# STAFF PAPER

March 2015

## ASAF 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 ASAF members;
   (b) obtain feedback from ASAF 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 ASAF members are set out at paragraph 17.

### Update on the research project

3. In June 2014, the staff discussed with the ASAF the scope of the research project on BCUCC. Most ASAF members believed that the scope of the project should be narrow and should focus on the most pervasive application issues—business combinations under common control and group restructurings. They noted that the IASB could consider any further related issues in the future.

4. Some ASAF members emphasised that particular attention should be given to transactions in which third parties are involved, eg an existing or new non-controlling interest (NCI). ASAF members expressed mixed views on whether the project should address accounting only in consolidated financial statements of the acquirer, or whether it should also capture accounting in separate financial statements of the acquirer or financial statements of other parties to the transaction. Some ASAF members believed that the description of a BCUCC should be clarified.

5. A complete extract from the June 2014 ASAF meeting summary on BCUCC is provided in Appendix A.

6. Later in June 2014, the staff discussed the scope of the project with the IASB and presented to the IASB the feedback received from the ASAF.[1] Consistently with the general direction recommended by the ASAF, 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’.

7. The IASB also 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.

8. 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. To date, the staff have received 15 responses to that request.

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[1] Agenda Paper 14 of June 2014.

9. 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.

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

## Scope

11. The staff are initially focusing on BCUCC that involve—or are related to transactions with—third-party equity investors and are 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 is more appropriate for such BCUCC.

12. 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).

13. 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.

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

15. 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.

## Summary and questions for the ASAF

16. On balance, the preliminary analysis performed by the staff supports the application of the predecessor method of accounting for all types of BCUCC that involve—or are related to transactions with—third-party equity investors. However, this preliminary view is subject to further investigation and outreach, most notably with users of financial statements.

17. The staff are seeking the ASAF's advice on the preliminary views set out in this paper.

**Questions 1-3 for the ASAF**

1. Do you have any comments on the preliminary view set out in this paper regarding the use of the predecessor method for all types of BCUCC that involve—or are related to transactions with—third-party equity investors?

2. Should any types of BCUCC that involve—or are related to transactions with—third-party equity investors be accounted for under the acquisition method of accounting as set out in IFRS 3, and if so, why?

3. Should the staff consider any additional issues related to such BCUCC?

## 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 1); and

(b) a combination that involves an existing non-controlling interest (NCI) in the acquirer (Illustration 2).

**Illustration 1—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.

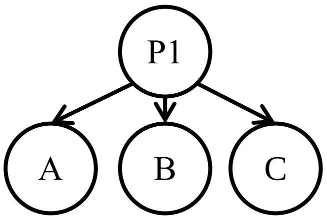
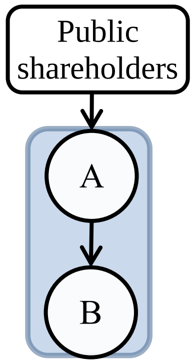
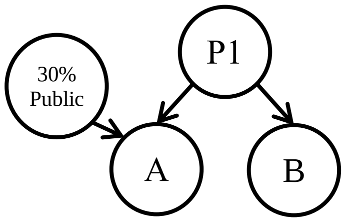
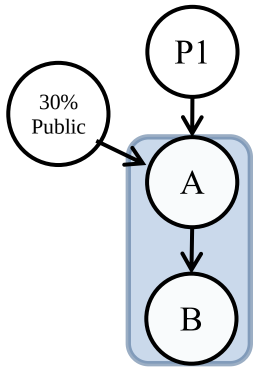
| Before BCUCC and IPO | After BCUCC and IPO |
|---|---|
|   |   |

**Illustration 2—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.

| Before BCUCC | After BCUCC |
|---|---|
|   |   |

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 1), 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 2), 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*[2]

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 3a); and

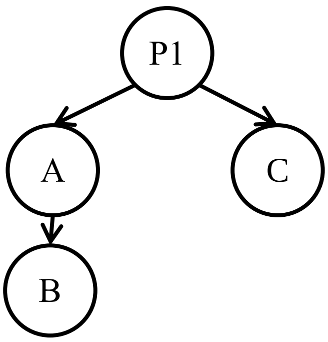
    (b) combining existing businesses under common control in preparation for an IPO and then selling them in an IPO (Illustration 3b).

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 3a and 3b), which were previously wholly owned by the controlling party in the group (P1 in Illustrations 3a and 3b).

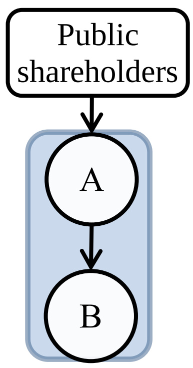
**Illustration 3a—IPO without BCUCC**

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.

Before IPO



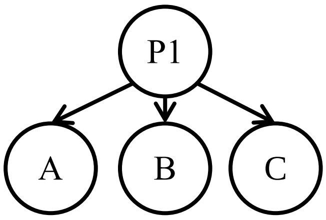
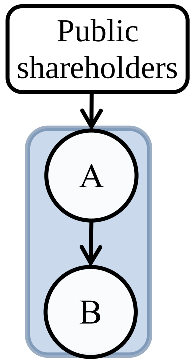

After IPO




[2] 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.

**Illustration 3b—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.

| Before BCUCC and IPO | After BCUCC and IPO |
|---|---|
|   |   |

22. Consequently, the staff think that IFRS financial statements[3] 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:

    (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.

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

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 3a), 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.[4] 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 this preliminary view is supported by the research that has been performed to date on the current practice in an IPO, notably the information received from national and regional standard-setters. The responses received by the staff indicate that the predecessor method represents the prevailing practice in an IPO. However, those responses only cover a subset of jurisdictions that apply IFRS. The staff will continue the research to better understand the current practice and requirements in various jurisdictions.

27. 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 mixed. The staff will continue outreach with users of financial statements and will consider the feedback received in developing recommendations for the IASB.

### *BCUCC that involves an existing NCI*

28. In a BCUCC that involves an existing NCI in the acquirer, the NCI is affected by the BCUCC (Illustration 4b). Arguably, this is similar to a scenario in which the acquirer acquires a business from a third party (Illustration 4a). In both cases, the assets and liabilities in which the NCI holds a share change as a result of the

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

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 4a and 4b).

**Illustration 4a—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.

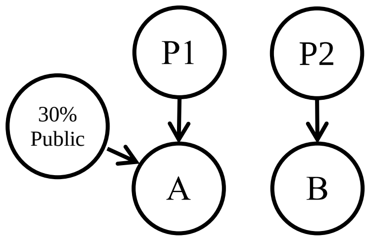
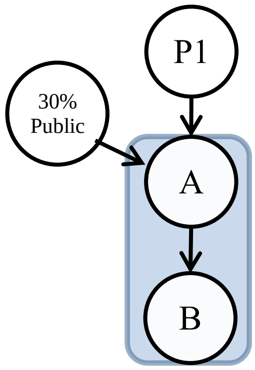
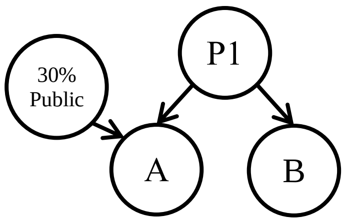
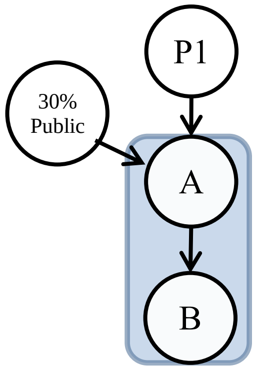
| Before business combination | After business combination |
|---|---|
|  |  |

**Illustration 4b—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.

| Before BCUCC | After BCUCC |
|---|---|
|  |  |

29. In Illustration 4a, 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).

30. Economically, from the NCI perspective, the BCUCC in Illustration 4b is similar to the business combination in Illustration 4a. Consequently, applying the acquisition method set out in IFRS 3 to BCUCC in Illustration 4b 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.

31. 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.

32. The staff find the arguments in paragraph 31 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.

## Appendix—Extract from the June 2014 ASAF meeting summary

### *Business combinations under common control*

A1. The IASB staff introduced a paper that sought input from ASAF members on the scope of the research project on business combinations under common control.

A2. Most ASAF members believed that the scope of the project should be narrow and should focus on the most pervasive application issues—business combinations under common control and group restructurings. They noted that if the scope of the project is broad, it would probably take a long time to complete the project and would delay the issuance of the much-needed guidance. Most ASAF members specifically stated that the IASB should not consider the broader new basis issues or transfer pricing issues at this stage. They noted that the IASB could consider any further related issues in the future.

A3. One ASAF member commented that, on the basis of past standard-setting experience in their jurisdiction, it would be difficult to develop a Standard without first developing some general principles for measuring all related party transactions. Setting narrow boundaries on the project would lead to debates in practice around whether the new requirements applied to certain transactions and whether those requirements should be applied to transactions outside the scope of the Standard.

A4. Many ASAF members made other comments about the scope. Some ASAF members emphasised that particular attention should be given to transactions in which third parties are involved, eg an existing or new non-controlling interest. Some ASAF members believed that the description of a 'business combination under common control' should be clarified. Some ASAF members emphasised that the IASB should not only consider accounting in the consolidated financial statements of the acquirer, but also accounting in the acquirer's separate financial statements and in the financial statements of other parties to the transaction. Other ASAF members, in contrast, believed that at this stage the IASB should focus on consolidated financial statements only of the acquirer.