

Combinations of businesses under common control—one size does not fit all

Project update



Accounting requirements for business combinations between unrelated parties—sometimes called mergers and acquisitions—are set out in IFRS 3 *Business Combinations*. However, IFRS 3 does not specify how to account for combinations of businesses under common control.

The International Accounting Standards Board (Board) is carrying out a research project to consider filling this gap in IFRS Standards to improve the comparability and transparency of reporting these combinations.

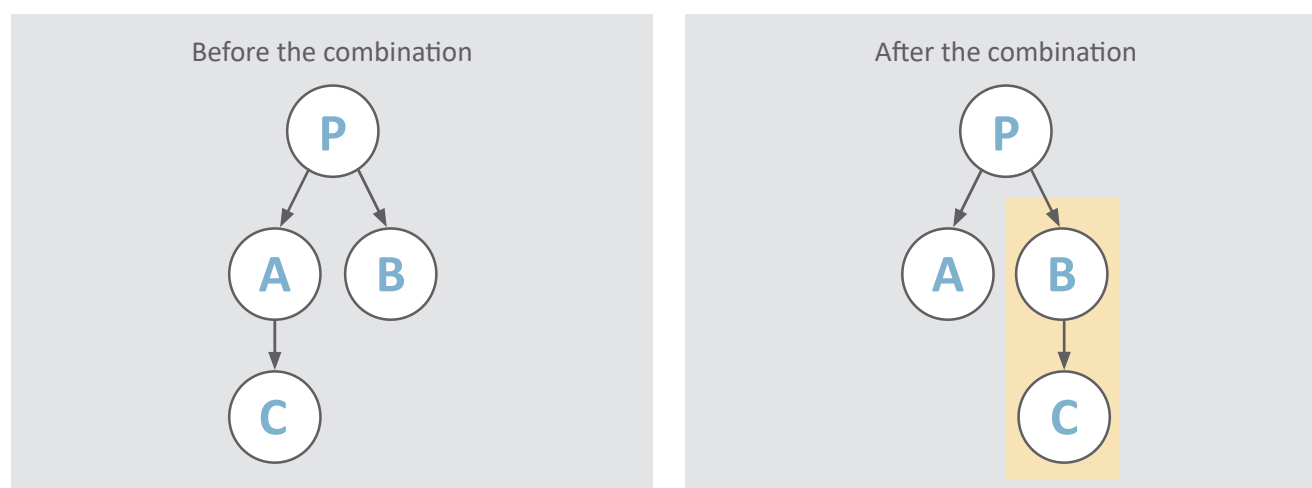
In this update, Gary Kabureck, a member of the Board, discusses the Board's preliminary views.

What are these business combinations?

Combinations of businesses under common control involve companies or businesses that are ultimately controlled by the same party before and after the combination. Diagram 1 shows a simple example of a combination of businesses under common control.

In this example, control of Company C (the **transferred company**) is transferred from Company A to Company B (the **receiving company**). The combining companies are ultimately controlled by Company P (the **controlling party**) before and after the transaction. The controlling party could be a company, an individual or a group of individuals. For that party, the group as a whole is unchanged.

Diagram 1—A combination of businesses under common control



Why is the Board doing the project?

IFRS Standards specify reporting requirements for the controlling party (Company P), the transferring company (Company A) and the transferred company (Company C). However, IFRS Standards do not specify how the receiving company (Company B) should report its combination with the transferred company. A receiving company that prepares financial statements in accordance with IFRS Standards must therefore develop its own accounting policy for reporting such transactions.

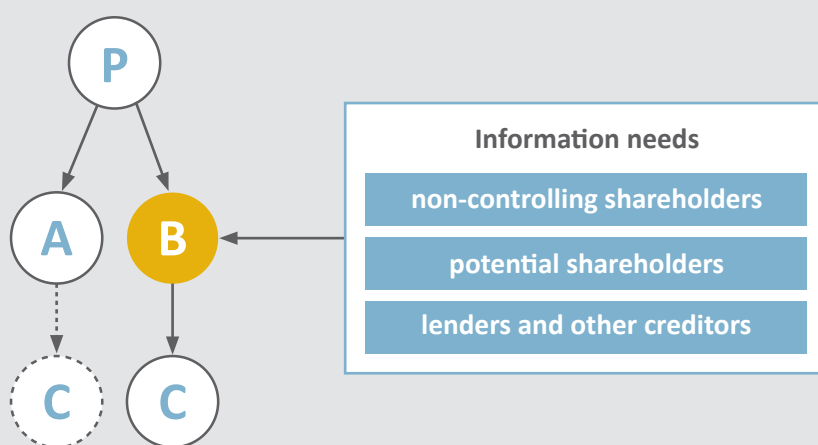
The lack of specific requirements has resulted in diversity in practice. For example, in some cases, companies report these combinations using the acquisition method set out in IFRS 3, which measures assets and liabilities received in the combination at fair value. In other cases, companies use a book-value method, which measures assets and liabilities at their book values. In addition, a variety of book-value methods are currently used.¹ Such diversity makes it difficult for users of financial statements to understand how a combination of businesses under common control affected the receiving company and to compare companies that undertake similar transactions but apply different accounting policies.

What is the focus of the project?

Financial statements prepared in accordance with IFRS Standards are intended to meet common information needs of the company's existing and potential shareholders, lenders and other creditors who must rely on those financial statements for much of their information needs because they cannot require the company to provide information tailored to their information needs directly to them. In developing IFRS Standards, the Board views those shareholders, lenders and other creditors as the primary users of the company's financial statements.²

This project considers reporting by the receiving company (Company B) and focuses on the information needs of that company's existing non-controlling shareholders, potential shareholders and existing and potential lenders and other creditors, as shown in Diagram 2. The project does not seek to meet the information needs of the controlling party. The controlling party controls the receiving company and therefore does not need to rely on that company's financial statements for meeting its information needs. Furthermore, the project will not affect information received by existing and potential shareholders, lenders and other creditors of the controlling party. That information is provided in the financial statements of that party, not of the receiving company.

Diagram 2—Primary users of information



¹ Various labels are used for book-value methods, including predecessor method, pooling (or uniting) of interests method and merger accounting. This article uses 'book-value method' as a collective term for all these methods.

² Paragraph 1.5 of the *Conceptual Framework for Financial Reporting*.

What has the Board heard?

Stakeholders have expressed diverse views on which measurement method should be applied to combinations of businesses under common control and why.

Some stakeholders consider that all combinations of businesses under common control differ from business combinations covered by IFRS 3 because a combination under common control does not change ultimate control of the transferred company by the controlling party. These stakeholders consider that the controlling party simply moves its economic resources within the group from one 'location' to another. Thus, they consider that the acquisition method should not be used for such combinations. Instead, a book-value method should be used for all such combinations.



The Board has reached the preliminary view that one size does not fit all—the acquisition method should be used for some combinations of businesses under common control and a book-value method should be used for all other such combinations.



Some stakeholders consider that most, if not all, combinations of businesses under common control are similar to business combinations covered by IFRS 3. These stakeholders note that from the perspective of the receiving company (but not the perspective of the controlling party), a combination under common control transfers control of the transferred company to the receiving company, just as occurs in a business combination covered by IFRS 3. Thus, they consider that the acquisition method should be used, except when the benefits of information produced by that method do not justify the costs of applying it.

Some stakeholders consider that some combinations of businesses under common control are similar to business combinations covered by IFRS 3 and others may not be similar. Thus, they consider that the acquisition method should be used in some cases and a book-value method should be used in other cases.

Why not a single method in all cases?

The Board explored whether combinations of businesses under common control are similar to combinations covered by IFRS 3, what information would be useful to the primary users of the receiving company's financial statements and the related costs of providing that information. It has reached the preliminary view that **one size does not fit all**—the acquisition method should be used for some combinations of businesses under common control and a book-value method should be used for all other such combinations.

Specifically, the Board has reached the preliminary view that some combinations of businesses under common control are similar to combinations covered by IFRS 3, and the acquisition method should apply to these transactions. However, other such combinations may not be similar, indicating that the acquisition method may not be appropriate. In addition, cost-benefit considerations may suggest that the acquisition method is not appropriate for some such combinations.

The Board has taken the view that it should not provide companies with a set of indicators to use in selecting the appropriate accounting method. Instead, the Board focused on an objective criterion supported by many stakeholders during the project: whether the combination affects non-controlling shareholders of the receiving company.

When would the acquisition method be applied?

The Board has reached the preliminary view that, in principle, the acquisition method should apply to combinations of businesses under common control that affect non-controlling shareholders of the receiving company.

Such combinations are not simply reallocations of economic resources within the group. Rather, from the point of view of the primary users of the receiving company's financial statements, they result in a substantive change in ownership interests in the transferred company, just as happens in a business combination covered by IFRS 3. This is because in such combinations under common

control, non-controlling shareholders of the receiving company indirectly obtain an ownership interest in the transferred company.

That similarity is illustrated in Diagrams 3 and 4. In both scenarios, non-controlling shareholders of the receiving company (Company B), obtain an ownership interest in the transferred company (Company C), regardless of whether ultimate control of the transferred company changes. Both combinations result in a substantive change in the ownership interest in the transferred company.

Furthermore, when a combination under common control affects non-controlling shareholders of the receiving company, the primary users who rely on the receiving company's financial statements for meeting their information needs are those non-controlling shareholders, as well as potential shareholders and lenders and other creditors of the receiving company. In the Board's preliminary view, the acquisition method would best meet their common information needs, because those types of primary users are the same as the types of primary users of information in a combination covered by IFRS 3.

Diagram 3—Non-controlling shareholders: Business combinations covered by IFRS 3

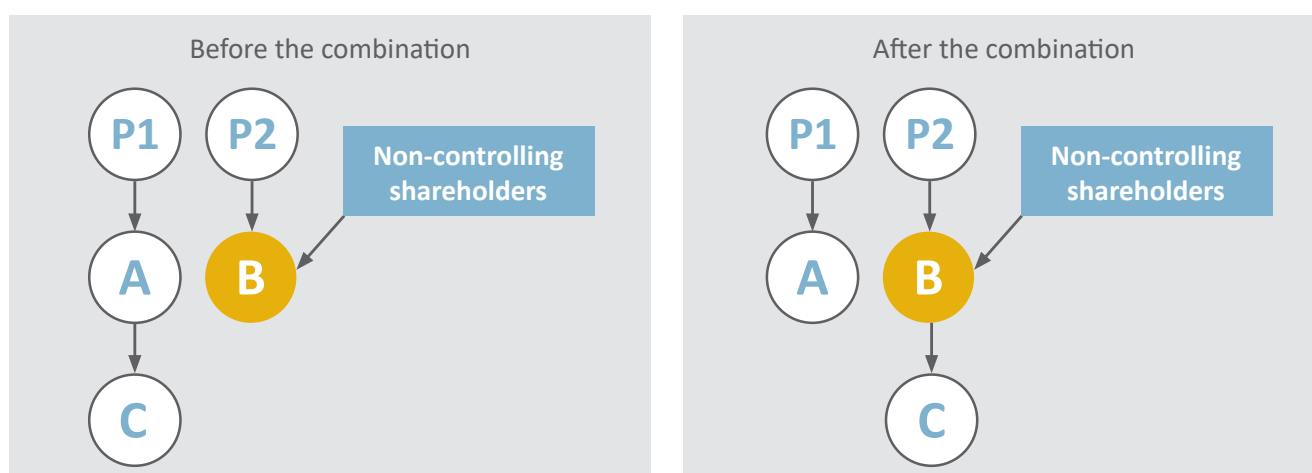
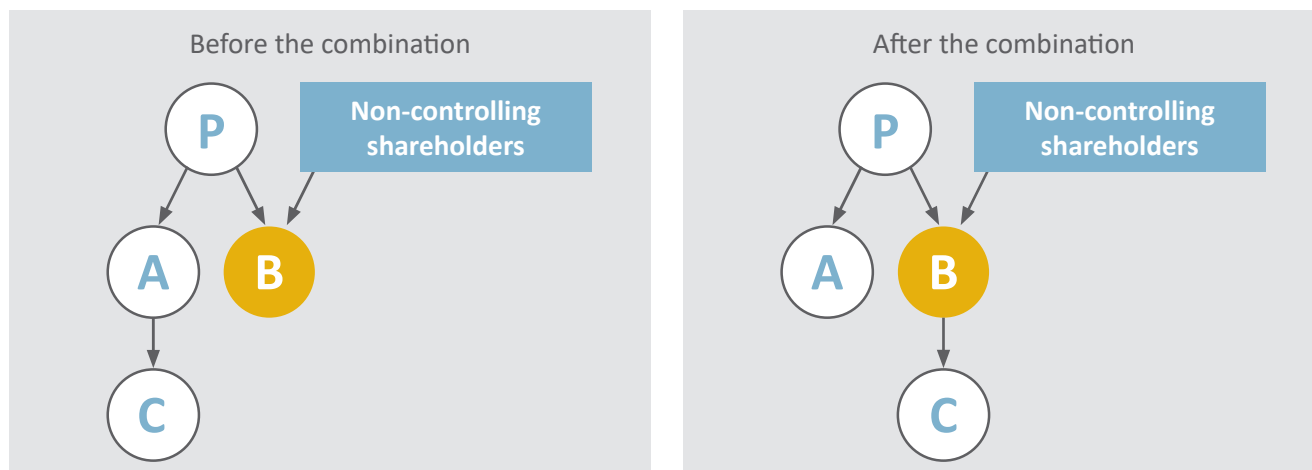


Diagram 4—Non-controlling shareholders: Common control



How would the acquisition method be applied?

In the Board’s preliminary view, the acquisition method should apply as set out in IFRS 3. However, to address a feature that is not present in business combinations between unrelated parties, companies should be required to recognise any excess fair value of the acquired assets and liabilities over the consideration paid as a capital contribution and not in the statement of profit or loss as a gain on a bargain purchase.

The Board also considered whether companies should be required to report any capital distribution if the consideration paid exceeds the consideration that would have been negotiated between unrelated parties.

However, any such distribution could be difficult to identify and measure, and is unlikely to occur in a combination that affects non-controlling shareholders. Therefore, the Board has reached the view that the receiving company should not be required to identify and measure any such distribution.

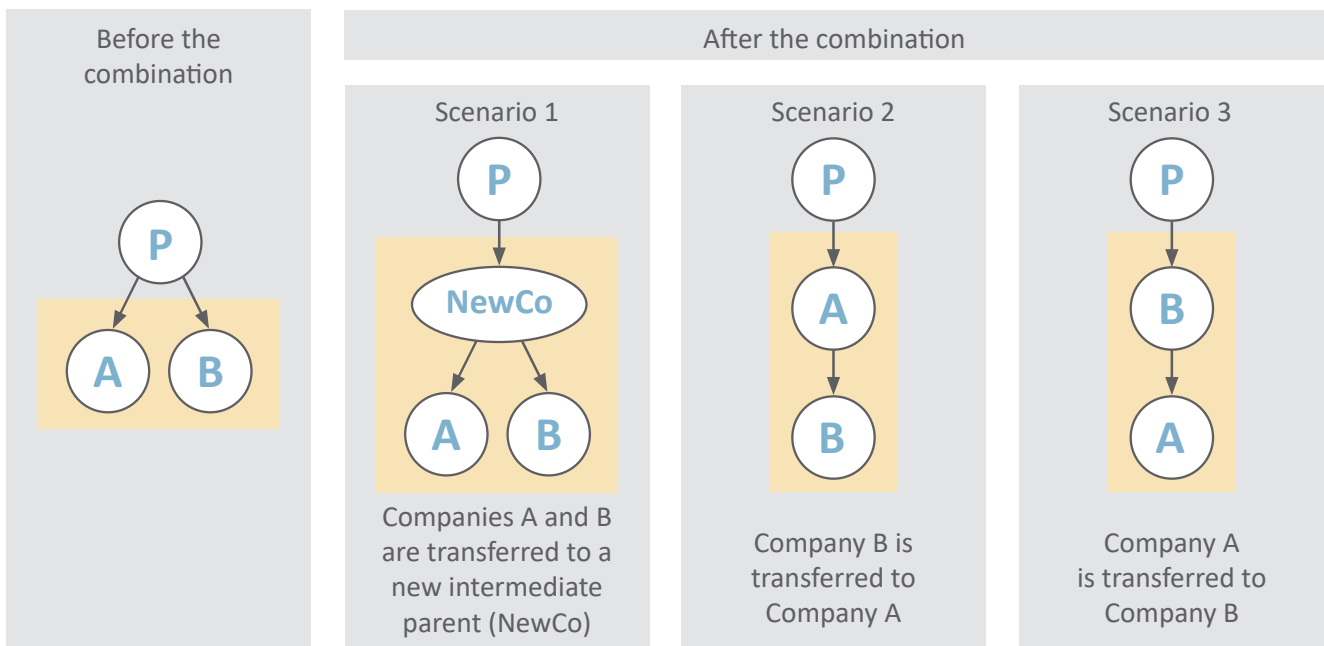
When would a book-value method be applied?

The Board has reached the preliminary view that a book-value method should apply to combinations of businesses under common control that do not affect non-controlling shareholders of the receiving company (such as in a combination involving wholly-owned companies). In all such combinations, there is no substantive change in ownership interests in the combining companies. In such circumstances, questions may arise about the substance of the combination and the suitability of the acquisition method.

Stakeholder feedback indicates that companies may have a variety of business reasons for undertaking internal reorganisations that do not result in a substantive change in ownership interests in the combining entities. The Board has reached the preliminary view that a book-value method should apply to all such combinations.

Diagram 5 shows an example of a controlling party (Company P) that wishes to sell its wholly-owned subsidiaries (Companies A and B) in an initial public offering. In preparation, Company P would need to restructure its subsidiaries. Company P could do so in various ways, as illustrated in Diagram 5.

Diagram 5—A combination under common control between wholly-owned companies



Regardless of how the controlling party chooses to structure the combination, potential shareholders are invited to invest in the same economic resources in all scenarios, as illustrated by the shaded areas in Diagram 5. Thus, similar information should be provided about those economic resources in all scenarios. A book-value method achieves that outcome—all assets and liabilities of the combining companies would continue to be measured at their book values.

In contrast, if the acquisition method is applied to the scenarios in Diagram 5, the nature and extent of the information provided to potential shareholders could vary greatly, depending on which company is identified as the ‘acquirer’—Company A, Company B or NewCo.³ The assets and liabilities of the company identified as the acquirer would be measured at their existing book values, whereas the assets and liabilities of the other combining companies would be measured at fair value. For combinations that involve no substantive change in ownership interest in the combining companies, it might be difficult to identify the acquirer in a way that provides useful information to potential shareholders.

Combinations that involve no substantive change in ownership interests in the combining companies may affect lenders and other creditors of the receiving company. However, the Board received feedback that lenders and other creditors primarily need information about the receiving company’s cash flows and debt commitments, so that they can assess the company’s ability to service its existing debt and to raise new debt. The information they need is largely unaffected by whether the acquisition method or a book-value method is used to report the combination.

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How would a book-value method be applied?

A variety of book-value methods are currently used. To reduce that diversity and improve comparability, the Board is of the view that it should specify how to apply a book-value method to combinations of businesses under common control. For example, in the Board’s preliminary view:

- (a) the receiving company should measure the assets and liabilities received using the book values in the financial statements of the transferred company, not the book values in the consolidated financial statements of the controlling party; and
- (b) the results, assets and liabilities of the transferred company should be combined with those of the receiving company from the combination date, without restating pre-combination information.

What about costs to companies?

Some stakeholders have suggested that the benefits to the primary users of the receiving company’s financial statements from using the acquisition method may not always outweigh the costs to the company of using that method. For example, the costs could outweigh the benefits when the ownership interest of non-controlling shareholders in the receiving company is small or when those shareholders are the company’s related parties who do not need to rely on the company’s financial statements for their information needs. Some stakeholders have also expressed concerns that opportunities for accounting arbitrage could arise if the acquisition method were required in such cases.

The Board has reached the preliminary view that for companies whose shares are traded in a public market the benefits of using the acquisition method would always outweigh the costs of using that method. This is because capital markets regulations typically prevent listing of instruments if publicly traded ownership interest in the company is small.

³ Paragraph B18 of IFRS 3 limits the circumstances when a new company can be identified as the acquirer. Applying IFRS 3, if NewCo cannot be identified as the acquirer, either Company A or Company B must be identified as the acquirer.

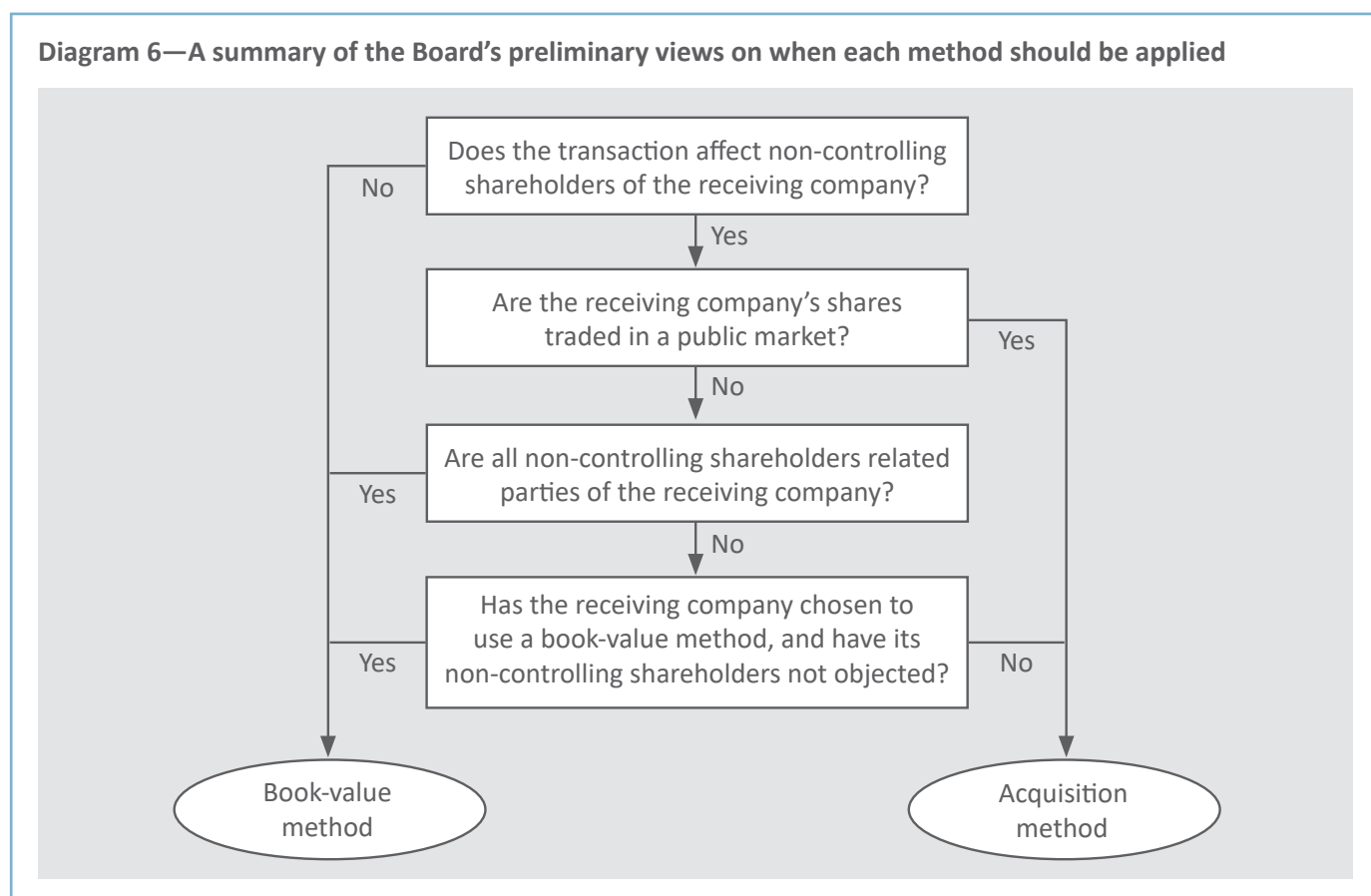
Furthermore, a criterion that shares are traded in a public market is objective, easy to apply and would not create opportunities for accounting arbitrage.⁴

However, the Board has concluded that for privately-held companies (ie those whose shares are not traded in a public market) the benefits of using the acquisition method might not always outweigh the costs of doing so. Thus, the Board has reached the preliminary view that it should allow such companies to opt out of the acquisition method and to apply a book-value method instead, provided that non-controlling shareholders do not object. This condition is based on one already used in IFRS Standards for exempting privately-held companies from some requirements when, in the Board's view, the costs of applying those requirements may outweigh the benefits of doing so.⁵

The Board has also reached the preliminary view that a privately-held company should be required to use a book-value method if all of its non-controlling shareholders are the company's related parties as defined in IAS 24 *Related Party Disclosures*. In such cases, the benefits of using the acquisition method may not be enough to justify the costs. Requiring a book-value method in these cases would also prevent opportunities to structure a combination to achieve a favourable accounting outcome.

In addition, the Board considered whether it should allow publicly-traded companies to opt-out of the acquisition method and whether it should require them to use a book-value method if all non-controlling shareholders are the company's related parties. In the Board's preliminary view, it should not extend that option and that requirement to publicly-traded companies. However, the Board will seek stakeholder feedback on that preliminary view.

Diagram 6—A summary of the Board's preliminary views on when each method should be applied



⁴ IFRS Standards describe public market as a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets.

⁵ See paragraph 4 of IFRS 10 *Consolidated Financial Statements* and paragraph 17 of IAS 28 *Investments in Associates and Joint Ventures*.

How would financial reporting improve?

If the Board's preliminary views are confirmed and implemented, diversity in practice would reduce and comparability in reporting business combinations would improve because:

- (a) the acquisition method would be applied both to business combinations covered by IFRS 3 and to similar combinations of businesses under common control;
- (b) IFRS Standards would specify which method should be applied in which circumstances, so that companies undertaking similar transactions would apply the same accounting policies; and
- (c) IFRS Standards would specify a single book-value method, thus eliminating the diversity caused by the variety of book-value methods used.

In summary, in a given set of circumstances, one accounting method would apply, thus reducing diversity and improving comparability.

What about disclosures?

The Board has reached the preliminary view that disclosure requirements in IFRS 3 should also apply to combinations of businesses under common control when the acquisition method is used. In addition, some of those requirements should also apply when a book-value method is used.

Furthermore, the Board is now seeking feedback on its [Discussion Paper *Business Combinations—Disclosures, Goodwill and Impairment*](#)—which discusses, among other matters, possible improvements to disclosure requirements in IFRS 3. Any such improvements may also apply to all or some combinations of businesses under common control. That discussion paper is open for comment until 31 December 2020.

What happens next?

The Board is preparing a discussion paper setting out its preliminary views on reporting combinations of businesses under common control. The Board expects to issue the discussion paper later this year.

The Board will consider the comments on the discussion paper before deciding whether to develop an exposure draft containing proposals on any of the topics discussed in the discussion paper.



To read further information about the proposals or to receive project updates

Visit the Business Combinations under Common Control [project page](#) on the IFRS Foundation website.

To get in touch

Contact Yulia Feygina at yfeygina@ifrs.org.

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