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Business Combinations under Common Control: Filling a Gap in IFRS Standards

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The aim of this paper is to explain the International Accounting Standards Board's (IASB) preliminary views for accounting for business combinations under common control, an issue not currently addressed in International Financial Reporting Standards. Such combinations are widespread and the accounting for them is diverse. The IASB's preliminary views aim to reduce diversity in practice and to improve the information provided to investors so they can understand the effects of these transactions and compare companies that undertake them. Accounting for business combinations under common control is not currently addressed in International Financial Reporting Standards. The author describes some of the International Accounting Standard Board's proposals to reduce diversity and improve investors' information in this area.

Business combinations under common control (hereafter BCUCC) are mergers and acquisitions involving companies within the same group.[1] A common control situation is shown in Figure 1 where Company P is the controlling party of Companies A, B and C. Company C is a business which was under the control of Company A; subsequently it is transferred to be under the control of Company B. International Financial Reporting Standard (IFRS) 3 *Business Combinations* sets out accounting requirements for business combinations and requires the use of the acquisition method of accounting, but BCUCC are excluded from IFRS 3's scope. Company B's accounting for the acquisition of Company C is therefore not covered in current IFRS Standards.

Consequently, there is a gap in IFRS Standards and companies that receive a business in BCUCC account for these transactions in a variety of ways. Some use IFRS 3's acquisition method – they record the assets and liabilities received in the combination at fair value and any goodwill arising. Others use a book-value method which records the assets and liabilities received at the existing book values. A book-value method is not specified in IFRS Standards, so in practice a variety of book-value methods is used.

BCUCC transactions occur in many countries throughout the world, but the accounting methods used are diverse. Research by the International Accounting Standards Board (IASB) reported on a sample of 207 annual reports (267 transactions) in the period January 2018 to March 2019. They found that 4% of transactions used the acquisition method while 94% used a form of the predecessor method, with great variation in how the methods were applied.[2] This diversity makes it difficult for investors to understand the effects of these transactions and to compare companies that undertake them.

The IASB's project, as outlined in the Discussion Paper *Business Combinations under Common Control* (IASB 2020a), seeks to address this diversity. The objective of the IASB in issuing the Discussion Paper is to: 'explore possible reporting requirements for business combinations under common control that would reduce diversity in practice, improve transparency in reporting these combinations, and provide users of financial statements with better information' (IASB 2020b: 1).

The aim of this paper is to explain the IASB's preliminary views and to stimulate debate. I outline different views that the IASB considered in developing its preliminary views set out in the Discussion Paper and explain why the IASB reached those views. Following the publication of the Discussion Paper, the IASB has undertaken extensive consultation to obtain stakeholders' feedback about its preliminary views.[3] The IASB will consider the feedback received and deliberate about whether to confirm its preliminary views or to reconsider them. Examples of feedback include the article by Seah-Tan (2021) in this issue, which provides a practitioner view of accounting for BCUCC in Hong Kong where predominantly book-value-type methods are used.

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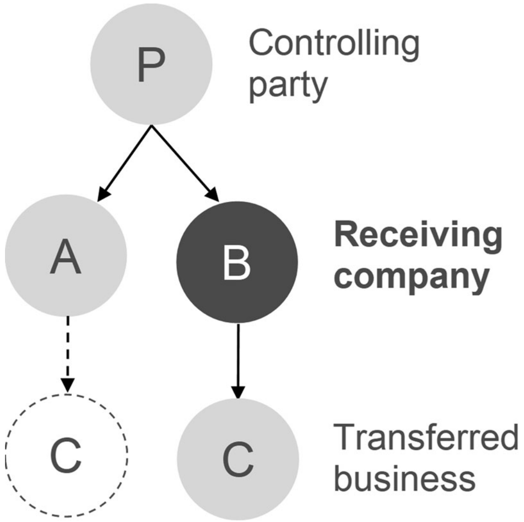

Figure 1 Scope of the project (IASB 2020b: 3). This figure shows a business combination under common control. The proposals in the Discussion Paper relate to reporting by the receiving company B.

Scope of the Project

The Discussion Paper refers to business combinations under common control, as shown in Figure 1. In this figure, Company C is a business so the transaction is within the scope of the Discussion Paper. The project does not consider transfers of assets under common control or of companies that do not have a business. The project relates to the (typically consolidated) financial statements of the receiving company, that is, Company B in Figure 1.

When to Apply the Acquisition Method and a Book-value Method

In developing the Discussion Paper, the IASB considered stakeholders' feedback on BCUCC, existing reporting practice, applicable requirements and guidance in various jurisdictions.

Stakeholders' views: BCUCC are different from other business combinations

Some stakeholders view BCUCC from the perspective of the controlling party, that is, Company P in Figure 1. They argue that BCUCC differ from business combinations between unrelated parties covered by IFRS 3 and lack economic substance because ultimate control of the transferred business by the controlling party does not change. These stakeholders take a view that a book-value method should apply to all BCUCC to reflect that party's continued control of the combining companies. They argue that the acquisition method should not apply to these combinations because that method is designed for transactions that involve a change in the ultimate control of a business.

These stakeholders also argue that a book-value method would provide useful information to all users of the receiving company financial statements. Its shareholders (including the controlling party), lenders and

Table 1 How to apply each method (IASB 2020b: 13)

	Generally, the acquisition method should be applied as set out in IFRS 3	IFRSs would specify a single book-value method
How to measure the assets and liabilities received?	Measure the assets and liabilities received at their fair values	Measure the assets and liabilities received at their existing book values reported by the transferred company
How to measure the consideration paid?	Measure all forms of the consideration paid at fair value	In general, measure the consideration paid at book value (the IASB would not prescribe how to measure the consideration paid in own shares)
How to report the difference between those amounts?	Recognise any such difference as goodwill or, in rare cases, as a contribution to equity instead of as a gain in the statement of profit or loss	Recognise any such difference as a decrease or increase in equity
How to provide pre-combination information?	Include the transferred company from the combination date, without restating pre-combination information	Include the transferred company from the combination date, without restating pre-combination information
What information to disclose?	Disclose all information required by IFRS 3 Provide information about the terms of the combination, including how the transaction price was set	• Disclose some, but not all, information required by IFRS 3 • Provide information about the difference between the consideration paid and the assets and liabilities received

This table summarises how to apply the acquisition method and the book-value method as per the proposals in the Discussion Paper.

other creditors are less costly to apply and are already applied in practice in many jurisdictions. They further argue that applying the acquisition method would not provide the most useful information about BCUCC because it would involve significant measurement uncertainty, create goodwill that is not evidenced by an external transaction and, if only applied to some BCUCC, reduce comparability.

Stakeholders' views: BCUCC are similar to other business combinations

Some stakeholders view BCUCC from the point of view of the company that reports the combination – the receiving company. These stakeholders argue that BCUCC are similar to business combinations between unrelated parties covered by IFRS 3. They argue that the controlling party's perspective is irrelevant to the receiving company's financial statements and point out that from the perspective of the receiving company, a BCUCC transfers control of a business to that company, just as occurs in a business combination covered by IFRS 3, so it has economic substance for that company.

Therefore, these stakeholders argue that the acquisition method would provide the most useful information about BCUCC to users of the receiving company's financial statements and provide consistency with reporting other business combinations. However, these stakeholders acknowledge that the cost of providing fair value information about BCUCC may outweigh the benefits in some circumstances.

Stakeholders' views: Some (but not all) BCUCC are similar to other business combinations

Some stakeholders argue that BCUCC are not similar to each other – some are similar to business combinations between unrelated parties covered by IFRS 3 (so the acquisition method would provide the most useful information) but others are not. These stakeholders suggest using criteria to evaluate whether a BCUCC is similar to business combinations covered by IFRS 3. Such criteria could include the presence of non-controlling shareholders, the combination pricing, evidence of fair value, the purpose of the combination and which party initiated it.

The IASB's preliminary view

The IASB collected feedback from stakeholders[4] and considered data including the Hong Kong Institute of Certified Public Accountants and Organismo Italiano Contabilità's joint investor survey.[5]

In the IASB's view, all BCUCC have economic substance for the receiving company. Furthermore, if a BCUCC affects existing non-controlling shareholders of the receiving company then in the IASB's view the BCUCC is similar to a business combination between unrelated parties covered by IFRS 3. In such cases, even though there is no change in the ultimate control of the transferred business by the controlling party, there is a change in the ultimate ownership interests in the transferred business. This is because non-controlling shareholders of the receiving company indirectly acquire ownership interest in the transferred business just as occurs in a business combination between unrelated parties. The information needs of non-controlling shareholders would also be similar in those scenarios. Accordingly, the acquisition method should apply, subject to the cost-benefit trade-off and other practical considerations.

If a BCUCC does not affect non-controlling shareholders of the receiving company then in the IASB's view a book-value method should apply. That is consistent with the view that some BCUCC – notably those between wholly owned companies – are different from business combinations between unrelated parties covered by IFRS 3 and also reflects the cost-benefit trade-off.

Figure 2 shows the criteria that would determine when a receiving company should use the acquisition method or a book-value method. The criteria used are all based on conditions from existing IFRS Standards. There are four steps, to be followed in sequence:

1. Does the combination affect non-controlling shareholders of the receiving company?[6]
2. Are the receiving company's shares traded in a public market?[7]
3. Are all non-controlling shareholders related parties of the receiving company?[8]
4. Has the receiving company chosen to use a book-value method, and have its non-controlling shareholders not objected?[9]

The first criterion in determining which accounting method should apply is whether the combination affects non-controlling shareholders of the receiving company, for the reasons explained above. This overall principle is supported by further requirements that are designed to take into account the cost-benefit trade-off and other practical considerations.

The second criterion is whether the receiving company's shares are traded in a public market. In this case, the non-controlling interest is likely to be significant due to public market regulations. Accordingly, in the IASB's view, the benefit of applying the acquisition method is likely to justify the cost for public companies. Therefore, the acquisition method should be applied in such cases.

If the receiving company is privately held, its non-controlling interest might be small, or it might be held

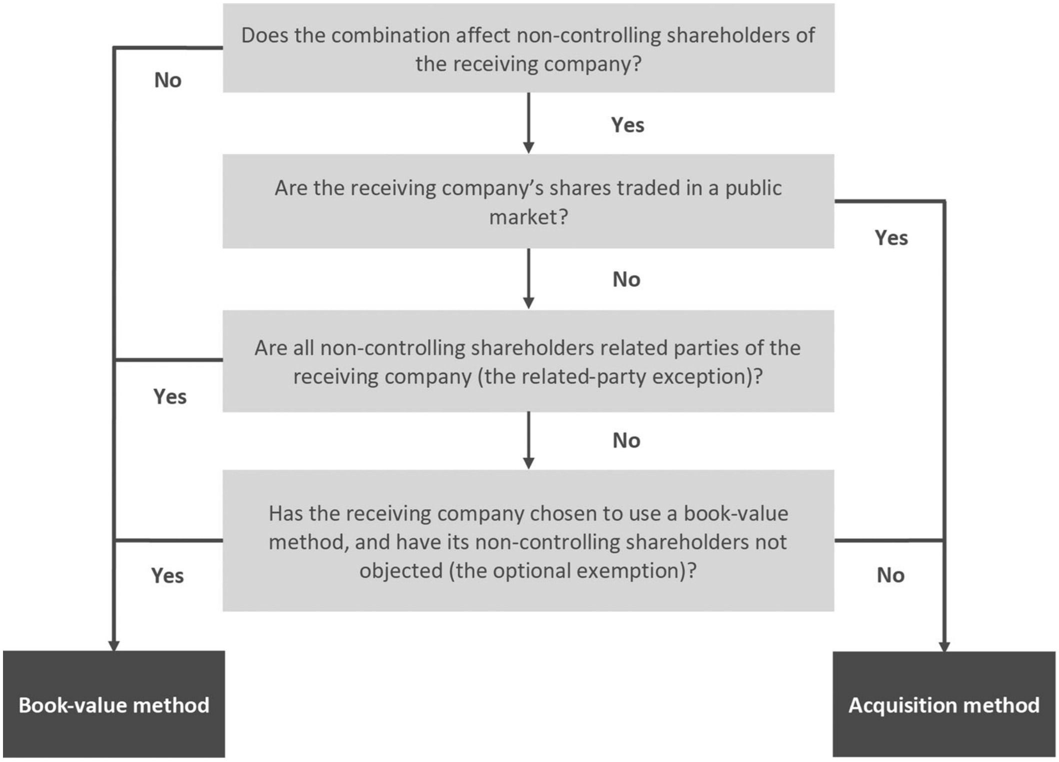

Figure 2 **Summary of the IASB's preliminary views (IASB 2020b: 8). This figure summarises the criteria that determine when a receiving company should use the acquisition method and when it should use a book-value method.**

by the receiving company's related parties, for example, its key management personnel. In such cases, the benefit of applying the acquisition method may not justify the cost. Furthermore, if the acquisition method were required in all cases when non-controlling interest exists in private companies, that could create opportunities for accounting arbitrage. In other words, companies might be able to structure a transaction with the sole objective of achieving a desired accounting treatment.

For those reasons, the IASB is suggesting an exception to and an exemption from the acquisition method for private companies. Specifically, in the IASB's view, a book-value method should be required if all non-controlling shareholders in a private company are that company's related parties. Otherwise, that company would be permitted to apply the book-value method if it informs all its non-controlling shareholders that it proposes to use that method and they do not object. This exemption is based on an existing condition in IFRS Standards.

How to Apply the Acquisition Method

In principle, when the acquisition method is applied to a BCUCC (see Figure 2), it should be applied as set out in IFRS 3. However, there is one potential feature of BCUCC that does not exist in business combinations between unrelated parties. The consideration paid in a BCUCC might differ from an arm's length price that would have been negotiated by unrelated parties.

In a business combination between unrelated parties covered by IFRS 3, the excess of the fair value of the consideration paid over the fair value of the net assets received is recognised as goodwill. This goodwill amount reflects pre-existing goodwill in the acquired business and the price paid for any synergies expected from the combination. In a rare case of a bargain purchase, IFRS 3 requires that the excess of the fair value of the net assets received over the fair value of the consideration paid is recognised as a gain in the statement of profit or loss.

In a BCUCC, the controlling party might have determined the amount of the consideration paid. If the consideration paid is higher, economically that excess constitutes a distribution from equity of the receiving company to the controlling party. If the consideration paid is lower, economically that difference constitutes a contribution to equity of the receiving company from the controlling party.

The IASB's preliminary view

The IASB has reached a preliminary view that it would be impossible for a receiving company to identify, measure and separately recognise any distributions from equity and that such distributions are unlikely to occur in practice for BCUCC that affect non-controlling shareholders. Instead, the excess of the fair value of the consideration paid over the fair value of the assets and liabilities received would be included within the initial carrying amount of goodwill which would be subject to regular impairment tests just as occurs in business combinations between unrelated parties covered by IFRS 3.

In contrast, the IASB noted that IFRS 3 already requires companies in a rare case of a 'bargain purchase' to recognise the excess of the fair value of the assets and liabilities received over the fair value of the consideration paid as a gain in profit or loss. In a BCUCC, any such excess economically represents a contribution to the receiving company's equity. Accordingly, the IASB has reached a view that any such excess should be recognised as a contribution, not as a gain on a bargain purchase (see Table 1).

How to Apply a Book-value Method

Existing IFRS Standards do not refer to any book-value method and there is diversity in practice in how book-value methods are applied. The IASB's preliminary view is that it should specify a single book-value method and require the receiving entity to:

- measure assets and liabilities received using the book values in the financial statements of the transferred company;
- generally, measure the consideration paid at book value;
- recognise within equity any difference between the consideration paid and the book value of the net assets received; and
- include in its financial statements the results, assets and liabilities of the transferred company prospectively from the combination date.

The IASB has not yet considered further detailed aspects of how a book value method should be applied. It plans to consider them in the next stage of the project after the foundations of the model are confirmed.

In discussing the IASB's preliminary views on which methods should apply to BCUCC, I note that some stakeholders take the controlling party's perspective in analysing these transactions while others take the receiving company perspective.

Which book values to use

One aspect of applying a book value method – which book values to use to measure the assets and liabilities received – would to some extent depend on whether BCUCC are viewed from the controlling party's or the receiving company's perspective.

The stakeholders who view BCUCC from the controlling party's perspective and argue that BCUCC are different from business combinations between unrelated parties covered by IFRS 3 typically advocate using the controlling party's book values to measure assets and liabilities received. They argue that using the controlling party's book values may simplify internal reporting within the group, reducing the cost of reporting.

However, the stakeholders who view BCUCC from the point of view of the receiving company and argue that BCUCC are similar to business combinations between unrelated parties covered by IFRS 3 express mixed views on which book values should be used. Some of these stakeholders favour using the transferred company's book values to reflect the perspective of the combining companies, not the controlling party.

They point out that *The Conceptual Framework for Financial Reporting (Conceptual Framework)* (IASB 2018) focuses on information from the perspective of the reporting entity, in this case the receiving company, not its controlling party. They note that the controlling party is not a party to the combination so it may be inconsistent with the *Conceptual Framework* to use the controlling party's book values.

Furthermore, they note that using the transferred company's book values provides consistent book value information regardless of how the transaction is structured (i.e. regardless of whether Company C is moved under Company B in the illustration or vice versa). Under the IASB's preliminary view, in either scenario both Companies B and C will be reported at their historical book values. In contrast, using the controlling party's book values would mean that the receiving company would continue to use its own historical book values but would measure the transferred company using the controlling party's book values. Accordingly, the reporting of that transaction would be different depending on how the transaction is structured.

Finally, using the transferred company's book values would provide uninterrupted historical information about the transferred company that is useful in analysing trends.

On the other hand, some stakeholders who view BCUCC from the reporting entity perspective nonetheless advocate using the controlling party's book values to measure assets and liabilities received in a BCUCC. This is because those book values may be more up to date.

Which book values to use: The IASB's preliminary view

The IASB's view, for the reasons explained above, is that the transferred company's book values should be used (see Table 1).

Prospective or retrospective approach

In some cases when applying a book-value method, companies combine the assets, liabilities, income and expenses of the transferred company retrospectively. In other words, the receiving company's financial statements are prepared as if the combining companies had always been combined, with pre-combination information restated to include the transferred company's assets, liabilities, income and expenses from the beginning of the earliest period presented. In other cases, companies combine those items prospectively, that is, from the date of the combination, as is required for business combinations covered by IFRS 3.

A retrospective approach would be similar to the concept of combined financial statements discussed in the *Conceptual Framework* and result in the same information being provided, regardless of how a combination is legally structured. However, some stakeholders expressed a view that a retrospective approach would provide a 'pro forma' picture of a group in a period when that group did not exist and may involve significant judgement and uncertainty.

A prospective approach would be less costly to apply. The two approaches would provide different information only in the financial statements for the period in which the combination occurs and the following period (only when presenting comparative information).

Prospective or retrospective approach: The IASB's preliminary view

The IASB has reached the view that the benefits of information provided by a retrospective approach may be limited and may not outweigh the costs of providing that information. Accordingly, the IASB has reached the preliminary view that the receiving company should combine the transferred company's assets, liabilities, income and expenses prospectively from the combination date. The IASB has also reached the preliminary view that the benefits of requiring disclosure of pre–combination information in the circumstances when a book-value method is applied would not outweigh the costs of doing so, and so such disclosure would not be required although it would also not be prohibited (see Table 1).

Conclusion

If the IASB confirms its preliminary views and they are implemented, diversity in practice would be reduced, transparency in reporting would be improved and users of financial statements would receive better information. This will occur because the acquisition method would be applied both to business combinations between unrelated parties covered by IFRS 3 and to similar business combinations under common control when the benefits of applying that method outweigh the costs. IFRS Standards would specify which method should be applied in which circumstances, so that companies undertaking similar transactions would typically apply the same accounting policies. IFRS Standards would specify a single book-value method, thus eliminating the diversity caused by the variety of book-value methods currently used (IASB 2020b: 14).

Notes

1 Further information about the IASB Business Combinations under Common Control project can be found here: https://www.ifrs.org/projects/work-plan/business-combinations-under-common-control/. Material in this article has been taken from the IFRSs Discussion Paper Snapshot: Business Combinations under Common Control available here: https://www.ifrs.org/content/dam/ifrs/project/business-combinations-under-common-control/snapshot-dp-bcucc-november-2020.pdf
2 For further information see details of the desktop review of BCUCC transactions included in Appendix C of Agenda Paper 23B for the February 2020 Board meeting available here: https://www.ifrs.org/content/dam/ifrs/meetings/2020/february/iasb/ap23b-bcucc.pdf
3 The consultation period closed 1 September 2021. Comment letters submitted to the IASB are available here: https://www.ifrs.org/projects/work-plan/business-combinations-under-common-control/discussion-paper-and-comment-letters-business-combinations-under-common-control/
4 The activities undertaken by the IASB, Board members and IASB staff to collect feedback from stakeholders are explained further in Agenda Paper 23B for the February 2020 Board meeting available here: https://www.ifrs.org/content/dam/ifrs/meetings/2020/february/iasb/ap23b-bcucc.pdf
5 Hong Kong Institute of Certified Public Accountants and Organismo Italiano Contabilità's Business Combinations under Common Control Summary of Joint Investor Survey is available here: https://www.ifrs.org/content/dam/ifrs/meetings/2018/july/asaf/ap5-bcucc-joint-survey-findings.pdf
6 Non-controlling shareholders are shareholders other than the controlling party (see paragraph B1 onwards of IFRS 3). For simplicity, the Discussion Paper uses the term 'shareholders' to refer to all holders of the company's equity instruments, as defined in IAS 32 *Financial Instruments: Presentation*.
7 A similar condition is already used in paragraph 4(a)(ii) of IFRS 10 *Consolidated Financial Statements*, paragraph 2(b)(i) of IFRS 8 *Operating Segments* and paragraph 2(b)(i) of IAS 33 *Earnings per Share*.
8 Related parties are defined in paragraph 9 of IAS 24 *Related Party Disclosures*.
9 A similar condition is already used in paragraph 4 of IFRS 10 and paragraph 17 of IAS 28 *Investments in Associates and Joint Ventures*.

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