in Agenda Paper 23D to this meeting.

Structure of this paper

4. The paper includes:

   (a) preliminary views (paragraphs 5–9)

   (b) key messages (paragraph 10–12);

   (c) feedback (paragraphs 13–25);

      (i) distributions from equity (paragraph 14–19);

      (ii) contribution to equity (paragraph 20–22); and

      (iii) other special requirements (paragraph 23–25); and

   (d) question for the IASB; and

   (e) Appendix A—Preliminary views and rationale.

Preliminary views

5. When applying the acquisition method to a BCUCC[1], the IASB's preliminary view is that in principle a receiving entity should apply the acquisition method as set out in IFRS 3 *Business Combinations*.

6. However, the consideration paid in a BCUCC might be directed by the controlling party and therefore might differ from an arm's length price that would have been negotiated between unrelated parties in a business combination covered by IFRS 3. Any difference between the consideration paid and the amount that would have been paid to an unrelated party in an arm's length transaction indicates that the BCUCC includes an additional component—a transaction with owners acting in their capacity as owners (such as a contribution from or distribution to owners). Accordingly, the IASB considered whether to develop specific requirements in this regard.

7. For the rationale explained in paragraphs 3.11–3.13 and 3.17–3.19 of the Discussion Paper (reproduced in Appendix A), the IASB's preliminary views are to:

   (a) not develop a requirement for a receiving entity to identify, measure and recognise a distribution from equity; and

   (b) develop a requirement for a receiving entity to recognise any excess fair value of the identifiable acquired assets and liabilities over the consideration paid[2] as a contribution to equity, not as a gain in the statement of profit or loss.

8. Appendix C to the Discussion Paper discusses two possible approaches to identify, measure and recognise a distribution from equity that the IASB considered if it were to require the receiving entity to identify and recognise a distribution. These approaches included:

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[1] As explained in Agenda Paper 23B of the IASB's December 2021 meeting, the IASB's preliminary view is that in principle the acquisition method should apply if a BCUCC affects non-controlling shareholders of the receiving entity.

[2] For simplicity, we refer to this difference as a bargain purchase.

(a) measuring that distribution as the excess of the fair value of the consideration transferred over the fair value of the acquired business (fair-value-based approach); and

(b) measuring that distribution by applying the requirements on testing goodwill for impairment in IAS 36 *Impairment of Assets* (impairment-based approach).

9. The IASB did not identify a need to develop any other special requirements on how to apply the acquisition method to BCUCCs.

Key messages

10. Most respondents agree with the preliminary views that a receiving entity should apply the acquisition method generally as set out in IFRS 3 and, when applying the acquisition method, should recognise:

(a) goodwill if the fair value of the consideration paid exceeds the fair value of the identifiable net assets received; and

(b) a contribution to equity—not a gain in profit or loss—if the fair value of the identifiable net assets received exceeds the fair value of consideration paid.

11. Some respondents disagree. In particular:

(a) some suggest recognising a distribution from equity if the fair value of the consideration paid exceeds the fair value of the identifiable net assets received because BCUCCs are not arm's length transactions[3]—some of these respondents suggest recognising the entire excess as a distribution, some suggest recognising only an 'overpayment' component of the excess as a distribution and some did not specify whether the entire excess or only a component should be recognised as a distribution; and

[3] Agenda Paper 23 of the IASB's December 2021 meeting says these respondents suggest recognising any *overpayment* separately from goodwill as a distribution from equity because at that time we identified it to be the most common alternative suggestion. Further analysis revealed a similar number of respondents also suggest recognising the entire excess as a distribution or do not make a particular suggestion in this respect.

(b) some suggest recognising a bargain purchase as a gain in profit or loss for consistency with IFRS 3.

12. We did not identify trends in feedback by region or stakeholder type but note that within any region or stakeholder group—except for academics[4]—at least a majority of respondents agree with the preliminary views in paragraph 7 of this paper.

Feedback

13. Seventy-three comment letters include feedback on how to apply the acquisition method to a BCUCC. We also received feedback through outreach meetings with stakeholders. Our analysis summarises separately feedback on the preliminary views regarding:

   (a) distributions from equity (paragraph 14–19);

   (b) contributions to equity (paragraph 20–22); and

   (c) other special requirements (paragraph 23–25).

Distributions from equity

14. Most respondents agree that the IASB should not develop a requirement for a receiving entity to identify, measure and recognise a distribution from equity for some or all of the reasons considered by the IASB in developing its preliminary view (see Appendix A).

15. Some respondents disagree with the preliminary view. Paragraphs 16–17 summarise their reasons and paragraphs 18–19 summarise their suggestions.

Reasons for disagreeing

16. Most of the respondents who disagree say, because BCUCCs are not arm's length transactions, the consideration paid in a BCUCC could include other components, such as a distribution from equity or a payment for tax benefits. Accordingly, any

[4] Two comment letters were received from academics—both agree with the preliminary view on distributions from equity, but for contributions to equity one agrees and one disagrees.

excess fair value of the consideration paid over the identifiable net assets might not solely represent goodwill arising from the BCUCC.

17. These respondents also say:

(a) situations in which a receiving entity 'overpays' for a BCUCC might not be uncommon and legal regulations aimed at protecting the interest of non-controlling shareholders in some jurisdictions may not work effectively in practice (a few respondents);

(b) allocating goodwill arising from a BCUCC to cash generating units as required by IAS 36 could be challenging because, for example, synergies might already have existed between a receiving entity and a transferred entity before a BCUCC (a few respondents)[5];

(c) any goodwill recognised in a BCUCC would be subject to the limitations of the impairment test—for example, respondents say the impairment test results in entities not recognising impairment losses on a timely basis (a few respondents);

(d) the preliminary view could result in recognising goodwill generated internally within the group (a few respondents); and

(e) recognising any excess of the fair value of the consideration paid over the fair value of the identifiable net assets as a distribution in equity would:

(i) be symmetrical with the IASB's preliminary view on how to account for a bargain purchase (see paragraph 7(b));

(ii) better reflect the differing nature of a BCUCC from other business combinations; and

(iii) improve comparability with BCUCCs that would apply a book-value method[6] (a few respondents).

[5] See paragraph 80 of IAS 36 *Impairment of Assets* for further information.

[6] As explained in Agenda Paper 23B for this meeting, applying the preliminary views on how to apply a book value method, the receiving entity would recognise within equity any difference between the consideration paid and the book value of the assets and liabilities received.

Alternative suggestions

18. Of the respondents who disagree with the IASB's preliminary view:

    (a) some say the receiving entity should recognise the entire excess of the fair value of the consideration paid over the fair value of identifiable net assets as a distribution in equity (that is, it should not recognise any goodwill);

    (b) some suggest the receiving entity should recognise any 'overpayment' (see paragraph 19) as a distribution in equity, separately from goodwill; and

    (c) some respondents disagree with the preliminary view but do not specify whether the entire excess or only any overpayment should be recognised as a distribution in equity.

19. A few respondents who suggest recognising any 'overpayment' as a distribution in equity suggest using the fair-value-based approach (see paragraph 8(a)) to determine the amounts to be recognised as a distribution / as goodwill. In their view, although this approach would be costlier than applying the preliminary view, it would better reflect the actual value transferred. The other respondents who suggest recognising any overpayment as a distribution in equity separately from goodwill do not say how to measure any overpayment.

Contributions to equity

20. Most respondents agree with the preliminary view that, when applying the acquisition method to a BCUCC, a receiving entity should recognise a bargain purchase as a contribution to equity—not as a gain in profit or loss—for some or all of the reasons considered by the IASB in developing its preliminary view (see Appendix A).

21. Some respondents disagree. Of these respondents:

    (a) most say the acquisition method applied to a BCUCC should align with IFRS 3 and, accordingly, any bargain purchase should be recognised as a gain in profit or loss. They say doing so would reduce costs for preparers and enhance understandability. One national standard-setter says IFRS Accounting Standards do not generally require different accounting treatments for transactions at arm's length and similar transactions under common control.

(b) a few respondents say a bargain purchase is unlikely to occur for BCUCCs to which the acquisition method applies—that is, BCUCCs that affect non-controlling shareholders—so the IASB does not need to develop specific requirements to address this situation.

(c) a few say a bargain purchase might not necessarily represent only an distribution but could also include other components, such as a gain.

(d) one preparer says the preliminary view could result in unintended consequences. For example, entities might apply the principle underlying the preliminary view to other common control transactions such as transfers of property, plant and equipment and inventories.

22. One user says regardless of whether a bargain purchase is recognised as a contribution to equity or in profit or loss, a receiving entity should be required to disclose the amount of any bargain purchase recognised.

Other special requirements

23. The Discussion Paper asked if the IASB should develop any other special requirements on how to apply the acquisition method to BCUCCs.

24. Some respondents recommend the IASB develop other special requirements for the receiving entity on how to apply the acquisition method to BCUCC. They say the IASB should:

(a) clarify whether IFRS 3's requirements on pre-existing relationships and separate arrangements that are not part of the business combination (paragraph 51 of IFRS 3) and contingent consideration (paragraph 58 of IFRS 3) apply (some respondents, many of which suggest that IFRS 3 requirements should apply); and

(b) allow a receiving entity to restate pre-combination information when applying the acquisition method if users need such information (one respondent).

25. Some respondents suggest providing guidance on how to identify the acquirer in a BCUCC, particularly for BCUCCs that involve a new entity or a reverse acquisition. They say for example:

    (a) some of the factors in paragraph B15 of IFRS 3 (which lists factors to consider when identifying the acquirer in a business combination) might not be relevant for a BCUCC because of the controlling party's role in the transaction and the fact that the consideration paid might not reflect an arm's length price;

    (b) reverse acquisitions may be common in BCUCCs so the IFRS 3 requirements on reverse acquisitions should not apply to BCUCCs; and

    (c) the acquisition method would be expected to be more prevalent in the context of BCUCC.

Question for the IASB

Does the IASB have any questions or comments on the feedback discussed in this paper? Specifically:

(a) is there any feedback that is unclear?

(b) are there any points you think the IASB did not consider in developing the Discussion Paper but should consider in the deliberations?

(c) are there any points you would like staff to research further for the deliberations?

Appendix A—Preliminary views and rationale

Distribution from equity

A1. The following excerpts from the Discussion Paper explain the rationale for the IASB's preliminary views on whether it should develop requirements for the receiving company to identify and recognise a distribution from equity:

> 3.11… If the [IASB] were to require the receiving company to identify and recognise a distribution from equity in a business combination under common control, the [IASB] would need to specify how to measure any such distributions. The [IASB] considered a similar issue when it developed IFRS 3: whether to provide special requirements for business combinations in which a buyer 'overpays' for the acquisition. No such requirements are included in IFRS 3, because the [IASB] concluded that, in practice, an overpayment is unlikely to be detectable or known at the acquisition date and that the overpayment would be difficult, if not impossible, to quantify. Accordingly, if an overpayment occurs, it is initially included in goodwill recognised in a business combination and is addressed through subsequent testing of goodwill for impairment…
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> 3.12… In the [IASB]'s view, similar difficulties would arise in identifying and measuring a distribution to the controlling party in a business combination under common control. Appendix C [of the Discussion Paper] discusses such difficulties.
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> 3.13… The [IASB] also considered whether a distribution from equity would be likely to occur in practice in business combinations under common control that affect non-controlling shareholders of the receiving company. In effect, any such distribution would transfer wealth from those non-controlling shareholders to the transferring company, and ultimately to the controlling party. Research for this project and stakeholder input suggest that distributions to the controlling party are unlikely to occur in such combinations. Such distributions are unlikely to occur because many jurisdictions have legal requirements and

regulations that are designed to protect the interests of non-controlling shareholders.

3.14… For the reasons discussed in paragraphs 3.12–3.13 [of the Discussion Paper], the [IASB] has reached the preliminary view that it should not develop a requirement for the receiving company to identify, measure and recognise a distribution to the controlling party applying the acquisition method. Accordingly, in the unlikely event that an overpayment occurs in a business combination under common control that affects non-controlling shareholders, it would be initially included in goodwill and addressed through subsequent testing of goodwill for impairment, just as occurs in a business combination covered by IFRS 3. Many stakeholders who provided their views on this matter during the development of this Discussion Paper (see paragraph IN.9), notably investors and analysts, agreed with that conclusion.

3.15… However, investors and analysts also emphasised that they need information about the economics of the combination to help them make their own assessment of whether the consideration paid includes an overpayment. Disclosure requirements when applying the acquisition method to business combinations under common control are discussed further in Section 5 ... In particular, that Section explains that in another active project—Goodwill and Impairment—the [IASB] is considering possible improvements to IFRS 3, including improved disclosure requirements designed to help investors and analysts understand whether the price paid in a business combination was reasonable… Any such improved disclosures would also provide useful information about the consideration paid in a business combination under common control to which the acquisition method is applied.

Contributions to equity

A2. The following excerpts from the Discussion Paper explain the rationale for the IASB's preliminary views on whether it should develop requirements for the receiving company to identify and recognise a contribution to equity:

> 3.17 The [IASB] also considered whether the receiving company should be required to recognise a contribution to equity when applying the acquisition method to a business combination under common control. The [IASB] first considered whether such a contribution would be likely to occur if such a combination affects non-controlling shareholders of the receiving company. The legal protections discussed in paragraph 3.13 [of the Discussion Paper] might not apply in this situation, because any such contribution would transfer wealth from the controlling party to the non-controlling shareholders of the receiving company and so would not adversely affect those shareholders. Nevertheless, the controlling party is unlikely to allow a transfer of wealth to non-controlling shareholders. Therefore, the [IASB] has reached the view that such contributions are also unlikely to occur in practice.
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> 3.18 However, in the unlikely event that a contribution did occur, the question arises whether it could be identified and measured and, if so, whether it should be recognised… in a business combination under common control, economically the amount of any contribution to equity equals the excess of the consideration that would have been negotiated between unrelated parties in an arm's length transaction over the consideration actually paid. In an arm's length transaction between unrelated parties, the amount of consideration is expected to reflect the fair value of the acquired business and the price paid for any synergies expected from the combination ... However, that amount would be difficult, if not impossible, to measure in practice. Hence, measuring the full amount of the contribution …would not be workable in practice.

3.19 The [IASB] next considered whether any portion of the contribution could be identified and measured. In considering that question, the [IASB] analysed the requirements of IFRS 3 for bargain purchase gains. A bargain purchase gain arises if the fair value of the consideration paid is below the fair value of identifiable assets and liabilities acquired in a business combination... The Standard explains that a bargain purchase gain might happen occasionally, for example, in a forced sale in which the seller is acting under compulsion. IFRS 3 requires such a gain to be recognised in the statement of profit or loss. However, based on the discussion in paragraph 3.6 [of the Discussion Paper], in a business combination under common control, any excess fair value of the identifiable acquired assets and liabilities over the consideration paid constitutes a contribution to equity and therefore should be reported as a change in the receiving company's equity. Accordingly, the [IASB] has reached the preliminary view that it should develop a requirement for the receiving company in a business combination under common control to recognise any excess of the fair value of the identifiable acquired assets and liabilities over the consideration paid as a contribution to equity, rather than as a gain in the statement of profit or loss…