IFRS in Focus

IASB publishes Discussion Paper on *Business Combinations under Common Control*

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The International Accounting Standards Board (Board) has issued Discussion Paper DP/2020/2 *Business Combinations under Common Control*. In this edition of *IFRS in Focus*, we outline the key concepts of the DP.

- The DP examines how to account for business combinations in which all of the combining businesses are ultimately controlled by the same party, both before and after the combination.
- The Board proposes that the accounting for a business combination under common control would depend on whether or not (i) the combination affects non-controlling shareholders of the receiving entity and (ii) the receiving entity's shares are traded in a public market.
- If the receiving entity does not have non-controlling shareholders, a book-value method would be applied.
- If the receiving entity is publicly-held and has non-controlling shareholders, the acquisition method would be applied.
- If the receiving entity is privately-held and has non-controlling shareholders, it would be:
  - permitted to use a book-value method if it has informed all of its non-controlling shareholders that it proposes to do so and they do not object; and
  - required to use a book-value method if all of its non-controlling shareholders are related parties as defined in IAS 24.
- When applying the acquisition method, the Board proposes that if the consideration paid does not equal the fair value of the identifiable assets and liabilities of the transferred entity, the receiving entity:
  - would be required to recognise a contribution to the equity if the fair value exceeds the consideration paid;
  - but would not recognise a distribution from equity when the consideration paid is higher than the fair value (instead, it would recognise higher goodwill that would be subsequently tested for impairment).
- When a book-value method is applied, the Board proposes:
  - the receiving entity should measure the assets and liabilities received using their carrying amounts in the financial statements of the transferred entity;
  - any difference between the consideration paid and the carrying amounts of the assets and liabilities received should be recognised within equity; and
  - the receiving entity would not restate pre-combination information.
- The comment period for the DP ends on 1 September 2021.

For more information please see the following websites:

www.iasplus.com

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Background

Business combinations, where the businesses are controlled by the same party (or parties), both before and after the combination, are not within the scope of IFRS 3 *Business Combinations*. Preparers have to develop an accounting policy for those combinations in line with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The absence of a specifically applicable IFRS Standard has resulted in diversity in practice. Some preparers report these combinations using the acquisition method. Others use a book-value method, for example the 'predecessor method' or a 'pooling of interests method', drawing on guidance available within their jurisdiction or within another GAAP, such as US GAAP.

The Board's 2011 and 2015 agenda consultations state that the diversity in practice makes it difficult for users of financial statements to understand how a business combination under common control affects the receiving entity and to compare entities that undertake similar transactions. The Board established a research project to examine business combinations under common control which explores whether reporting requirements can be developed for the receiving entity that eliminates the diversity and improves comparability and transparency. The DP is the first consultation document from this project.

Observation

The project is limited to considering business combinations between entities under common control. The IFRS Interpretations Committee has referred several issues to the Board related to common-control transactions, such as common-control non-cash distributions. But no other common-control transactions are being considered.

Furthermore, the project considers the financial reporting requirements of the receiving entity, but not the transferor. This is because the Board considers that existing IFRS Standards address the requirements that apply to the seller, the transferred entity and the common controlling party of the receiving and transferring entities.

Selecting the measurement method

The Board has explored whether it should require the acquisition method for all business combinations, including those under common control. Under the acquisition method, most identifiable assets and liabilities received in the combination are measured at fair value.

It also explored whether to require or permit a method based on the carrying amounts of the assets and liabilities (a book-value method), for some or all business combinations under common control and if so, which book-value method.

Observation

The Board discussed the 'fresh start' method in which all assets and liabilities of the combining businesses are measured at fair value. The Board dismissed that method because it considers that it is rarely used and it received little support during initial consultations with stakeholders.

The Board considered whether and when business combinations under common control are similar to business combinations within the scope of IFRS 3, and what information would be most useful to the primary users of the receiving entity's financial statements. The Board disagreed with stakeholders who asserted that all business combinations under common control are different in substance from business combinations within the scope of IFRS 3 and should be accounted for differently. Even though the ultimate control of the combining businesses does not change in combinations under common control, not all such combinations are simply reallocations of economic resources within a group. Some change the ownership interests of the resources, specifically when there are non-controlling shareholders of the business receiving the transferred entity.

Combinations that do not affect non-controlling shareholders

If there are no non-controlling shareholders in the receiving entity (such as in a business combination involving wholly-owned businesses), there is no change in the ultimate control of the combining businesses. The Board thinks that, in such circumstances, it might sometimes be difficult to identify the accounting acquirer (which may not necessarily be the legal acquirer) in a way that results in useful information. Also, in the absence of the need to protect non-controlling interests, the ultimate controlling party might direct the amount of consideration paid and that amount might differ from an arm's length price that would have been negotiated between unrelated parties in a business combination. Furthermore, the Board thinks the shareholder information needs are fundamentally less if the only shareholder involved is the controlling party. The information needs of lenders and other creditors focus on receiving principal and interest, i.e. an entity's cash flows and debt commitments, and that information is largely unaffected by whether the acquisition method or a book-value method is used to account for the business combination.

The Board concluded that when business combinations under common control do not affect non-controlling shareholders of the receiving entity, a book-value method should be applied.

Combinations that affect non-controlling shareholders
When a business combination under common control affects the non-controlling shareholders of the receiving entity, the users of the receiving party's financial statements includes the non-controlling shareholders in addition to potential shareholders and lenders and other creditors of that entity. Because the composition of users is similar to the composition of users in a business combination within the scope of IFRS 3, the information needs of those users are also similar. Accordingly, the Board proposes that when a business combination under common control affects non-controlling shareholders of the receiving entity, the acquisition method should be applied in principle.

The Board then examined the question of whether the acquisition method should be applied in all such circumstances, even if the ownership interest of non-controlling shareholders is not substantive or if all non-controlling shareholders are parties related to the receiving entity.

The Board proposes that the acquisition method should always apply when the receiving entity has non-controlling shareholders and its shares are traded in a public market. This is because, usually, the ownership by non-controlling shareholders would have to be more than insignificant to meet minimum listing requirements.

For privately-held entities, the Board proposes that the receiving entity should be:

- *permitted* to use a book-value method if it has informed all of its non-controlling shareholders that it proposes to do so and they do not object; and
- *required* to use a book-value method if all of the receiving entity's non-controlling shareholders are related parties as defined in IAS 24 *Related Party Disclosures*.

Observation
The Board considered, but rejected, extending the proposed exception for privately-held entities to publicly-traded entities. The Board concluded that informing all shareholders might be more difficult for those entities, given the number of shareholders and frequent changes in share ownership. The Board also found it unlikely that all of the shareholders in a publicly-traded entity would be related parties, because capital market regulations usually require a minimum number of shares to be held by unrelated parties.

Applying the acquisition method
The Board proposes that if the acquisition method is applied for a business combination under common control, the requirements in IFRS 3 generally apply.

However, the consideration paid 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. If that is the case, the combination includes a transaction with owners acting in their capacities as owners. The Board considered whether the receiving entity should recognise a distribution from (or a contribution to) equity if the consideration paid is higher (or lower) than an arm's length price.

Distributions
If the Board were to require the receiving entity to identify and recognise a distribution from equity in a business combination under common control, the Board would need to specify how to measure such distributions. The Board concluded that an overpayment is unlikely to be detectable in practice and would be difficult, if not impossible, to quantify.

The Board concluded that overpayments are unlikely to occur in practice in business combinations under common control that affect the non-controlling shareholders of the receiving entity. Any such overpayment would transfer wealth from those shareholders to the party transferring the business and ultimately to the controlling party. Many jurisdictions have legal requirements and regulations that directly or indirectly affect the transaction price or other mechanisms designed to protect the interests of non-controlling shareholders.

The Board therefore proposes not to develop guidance that would require the receiving entity to assess whether an overpayment has been made. 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.

Contributions
Contributions to equity when non-controlling shareholders are involved are similarly unlikely to occur in practice. Although there may be no legal protection in place, the controlling party is unlikely to allow the transfer of wealth to the non-controlling shareholders.

However, in the unlikely event that a contribution occurs, the Board proposes that it be measured and recognised in equity as the excess of fair value of the identifiable acquired assets and liabilities over the consideration paid. It should not be accounted for as a bargain purchase gain in the statement of profit or loss.

Applying a book-value method

In practice, several book-value methods exist, for example:

- The receiving entity measures the assets and liabilities received at the transferred entity's carrying amounts or at the amounts recognised in the consolidated financial statements of the controlling party.
- The receiving entity includes the transferred entity's assets, liabilities, income and expenses in its financial statements prospectively from the date of the combination, without restating pre-combination information, or retrospectively from the beginning of the earliest period presented, with pre-combination information restated as if the receiving entity and the transferred entity had always been combined.

The carrying amount of the assets and liabilities in the business being transferred and the amounts recognised in the consolidated financial statements should be the same if it has been controlled since its creation or for an extended period of time. However, if the business had previously been acquired from an external party, the controlling party would have measured the transferred entity's assets and liabilities at their fair values at the acquisition date, while the amounts reported in the separate financial statements of the acquired business would have been unaffected.

The Board proposes using the transferred entity's carrying amounts because they provide uninterrupted historical information about the transferred entity. This method also adopts the perspective of the combining entities (rather than the perspective of the controlling party) and provides information about the assets and liabilities of the combining entities on a consistent basis.

The Board believes that most business combinations under common control are transacted with cash or the company's own shares as consideration. However, sometimes the consideration is in the form of other non-cash assets or by incurring or assuming liabilities. The Board examined how to measure the consideration if it is not cash, and concluded:

- if consideration is paid by issuing shares, the Board proposes not to prescribe whether they are measured at their fair value or at their par value (if they have one);
- if consideration is paid by transferring assets, the Board proposes to measure the contribution paid at the receiving entity's carrying amount of those assets at the combination date; and
- if consideration is paid by incurring or assuming liabilities, the Board proposes to measure the contribution at the amount determined on initial recognition of the liability at the combination date applying IFRS Standards.

The Board thinks that any difference between the consideration paid and assets and liabilities received is typically recognised within the receiving entity's equity. They reached that conclusion even though, economically, not all of the difference reflects a contribution to or distribution from the receiving entity's equity. Some of it might be unrecognised goodwill or measurement differences arising from measuring assets and liabilities received. However, an approach that segregates the difference into components would be costly and complex to apply.

The Board decided that it should not prescribe in which component, or components, of equity the receiving entity should present that difference.

With regard to any transaction costs the Board proposes that the accounting should be consistent with IFRS 3, i.e. as an expense in the period in which they are incurred, except that the costs of issuing shares or debt instruments should be accounted for in accordance with the applicable IFRS Standards.

The Board also considered whether information prior to the combination should be restated to include the combined assets, liabilities, income and expenses of both the receiving entity and the transferred entity. However, the Board concluded that this 'pro-forma' information has limited benefit that is unlikely to outweigh the costs of providing it.

The Board therefore proposes that, when applying a book-value method, the receiving entity should include in its financial statements the assets, liabilities, income and expenses of the transferred entity prospectively from the date of the combination, without restating pre-combination information.

Observation

Prospective accounting when a book-value method is used would be a significant change for entities in many jurisdictions. Many jurisdictions have local requirements that treat such transactions like a reorganisation as if the new combination had always been in place.

Disclosure
For combinations to which the acquisition method applies, the Board proposes that the receiving entity should comply with the disclosure requirements in IFRS 3. However, the Board intends to provide guidance on how to apply those disclosure requirements in conjunction with the disclosure requirements in IAS 24.

For combinations to which a book-value method applies, the Board proposes that some, but not all of the disclosure requirements in IFRS 3 are suitable. In particular, the receiving entity should apply the disclosure objective in IFRS 3. Pre-combination information would not be required. However, the receiving entity should disclose the amount it recognises in equity for any difference between the consideration paid and the net carrying amount of the assets and liabilities recognised, together with the component of equity within which that difference is presented.

Next steps
The Board invites comments on all matters in the DP and, in particular, on the questions set out at the end of each section under 'Questions for respondents'. In addition, respondents are encouraged to raise other comments on the Board's preliminary views presented in the DP.

Comments are to be received by 1 September 2021.

The views expressed in the DP are preliminary and subject to change. The Board will consider the comments received on the DP before deciding whether to develop an Exposure Draft containing proposals to implement any or all of its preliminary views.

Further information
If you have any questions about the Discussion Paper please speak to your usual Deloitte contact or get in touch with a contact identified in this *IFRS in Focus*.

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Key contacts

Global IFRS Leader
Veronica Poole
ifrsglobalofficeuk@deloitte.co.uk

IFRS Centres of Excellence

Americas		
Argentina	Fernando Lattuca	**arifrscoe@deloitte.com**
Canada	Karen Higgins	**ifrsca@deloitte.ca**
Mexico	Miguel Millan	**mx_ifrs_coe@deloittemx.com**
United States	Robert Uhl	**iasplus-us@deloitte.com**
Asia-Pacific	Shinya Iwasaki	**shinya.iwasaki@tohmatsu.co.jp**
Australia	Anna Crawford	**ifrs@deloitte.com.au**
China	Gordon Lee	**ifrs@deloitte.com.cn**
Japan	Kazuaki Furuuchi	**ifrs@tohmatsu.co.jp**
Singapore	Lin Leng Soh	**ifrs-sg@deloitte.com**
Europe-Africa		
Belgium	Thomas Carlier	**ifrs-belgium@deloitte.com**
Denmark	Jan Peter Larsen	**ifrs@deloitte.dk**
France	Laurence Rivat	**ifrs@deloitte.fr**
Germany	Jens Berger	**ifrs@deloitte.de**
Italy	Massimiliano Semprini	**ifrs-it@deloitte.it**
Luxembourg	Martin Flaunet	**ifrs@deloitte.lu**
Netherlands	Ralph Ter Hoeven	**ifrs@deloitte.nl**
Russia	Maria Proshina	**ifrs@deloitte.ru**
South Africa	Nita Ranchod	**ifrs@deloitte.co.za**
Spain	Jose Luis Daroca	**ifrs@deloitte.es**
Switzerland	Nadine Kusche	**ifrsdesk@deloitte.ch**
United Kingdom	Elizabeth Chrispin	**deloitteifrs@deloitte.co.uk**

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