STAFF PAPER

January 2012

IASB Meeting

Project	IFRS 3 *Business Combinations*		
Paper topic	Identification of the acquirer and common control transactions		
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Introduction

1. At its meetings in July 2011 and September 2011, the IFRS Interpretations Committee (the Committee) discussed two submissions requesting guidance on the accounting treatment for two fact patterns that involve the formation of a new entity (referred to as 'Newco') to facilitate the spinning-off of a business within a group under IFRS 3 *Business Combinations* as follows:

   (a) The first submission requested guidance on the circumstances or factors that are relevant when identifying an acquirer in a business combination.

   (b) The second submission requested guidance on the accounting for common control transactions and included a request to clarify whether a business that is not a legal entity could be considered the acquirer in a reverse acquisition under IFRS 3.

   Both submissions included fact patterns to illustrate these requests for guidance.

2. At the September 2011 meeting, the Committee released final agenda decisions not to take the issues raised on to its agenda. The Committee observed that:

   (a) the accounting for fact patterns involving the creation of a newly formed entity and the accounting for common control transactions are too broad to be addressed through an interpretation or through an annual improvement;

(b) the issues on the accounting for common control transactions have previously been brought to the Board's attention; and

(c) the specific fact patterns submitted would be better considered within the context of a broader project on accounting for common control transactions, which the Board is planning to address at a later stage.

3. The full staff analysis that was presented at the Interpretations Committee in **July 2011** was set out in agenda papers 6A and 6B which can be found on the public website.

4. At its September 2011 meeting the Committee issued final agenda decisions[1]. The full staff analysis that was presented at the Interpretations Committee in **September 2011** was set out in agenda papers 3A and 3B which can be found on the public website.

Purpose of this paper

5. The purpose of this paper is to inform the Board of the Committee's recommendation to consider the fact patterns described as part of the Board's project on common control transactions.

Structure of the paper

6. This paper provides for the two submissions received:

(a) background information; and

(b) a summary of the reasons that led the Committee members to propose that the issues should not be taken onto its agenda and to recommend to the Board to consider the issues described in this paper as part of its project on common control transactions.

[1] http://media.ifrs.org/IFRICUpdateSept11.html#5

Issue 1: Factors relevant in identifying an acquirer

Background

7. The submission described a fact pattern where a group plans to spin off two of its subsidiaries ('Sub 1' and 'Sub 2') using a new entity (Newco). Newco will acquire these subsidiaries for cash from the parent company (Entity A) only on condition of the occurrence of Newco's initial public offering (IPO). The cash paid by Newco to Entity A to acquire the subsidiaries is raised through the IPO. After the IPO occurs, Entity A loses control of Newco. If the IPO does not take place, Newco will not acquire the subsidiaries.

8. A diagram containing an illustration of this fact pattern is included in Appendix A.

9. The submitter asks whether, in the identification of the acquirer in a business combination under IFRS 3, the following factors are relevant to this identification

    (a) the existence of a condition imposed to effect the acquisition (in this case, the IPO), in the absence of which the acquisition will not occur; and

    (b) the identity of the party that formed the new entity to effect a business combination.

Description of views

10. Two views were identified in determining who the acquirer is and whether the fact pattern described is or is not a business combination. These views are:

    (a) <u>View 1</u>—the IPO is an integral part of the transaction as a whole, because there would not have been a combination of Newco with the subsidiaries if the IPO had not occurred. In this view, the IPO creates a change in the ownership of the subsidiaries, because Newco's new shareholders obtain control of Sub 1 and Sub 2 in an arm's length transaction, while Entity A retains only a nominal interest in Newco. Consequently, Newco is the acquirer and the transaction is a business combination.

(b) View 2—the fact that the acquisition is conditional on the IPO is not relevant. The critical features in identifying the acquirer are who initiated the transaction and who made the strategic and operational decisions to create Newco. Proponents of this view think that this transaction would be considered a business combination under common control and that either Entity A or one of the subsidiaries (ie Sub 1 or Sub 2) could be considered to be the acquirer.

Staff analysis and recommendation

11. We determined that it could reasonably be concluded that Newco becomes the acquirer in this business combination because:

    (a) a newly formed entity could be regarded as the acquirer when it transfers cash as consideration in the acquisition in accordance with paragraph B18 of IFRS 3. We observed that Newco independently raised cash from the public (ie an unrelated party to the former controlling party) to fund the acquisition of the subsidiaries (Sub 1 and Sub 2) through the successful completion of an IPO.

    (b) the obtaining of 'control' is the fundamental concept for identifying the acquirer as stated in paragraph 7 of IFRS 3, not who incorporates the new entity. We observed that Newco obtains control in the subsidiaries acquired and it is not controlled by the former shareholders of the acquired subsidiaries after the transaction.

12. Because we observed that Newco would be identified as the acquirer, Newco would account for the acquired businesses as a business combination using the acquisition method as described in paragraph 4 of IFRS 3.

13. We also reported back to the Committee that, on the basis of the feedback that we received from our outreach activities, only some national standard-setters considered the issue raised in the submission to be prevalent in practice and only a minority of those respondents noted significant divergent interpretations.

14. Consequently, on the basis of on our technical analysis and the fact that the issue did not seem to be widespread in many jurisdictions, we did not recommend that the Committee should take this issue onto its agenda.

The Committee's recommendation

15. At the July 2011 meeting, a majority of the Committee members agreed with the staff analysis. They also agreed not to take this issue onto its agenda and published its tentative agenda decision in IFRIC Update for public comment.
16. At the September 2011 meeting the Committee discussed the comments received from constituents on the tentative agenda decision.
17. In the light of the comments expressed, the Committee decided to simplify the wording of its agenda decision because several respondents thought that the tentative agenda decision gave guidance in this topic and these respondents objected to guidance being issued in this manner. The Committee determined that the best place for providing clarity in the accounting guidance for conditional formations should be within the common control transactions project, if the Board decides to restart work on this project.
18. The final wording of the agenda decision for the factors affecting the identification of the acquirer can be found on the public website[2] and is reproduced in Appendix C of this paper.

Issue 2: Accounting for combinations of entities under common control

Background

19. The submission describes a fact pattern that illustrates a type of combination of entities under common control in which the parent company (Entity A), which is wholly owned by Shareholder A, transfers a business (Business A) to a new entity ('Newco') also wholly owned by Shareholder A.
20. An illustration of the structure of the group before and after the transfer of Business A to Newco is shown in Appendix B.
21. The submission requests clarification on the accounting at the time of the transfer of the business to Newco and, more specifically, on whether IFRS 3 could apply to this fact pattern. The submitter observes that IFRS 3 might not apply to this fact pattern because:

[2] http://media.ifrs.org/IFRICUpdateSept11.html#5

(a) paragraph 2(c) excludes combinations of entities or businesses under common control from its scope and paragraph B1 of IFRS 3 excludes combinations of entities under common control and in which control by the same party is not transitory; and

(b) none of the combining entities in the fact pattern can be identified as the acquirer because none of the factors included in paragraphs B13-B18 of IFRS 3 would apply to Newco, and so Newco can be considered to be the acquirer. In addition, Newco is not considered a business (as defined in Appendix A of IFRS 3) so that Business A could be considered the acquirer.

22. The submitter also asked the Committee to clarify whether the potential occurrence of an IPO of Newco, after the transfer of Business A to Newco:

(a) could be considered relevant in identifying the acquirer for this transaction if the transaction is analysed under IFRS 3; and

(b) would imply that common control of Newco and Business A is considered ‘transitory’ and whether the transaction would no longer be considered a combination of entities under common control in accordance with paragraph B1 of IFRS 3.

23. The submitter asks for the Committee’s views on which accounting treatment should be followed.

Staff analysis and recommendation

24. In our view, the combining entities or businesses are ultimately controlled by the same shareholder (Shareholder A) and control is not transitory, because it is the same party that controls the combining entities both before and after the transfer of Business A to Newco.

25. Consequently, we think that, in line with paragraph B1 of IFRS 3, the fact pattern described by the submitter can effectively be described as a combination of entities under common control, because there is no change of control as a result of the transfer of Business A to Newco.

26. We think that the possibility of an IPO occurring should not affect the categorisation of this transaction as a combination of entities under common

control, because the occurrence and the outcome of an IPO is unknown, and will depend on future capital market conditions.

27. We observed that the Committee should not give an interpretation as to which accounting method should be used to account for business combinations under common control because:

(a) the Board has explicitly excluded them from the scope of IFRS 3 in accordance with paragraphs B1 and 2(c) of IFRS 3 because it plans to deal with the accounting for this type of combinations at a later stage;

(b) the fact pattern analysed is too broad to be addressed by an interpretation or an annual improvement;

(c) in the absence of specific guidance on how to account for business combinations under common control, an entity should select an appropriate accounting policy using the hierarchy described in paragraphs 10 to 12 of IAS 8, *Changes in Accounting Estimates and Errors*.

28. Regarding the second issue raised by the submitter, with respect to whether a business that is not a 'legal entity' could be considered to be the acquirer in a reverse acquisition under IFRS 3, we concluded that an acquirer in a reverse acquisition does not need to be a legal entity, because IFRS 3 and the current Conceptual Framework do not require a 'reporting entity' to be a legal entity. In our view, as long as a business is a reporting entity, it can be considered to be the acquirer in a reverse acquisition.

The Committee's recommendation

29. At the July 2011 meeting, a majority of the Committee members agreed with the staff analysis. They also agreed not to take the issues raised by the submitter onto its agenda and published its tentative agenda decision in IFRIC Update for public comment.

30. At the September 2011 meeting the Committee discussed the comments received from constituents on its tentative agenda decisions on common control transactions and on the acquirer in a reverse acquisition.

31. In the light of the comments expressed, the Committee decided to simplify the wording of its agenda decision because several respondents thought that the tentative agenda decision gave guidance in the topics raised in the submission and these respondents objected to guidance being issued in this manner. The Committee determined that the best place for providing clarity in the accounting guidance for conditional formations should be within the common control transactions project, if the Board decides to restart work on this project.

32. Respondents commenting on the tentative agenda decision on the acquirer in a reverse acquisition broadly agreed with the Committee's tentative decision that a business that is not a legal entity could be considered the acquirer in a reverse acquisition under IFRS 3.

33. The final wording of the agenda decision for common control transactions and for the identification of the acquirer in a reverse acquisition can be found on the public website[3] and are reproduced in Appendix C of this paper.

Interpretations Committee's recommendation to the Board

34. On the basis of the staff's analysis and on the assessment of the agenda criteria, the Committee thinks that the accounting for fact patterns involving the creation of a newly formed entity and the accounting for common control transactions are too broad to be addressed through an interpretation or through an annual improvement.

35. Consequently, the Committee decided to recommend to the Board that it should consider the specific fact patterns submitted in the context of a broader project on accounting for common control transactions, which the Board might address at a later stage.

[3] http://media.ifrs.org/IFRICUpdateSept11.html#5

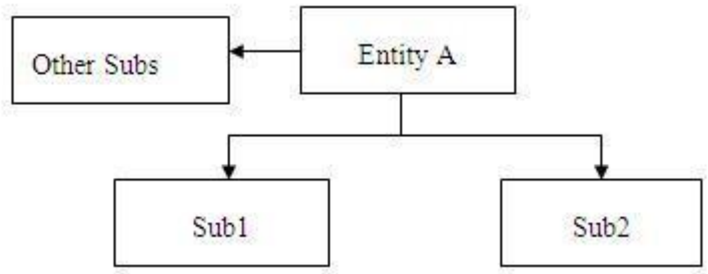
Question to the Board

Question—Identification of the acquirer and common control transactions
Does the Board have any further questions on the issues or is there anything further at this stage that the Board would like the staff or the Interpretations Committee to do?

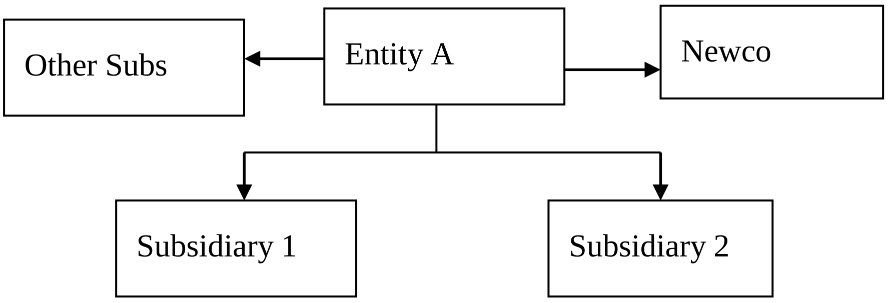
Appendix A

A1. The following diagram illustrates the fact pattern of Newco entering into a conditional acquisition.

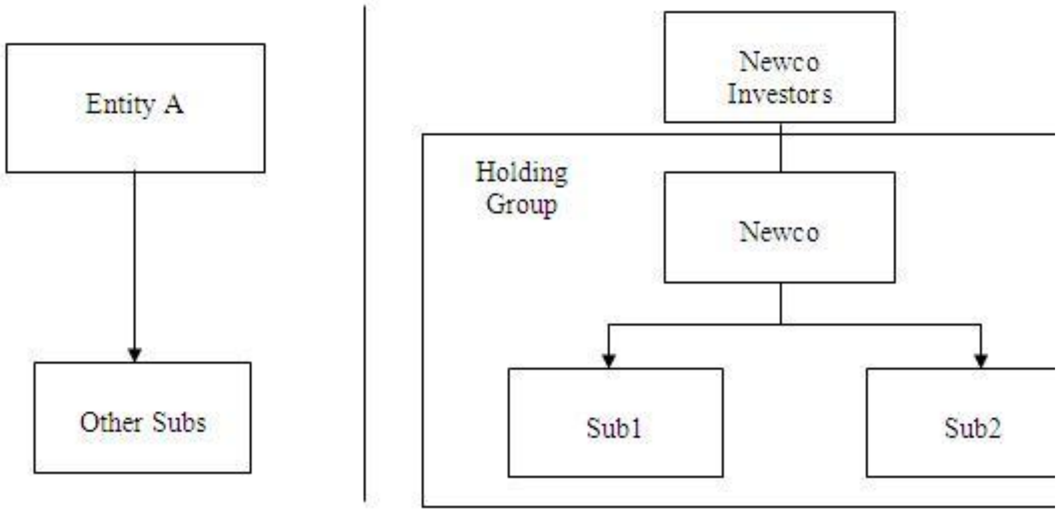
- Before restructuring



- Entity A incorporates a new company (Newco) with nominal equity and appoints independent directors to the board of Newco.



- After the IPO occurs, the respective group structures of Entity A and Newco appear as follows:

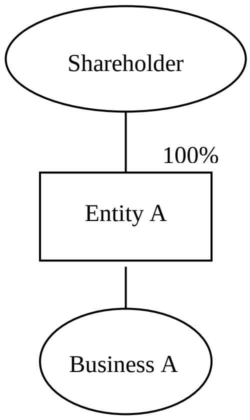


Appendix B

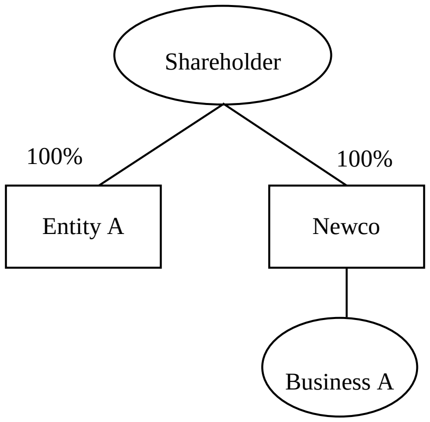
B1 The following is an example of one type of common control transaction that results in inconsistent treatment:

Entity A, owned 100 per cent by Shareholder A, transfers a business (Business A) into a Newco that has been formed for the purpose of acquiring Business A. Eventually Newco will raise new capital from public shareholders; however, a period of several months may lapse before a prospectus offering may occur.

Prior to transaction



After transaction



Appendix C

C1 The Committee's final agenda decisions at the September 2011 meeting are reproduced below for ease of reference.

IFRS 3 Business Combinations—business combinations involving newly formed entities: factors affecting the identification of the acquirer

The Interpretations Committee received a request for guidance on the circumstances or factors that are relevant when identifying an acquirer in a business combination under IFRS 3. More specifically, the submitter described a fact pattern in which a group plans to spin off two of its subsidiaries using a new entity ('Newco'). Newco will acquire these subsidiaries for cash from the parent company (Entity A) only on condition of the occurrence of Newco's initial public offering (IPO). The cash paid by Newco to Entity A to acquire the subsidiaries is raised through the IPO. After the IPO occurs, Entity A loses control of Newco. If the IPO does not take place, Newco will not acquire the subsidiaries.

The Committee observed that the accounting for a fact pattern involving the creation of a newly formed entity is too broad to be addressed through an interpretation or through an annual improvement. The Committee determined that the specific fact pattern submitted would be better considered within the context of a broader project on accounting for common control transactions, which the Board is planning to address at a later stage.

Consequently, the Interpretations Committee decided not to add the issue to its agenda and recommended the Board to consider the fact pattern described in the submission as part of its project on common control transactions.

IFRS 3 Business Combinations—business combinations involving newly formed entities: business combinations under common control

The Interpretations Committee received a request for guidance on accounting for common control transactions. More specifically, the submission describes a fact pattern that illustrates a type of common control transaction in which the parent company (Entity A), which is wholly owned by Shareholder A, transfers a business (Business A) to a new entity (referred to as 'Newco') also wholly owned by Shareholder A. The submission requests clarification on (a) the accounting at the time of the transfer of the business to Newco; and (b) whether an initial public offering (IPO) of Newco, which might occur after the transfer of Business A to Newco, is considered to be relevant in analysing the transaction under IFRS 3.

The Committee observed that the accounting for common control transactions is too broad to be addressed through an interpretation or through an annual improvement. The Committee also noted that the issues raised by the submitter have previously been brought to the Board's attention. The Committee determined that the specific fact pattern submitted would be better considered within the context of a broader project on accounting for common control transactions, which the Board is planning to address at a later stage.

Consequently, the Interpretations Committee decided not to add the issue to its agenda and recommended the Board to consider the fact pattern described in the submission as part of its project on common control transactions.

IFRS 3 Business Combinations—acquirer in a reverse acquisition

The Interpretations Committee received a request for guidance asking whether a business that is not a legal entity could be considered to be the acquirer in a reverse acquisition under IFRS 3.

The Committee noted that in accordance with paragraph 7 of IFRS 3, the acquirer is 'the entity that obtains control of the acquiree' and, in accordance with Appendix A of IFRS 3, the acquiree is 'the business or businesses that the acquirer obtains control of in a business combination'. Paragraph B19 in IFRS 3 states that '...The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.'

The Committee observed that IFRSs and the current Conceptual Framework do not require a 'reporting entity' to be a legal entity. Consequently, the Committee noted that an acquirer that is a reporting entity, but not a legal entity, can be considered to be the acquirer in a reverse acquisition.

The Committee noted that this issue is not widespread. Consequently, the Committee decided not to add this issue to its agenda.