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Business combination under common control - IASB's proposed accounting

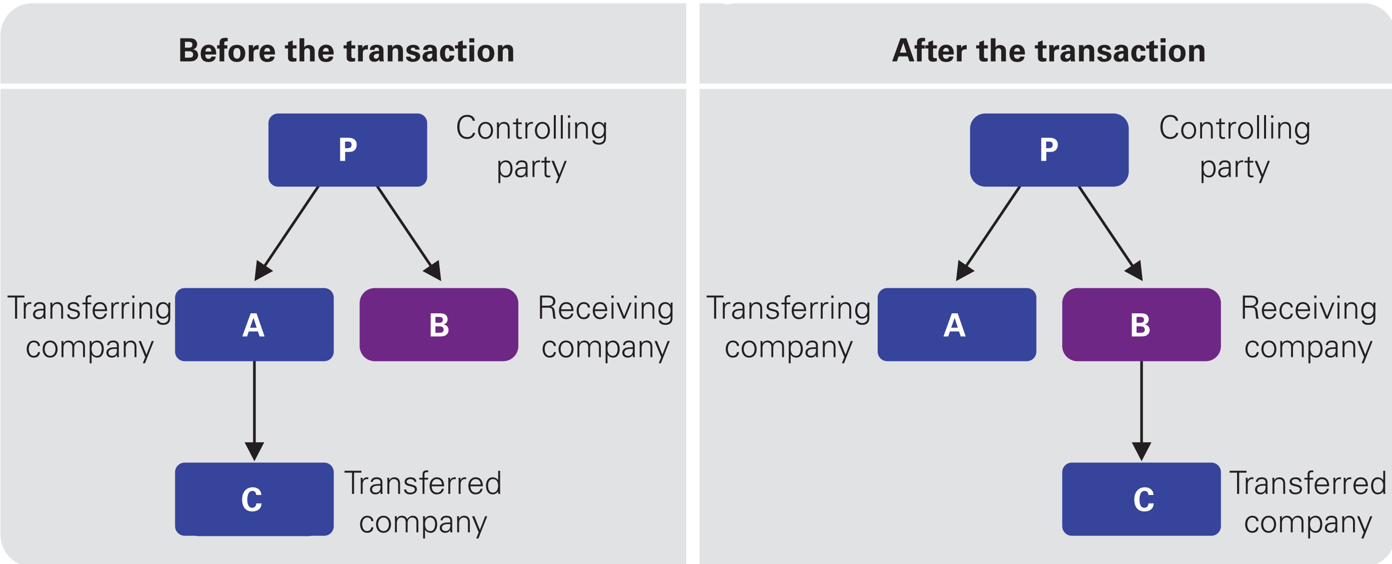
This article aims to:

Provide an overview of the accounting for business combination under common control transactions and related disclosures as proposed by the IASB in its discussion paper.

Introduction

Currently, the International Financial Reporting Standards (IFRS) 3, *Business Combinations* provides guidance on accounting for business combinations under the acquisition method. A business combination is a transaction or other event in which a reporting entity (the acquirer) obtains control of one or more businesses (the acquiree). The date of acquisition is the date on which the acquirer obtains control of the acquiree.

However, there is no guidance in IFRS standards for business combinations under common control - i.e. transactions in which the combining businesses are ultimately controlled by the same party both before, and after the combination. Such a transaction has been illustrated in the given diagram.



Source: IASB Discussion Paper on 'Business Combinations under Common Control' issued in November 2020

In the above diagram, control of company C is transferred from company A to company B (receiving company). However, all three companies are ultimately controlled by company P, the controlling party, both before and after the transaction. These transactions are outside the scope of IFRS 3. Therefore, significant diversity has emerged in how the receiving company (i.e. company B) accounts for the transaction in its financial statements. In the absence of a specifically applicable IFRS standard, the receiving company is required to develop its own accounting policy for these transactions. Basis the facts and circumstances of the case, some companies use the acquisition method[1] and others use a book-value method[2] for accounting such transactions. Also, a variety of book-value methods are used in practice.

Further, the diversity in practice makes it difficult for users of financial statements, in particular investors to understand the effects of these transactions and to compare companies that undertake them.

With a view to address these concerns and to provide users of the financial statements with better information about these transactions, recently, the International Accounting Standards Board (IASB) has issued a Discussion Paper (DP)[3] and proposed reporting requirements for a receiving company[4] in a common control business combination. The proposals would cover all transfers of businesses in which all of the combining companies are ultimately controlled by the same party, irrespective of whether the transfer is:

- Preceded by an acquisition from an external party or followed by a sale of one or more of the combining companies to an external party (that is, a party outside the group) or
- Conditional on a sale of the combining companies to an external party, such as in an Initial Public Offering (IPO).

1. Assets and liabilities received in the combination are measured at fair value and goodwill is recognised.
2. Assets and liabilities are measured at their existing book values.
3. DP/2020/2 - Business Combinations under Common Control issued in November 2020.
4. The term 'receiving company' refers not only to the immediate receiving company in the combination. It also refers to those parent companies (if any) of that immediate receiving company that did not control the transferred company before the combination.

Additionally, the proposed accounting would be applicable to group restructurings that involve a transfer of a business under common control but does not meet the definition of a business combination under IFRS 3. For example, some transactions might not meet that definition if they involve transferring a business to a newly established parent company.

In this article, we aim to provide an overview of the DP which sets out IASB's preliminary views on following aspects relating to accounting by a receiving company in case of a business combination under common control in its financial statements[5]:

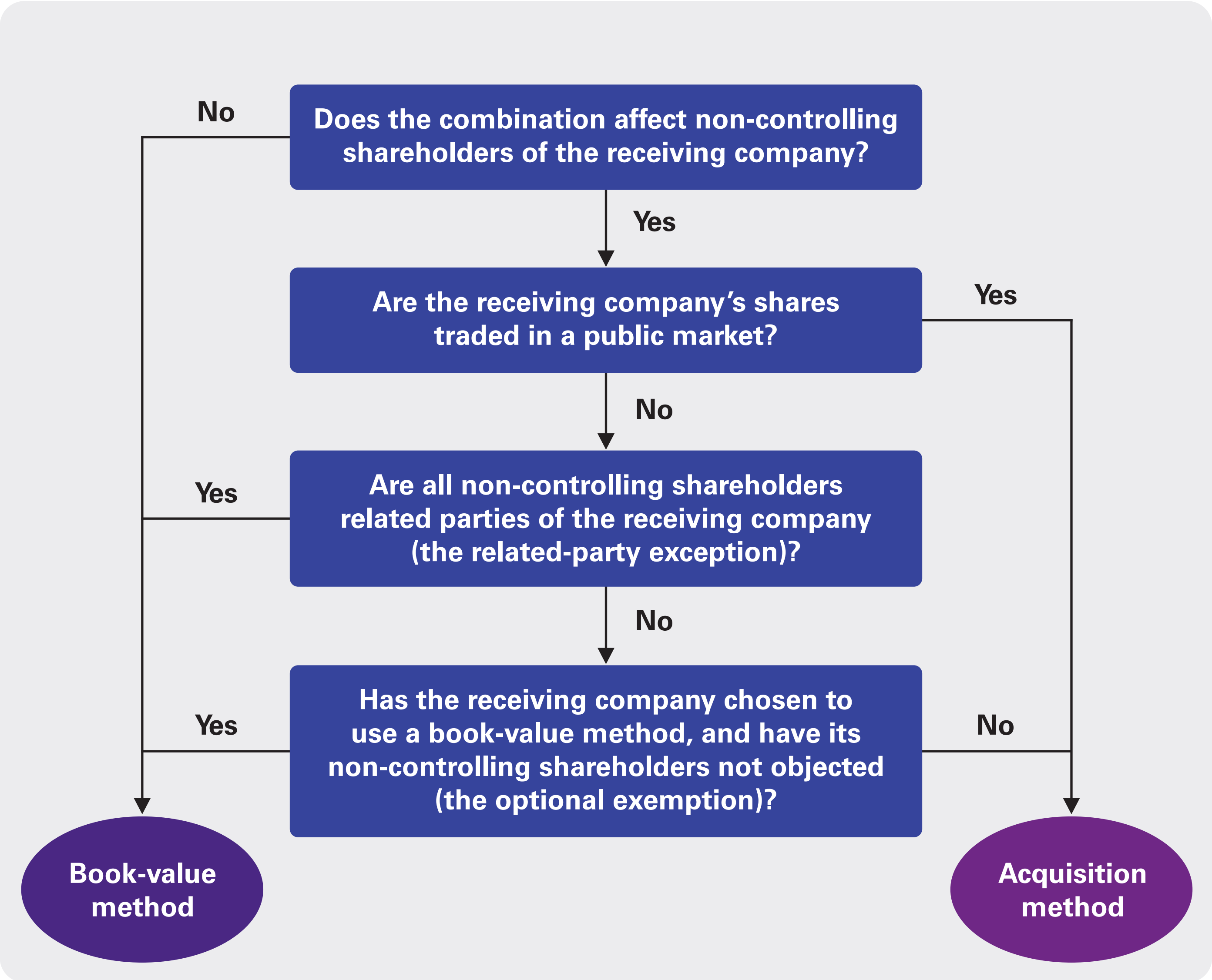
- Selection of the measurement method
- Application of each measurement method and
- Disclosure of information about these combinations.

Comments on the proposals can be submitted up to 1 September 2021.

Selection of the measurement method – Acquisition or book-value

As per IASB, one size does not fit all. Therefore, for some business combinations under common control, the acquisition method should be used, and for the others a book-value method should be used.

The following diagram depicts circumstances in which each of the method should be adopted:



Source: IASB Discussion Paper on 'Business Combinations under Common Control' issued in November 2020

5. It covers all financial statements prepared by the receiving company to which the possible reporting requirements would apply. However, the proposals do not address how a receiving company should report in its separate financial statements an investment in a subsidiary received in a business combination under common control.

Acquisition method

As per IASB, the acquisition method should be applied if the business combination under common control affects non-controlling shareholders of the receiving company, subject to the cost–benefit trade-off and other practical considerations.

Combinations that affect non-controlling shareholders

When non-controlling shareholders of the receiving company acquire an ownership interest in the economic resources transferred in a business combination under common control, the combination has a substantive effect not only on the receiving company but also on its shareholders. As per IASB, if such a transfer occurs, that transaction is similar to business combinations covered by IFRS 3.

Cost-benefit trade-off

The costs of applying the acquisition method would be justified for publicly traded companies. Typically, listing requirements or capital market regulations would:

- Prevent the listing of a 'small' number of shares and
- Limit how many shares can be held by a company's related parties.

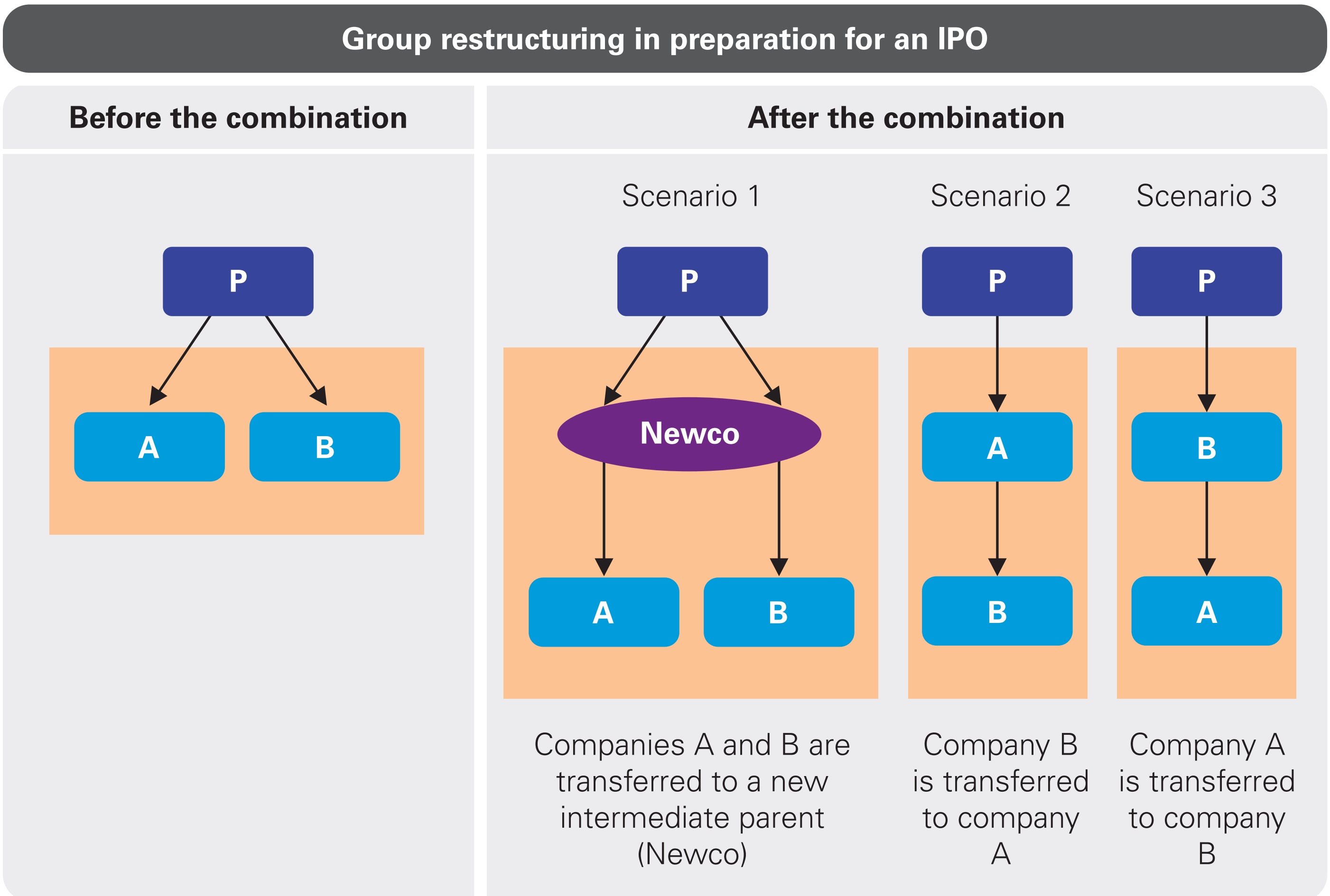
Therefore, IASB recommended that the receiving company whose shares are traded in a public market should be required to apply the acquisition method.

Book value method

On the other hand, book-value method should be applied to business combinations under common control that do not affect non-controlling shareholders of the receiving company including combinations that affect potential shareholders or lenders or other creditors of the receiving company.

Combinations that do not affect non-controlling shareholders

If the receiving company does not have non-controlling shareholders (such as in a business combination under common control involving wholly-owned companies), there is no change in the ultimate control of the combining companies and also no change in the ultimate ownership interests in the economic resources transferred in the combination. This is explained in the below diagram.



Source: IASB Discussion Paper on 'Business Combinations under Common Control' issued in November 2020

In the diagram, the controlling party, company P, decides to restructure its wholly-owned subsidiaries, company A and B, in preparation for an IPO. It could undertake that restructuring in various ways. However, in all scenarios potential shareholders would be investing in the same economic resources, as indicated by the shaded area in the diagram. Therefore, a book value method would provide useful information about these combinations to potential shareholders of the combining companies, because the information produced by the method does not depend on how the combination is legally structured.

A book-value method would also avoid the difficulties that could arise if the acquisition method was applied to combinations that do not affect non-controlling shareholders. For example, it would avoid the need to decide which company is the 'economic' acquirer. That decision is fundamental in applying the acquisition method but could be difficult to make for combinations like group restructuring illustrated in the above diagram.

Further, the costs of applying the acquisition method might not always be justified for privately held companies (i.e. companies whose shares are not publicly traded). Therefore, IASB suggested following special conditions for such companies:

An optional exemption

A privately held receiving company would be *permitted* to use a book-value method if it has informed all of its non-controlling shareholders that it proposes to use that method and they have not objected.

A related-party exception

A privately held receiving company would be *required* to use a book-value method if all non-controlling shareholders are related parties of the company, as defined under IAS 24, *Related Party Disclosures*. This is because the receiving company's related parties might not need to rely on its general-purpose financial statements to meet their information needs.

Also, use of book value method in such cases would prevent opportunities to structure a combination by issuing shares to related parties for the sole purpose of qualifying for the acquisition method.

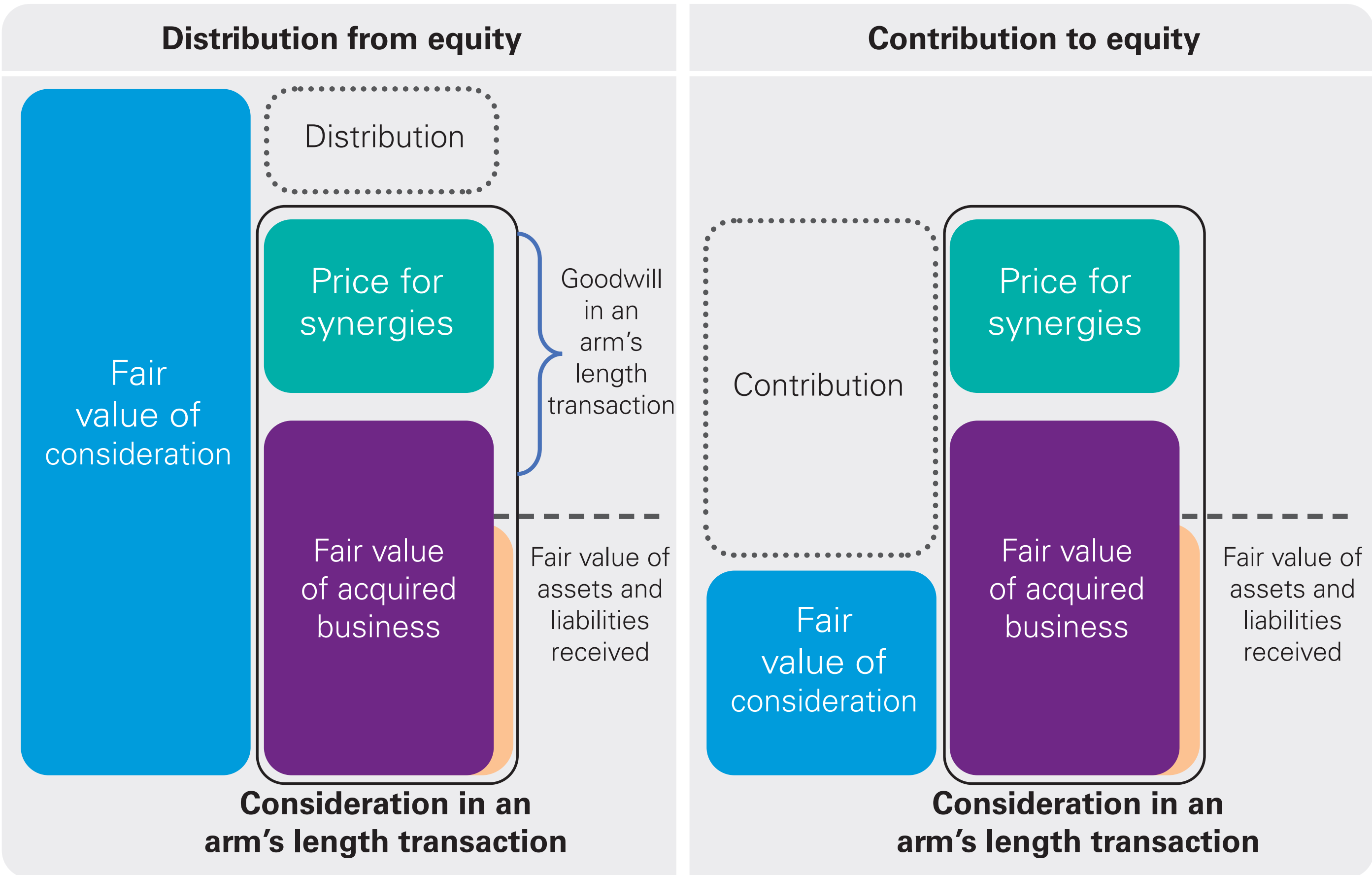
Application of the measurement method

Acquisition method

The acquisition method set out in IFRS 3 assumes that the consideration paid in the combination is negotiated at an arm's length and reflects the fair value of the acquired business and the price paid for any synergies expected from the combination. However, in a business combination under common control, the consideration paid might be determined by the controlling party and thus, might differ from an arm's length price that would have been negotiated between unrelated parties in a business combination covered by IFRS 3. The difference would indicate that the combination includes an additional component - a transaction with the owners acting in their capacity as owners. Accordingly,

a. *If the consideration paid is higher than in an arm's length transaction:* The excess constitutes a distribution from equity by the receiving company to the transferring company, and ultimately to the controlling party.

b. *If the consideration paid is lower than in an arm's length transaction:* The difference constitutes a contribution to equity of the receiving company from the transferring company, and ultimately from the controlling party.



Source: Snapshot of Discussion Paper on 'Business Combinations under Common Control' issued by IASB in November 2020.

Distribution from equity

As per IASB, the receiving company should not be required to identify, measure and recognise a distribution from equity (point (a) above) when applying the acquisition method to a business combination under common control. Instead, the receiving company should disclose information about the terms of the combination, including how the transaction price was set. Any 'overpayment' would be included in goodwill that would be subject to impairment testing, just as it occurs in reporting a business combination covered by IFRS 3.

Contribution to equity

IASB is of the view that the receiving company should recognise a contribution to equity if the fair value of the assets and liabilities received in a business combination under common control exceeds the fair value of the consideration paid, instead of recognising that difference as a gain on a bargain purchase in the statement of profit and loss, as required by IFRS 3.

Book value method

IFRS standards do not provide guidance on book-value methods and do not specify how such a method should be applied. In practice, a variety of book-value methods are used. The variations, in particular, relate to:

- **Measuring the assets and liabilities received:** Receiving company uses either the transferred company's book values or the controlling party's book values to measure those assets and liabilities.
- **Providing pre-combination information:** The receiving company includes the transferred company's assets, liabilities, income and expenses in its financial statements.

Accordingly, IASB has provided guidance on the following aspects relating to application of book value method:

- **Measurement of the assets and liabilities by the receiving company:** The receiving company should measure the assets and liabilities received at their book values reported by the transferred company. This is expected to provide the most useful information to users of the receiving company's financial statements at a cost justified by the benefits of that information.
- **Measurement of the consideration paid:** In practice, when a book-value method is applied, the consideration paid is measured either at fair value or at book value. In case the consideration is paid in receiving company's own shares, at their par value or a nominal value. As per IASB, while applying the book value method, the receiving company should measure the consideration paid as follows:
  - *If consideration is paid in assets:* At the receiving company's book values of those assets at the combination date.
  - *If consideration is paid by incurring or assuming liabilities:* At the amount determined on initial recognition of that liability at the combination date applying IFRS standards.

  IASB is of the view that it should not prescribe how the consideration paid in the receiving company's own shares should be measured. This is because the reporting of components within a reporting company's equity and the measurement of issued shares for the purpose of that reporting are often affected by national requirements and regulations and are generally not prescribed in IFRS standards.
- **Reporting the difference between the consideration paid and the book value of the assets and liabilities received:** When applying a book-value method to a business combination under common control, the receiving company should recognise within equity any difference between the consideration paid and the book value of the assets and liabilities received. The approach is consistent with the current practice.
- **Reporting transaction costs:** Companies might incur certain transaction costs while undertaking business combinations under common control such as, advisory, legal, accounting, valuation and other professional fees. The IASB is of the view that while applying a book-value method to a business combination under common control, the receiving company should recognise such transaction costs 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. This is consistent with the current approach provided under IFRS 3 for accounting such costs.
- **Providing pre-combination information:** The IASB has prohibited the restatement of pre-combination information in case of a business combination under common control. Accordingly, while applying a book-value method to a business combination under common control, the receiving company should include in its financial statements the assets, liabilities, income and expenses of the transferred company prospectively from the combination date, without restating pre-combination information. This would represent a change from current practice for some companies.

Disclosures

In the IASB's preliminary views, while accounting business combinations under common control under:

- **Acquisition method:** The receiving company should be required to comply with the disclosure requirements in IFRS 3, including any improvements to those requirements resulting from the Discussion Paper 'Business Combinations—Disclosures, Goodwill and Impairment'[6].
- **Book-value method:** In case of application of book value method to business combinations under common control, some but not all of the disclosure requirements of IFRS 3 would be appropriate.

6. The Discussion Paper was issued in March 2020 and was open for comments until 31 December 2020

Accordingly, the receiving company should, inter alia, make the following disclosures when a book-value method is applied:

a. The name and a description of the transferred company, the combination date, the percentage of voting equity interests transferred to the receiving company, the primary reasons for the combination and a description of how the receiving company obtained control.

b. The carrying amount of any non-controlling interest in the transferred company.

c. Aggregate information for individually immaterial combinations that are material collectively.

Additionally, it should disclose:

a. The amount recognised in equity for any difference between the consideration paid and the book value of the assets and liabilities received and

b. The component, or components, of equity that includes this difference.

However, the disclosure of pre-combination information would not be required.

Next steps

The proposals are expected to reduce the diversity in practice in case of accounting business combinations under common control, more particularly by the receiving company in such combinations. IASB has deliberated and proposed that one size cannot fit all. Therefore, it would be relevant for some companies to apply acquisition method, specifically those whose non-controlling shareholders are affected by such combinations subject to the cost-benefit trade-off and other practical considerations, while others may apply the book-value method. Also, an optional exemption has been provided to enable privately held companies to use book-value method, if none of their non-controlling shareholders object to such method.

The IASB has also proposed to prohibit restatement of pre-combined information. This implies that the financial information of the transferred company would be included in the financial statements of the receiving company prospectively - i.e. from the date of the transaction. The change is expected to affect current practice being followed by some companies which combine the assets, liabilities, income and expenses of the transferred company retrospectively.

In India, Indian Accounting Standard (Ind AS) 103, *Business Combinations* is largely based on IFRS 3. While IFRS 3 excludes from its scope business combinations of entities under common control, Ind AS 103 provides guidance in this regard (Appendix C). As per the guidance, business combinations involving entities or businesses under common control should be accounted for using the pooling of interest method. Under the method, the assets and liabilities of the combining entities are reflected at their carrying amounts and the financial information in the financial statements in respect of prior periods are restated as if the business combination had occurred from the beginning of the preceding period. For application of the guidance, the Ind AS Technical Facilitation Group (ITFG) of the Institute of Chartered of Accountants of India (ICAI) has also issued various clarifications.

With regard to the discussion paper, ICAI has also invited comments on the IASB's proposals up to 15 July 2021.

It should be noted that the proposals in the DP are preliminary and may change. Basis the comments it receives in response to the DP up to 1 September 2021, IASB would consider whether to develop an exposure draft containing proposals to implement any or all of its preliminary views. Companies should watch out for the developments in the area and provide their comments to ICAI.