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Research Project

Business Combinations under Common Control Issues Paper

Objective

1 The objective of this session is to seek input from EFRAG TEG and EFRAG CFSS members in preparation for the ASAF meeting in December 2017 on the following:

(a) the scope of the IASB research project on Business Combinations under Common Control (BCUCC) as clarified by the IASB in its latest discussions; and

(b) the starting point and the factors to be considered when deciding on the accounting method to be applied to transactions within the scope of the project.

Background

2 According to IFRS 3 *Business Combinations*, BCUCCs are business combinations in which 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.

3 Business Combinations under Common Control are excluded from the scope of IFRS 3 and entities are required to apply the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in order to develop an accounting policy that results in useful information.

4 In practice, entities generally account for BCUCC using the acquisition method as set out in IFRS 3 or the so-called predecessor method where the acquirer measures the net assets acquired at historical carrying amount (which may be based on local GAAP), however, there is diversity in practice as to how this method is applied. As a result, concerns were raised by different parties, mainly security regulators, about the absence of guidance in IFRS Standards on BCUCC and group restructurings and the consequent diversity in practise in accounting for these.

5 In 2012, the BCUCC project was added to the IASB research agenda and in 2014 the IASB made a tentative decision on the scope of the project. During 2014 – 2016 the IASB staff conducted a number of research and outreach activities focused on:

(a) which method(s) is (are) applied to account for BCUCC in practice and which method should be applied to provide useful information; and

(b) how the predecessor method is applied or should be applied to provide useful information about BCUCC.

Scope of BCUCC

6 In 2014, the IASB tentatively decided that the scope of the BCUCC research 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 business combinations under common control, including the meaning of 'common control'.

7 The IASB also tentatively decided to give priority to transactions that involve third parties such as transactions in preparation for an initial public offering (IPO). However, the scope was not restricted to such transactions.

8 In the following sections will discuss the scope in relation to (a) and (b) in paragraph 6 above.

The IASB staff analysis and recommendations with respect to transactions identified as business combinations under common control

9 As explained in paragraph 2 above, BCUCC are business combinations in which all the combining parties (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.

10 The key components of this description are:

(a) a **'business combination'** is a transaction or other event, as defined in IFRS 3, in which the acquirer obtains control of one or more businesses. In practice, application questions have arisen as to whether particular transactions satisfy that description.

(b) combining entities or businesses are **'under common control'** if they are ultimately controlled by the same party both **before** and **after** the business combination regardless of whether such entities and businesses are part of the same consolidated financial statements;

(c) the common control is **'not transitory'** in order to avoid business combinations at arm's length being structured so that for a short period immediately before the combination, the combining entities or businesses are under common control. While paragraphs B1-B4 in IFRS 3 define the meaning of the terms 'business combination' and 'common control', IFRS 3 does not provide a definition for 'transitory control' and the IFRS Interpretations Committee has received submissions relating to when control is transitory.

11 With respect to defining the scope of the BCUCC project, the IASB staff is proposing the focus to be on developing a holistic approach to account for business combinations that are not covered by current guidance, rather than focussing on the distinction between business combinations and business combinations under common control. Consequently, the scope of the BCUCC project should include:

(a) transactions preceded by an external acquisition;

(b) transactions followed by an external sale, including those conditional on an IPO; and

(c) transactions preceded by an external acquisition and followed by an external sale.

The IASB staff analysis and recommendations with respect to group restructurings

12 The term 'group restructurings' is currently not a defined term and is (hence) understood differently by different parties.

13 The IASB staff is proposing to define the term ‘group restructurings’ as transfers of businesses under common control which do not meet the definition of BCUCC.

14 The IASB staff noted that regardless of whether a transfer satisfies the description of a business combination under common control, such a transfer would involve the following parties:

(a) the controlling party (parent) (P);

(b) the transferring party (transferor) (B);

(c) the transferred party (entity or business) (C); and

(d) the receiving party (A).

15 Consequently, the transfer of a business between entities under common control from the point of view of the parties involved can be explained as follows:

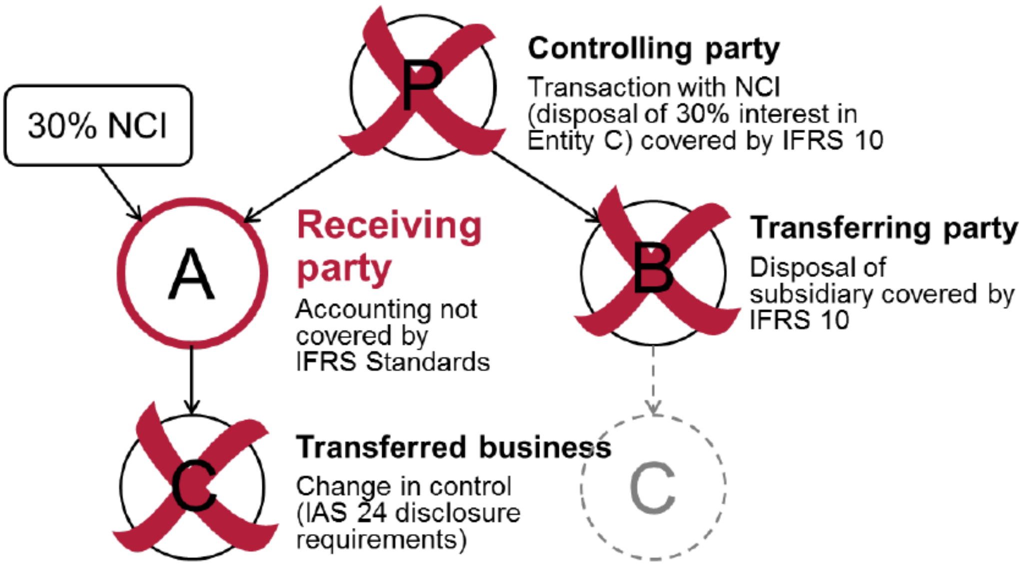
(a) **The controlling party (P)**: From the perspective of the controlling party, the transaction does not change the entities or businesses that the party controls. If there is a non-controlling interest (NCI) affected by the transfer, the accounting consequences of such a transfer are covered by the requirements in IFRS 10 *Consolidated Financial Statements*.

(b) **The transferring party (B)**: From the perspective of the transferring party, the transaction results in a disposal of an entity or business and the transaction is account for under the requirements of IFRS 10.

(c) **The transferred party (C):** From the perspective of the transferred party, the transaction results in a change in its immediate parent. IAS 24 *Related Party Disclosures* requires and entity to disclose the name of its parent and, if different, the ultimate controlling party.

(d) **The receiving party (A):** From the perspective of the receiving party, the transaction results in a change in entities or businesses that the receiving party controls and needs to report on. **The accounting for such transactions under common control is not covered by existing IFRS Standards**. After the transaction, its financial statements will also need to include financial information about the transferred entity or business.

16 The following figure (extracted from paper 8A for the ASAF meeting (Paper 09-03 for this meeting)) summarises the discussion in paragraph 15 by illustrating the transfer of a business between entities under common control where Entity A gains control over Entity C, and Entity C meets the definition of ‘business’ in IFRS 3.



17 A transfer of an entity or a business under common control only satisfies the description of a BCUCC if one of the combing parties can be identified as the acquirer according to IFRS 3. If an acquirer cannot be identified (for example, because the receiving party is a newly formed entity that issues shares to acquire one business), the transaction is not a business combination and the accounting for such transactions is not addressed in IFRS Standards. According to the IASB scope clarifications discussed in October 2017, such transaction is, however, included in the scope of the BCUCC project.

18 In October 2017, the IASB decided that the **project will focus on the transactions** that the entity needs to account for and the scope of the **project will not specify to which financial statements** of the reporting entity the developed accounting requirements will apply. The reason is that the financial statements affected by the scope of the BCUCC project will depend on the specifics of the transaction (whether or not the acquired business continue as a separate entity).

Questions for EFRAG CFSS and EFRAG TEG members

19 Does EFRAG CFSS and EFRAG TEG agree with the scope of the BCUCC project as proposed by the IASB staff? That is:

The project should include both:

(a) Business combinations under common control that are currently excluded from the scope of IFRS 3. The project should focus on developing a holistic approach to account for business combinations that are not covered by current guidance, rather than focussing on the distinction between business combinations and BCUCC. The scope of the project should include:

(i) transactions preceded by an external acquisition;

(ii) transactions followed by an external sale, including those conditional on IPO; and

(iii) transactions preceded by an external acquisition and followed by an external sale.

(b) Group restructurings (see proposed definition in paragraph 13 above).

The project will focus on the transactions that the entity needs to account for and the scope of the project will not specify to which financial statements of the reporting entity (e.g. consolidated or unconsolidated financial statements) the developed accounting requirements will apply.

If you disagree, please explain why?

20 Does EFRAG CFSS and EFRAG TEG have any other suggestions about transactions or perspectives which the IASB should consider in the BCUCC project? If yes, please explain what are those transactions or perspectives and why they need to be considered?

Methods of accounting for BCUCC

21 The IASB staff is proposing the following potential alternatives when accounting for transactions within the scope of the project:

(a) Acquisition method – under this method the net assets of the acquired entity are to be accounted for at fair value;

(b) Predecessor method – under this method the net assets of all combining entities are to be accounted for at their historical carrying amounts;

(c) Fresh start method – under this method the net assets of all combining entities are measured at fair value;

(d) Allocation of cost – under this method the consideration transferred is allocated to the acquired net assets.

22 The IASB could choose to use either:

(a) Only one of the methods listed above for all transactions; or

(b) Different methods depending on the characteristics of the transaction.

23 The IASB staff notes that a single method applied to all transactions would provide simplicity and consistent information for all transactions included in the scope. However, all transactions would be accounted for in the same way regardless of their characteristics.

24 When different methods are applied to account for transactions with different characteristics, this might provide information that is most useful for a particular type of transaction and achieves better comparability between transactions with similar characteristics. On the other hand, it might be difficult to define the subsets of transactions to which the different methods are applied.

Questions for EFRAG CFSS and EFRAG TEG members

25 What are the views of EFRAG CFSS and EFRAG TEG on applying the acquisition method versus the predecessor method as a starting point for accounting for transactions within the scope of the project?

26 Would each of the following factors (and if so how), in the views of EFRAG CFSS and EFRAG TEG influence the decision about which method should be applied to a particular transaction:

(a) **The decision-making process.** Some transactions may be initiated and negotiated by the combining entities which may also involve a formal tender process. Other transactions may be initiated and directed by the controlling party without any party to the combination being involved in the decision-making process. In some cases, even if the transaction is initiated by the combining parties, the controlling party approves the combination and/or determines the terms of the transaction. Should the decision-making process affect the method to be applied to particular transactions, and if so, which method would result in the most useful information for the primary users of the reporting entity's financial statements, at a cost that can be justified by the benefits of that information?

(b) **Purpose of the transaction.** A transaction might be conducted for the benefit of:

(i) The combining entities (for example, a vertical integration made for bringing the reporting entity additional distribution channels for its products);

(ii) The controlling party and/or other entities controlled by that controlling party (for example, a transaction conducted for tax purposes for the group),

Should the method to be applied to particular transactions be affected by whether the transaction mainly benefits the combing entities or the controlling party? If so, which method would result in the most useful information for the primary users of the reporting entity's financial statements, at a cost that can be justified by the benefits of that information?

(c) **Consideration.** Should the following factors affect the method to be applied to particular transactions, and if so, which method would result in the most useful information for the primary users of the reporting entity's financial statements, at a cost that can be justified by the benefits of that information:

(i) **Pricing of the consideration**. Is the consideration transferred in the transaction determined using the same assumptions that market participants would use when pricing the transferred business(es) if those market participants act in their economic best interest?

(ii) **Form of the consideration.** Is the consideration made in cash, shares, other assets, debts or something else?

(iii) **Evidence of fair value.** Is the fair value of the consideration supported by independent evidence? For example:

- Independent appraisals/valuations by appropriately qualified parties that are not related to the combining entities;
- Comparable recently quoted market prices, in an open and unrestricted market;
- Comparable independent bids on the same transaction; or
- Comparable amounts of similar transactions.

(iv) **Commercial substance.** Should whether there are significant changes in the combining entities' cash flows as a result of the transaction affect the method to be applied to particular transactions, and if so, which method would result in the most useful information for the primary users of the reporting entity's financial statements, at a cost that can be justified by the benefits of that information?

27 Do EFRAG CFSS and EFRAG TEG consider that there are any additional factors that should affect the method to be applied to particular transactions?

28 Do EFRAG CFSS and EFRAG TEG have any other observations in relation to the project?

Agenda Papers

29 In addition to this issues paper, agenda papers for this session are:

(a) Agenda paper 09-02 – ASAF 08 BCUCC Cover note – for background only;

(b) Agenda paper 09-03 – ASAF 08A BCUCC Scope of the project - for background only; and

(c) Agenda paper 09-04 – ASAF 08B BCUCC Methods of accounting – for background only.