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IFRS Developments

The IASB proposes new requirements for business combinations under common control

What you need to know

- On 30 November 2020, the IASB issued a DP which proposes how to account for BCUCC by receiving entities.
- The DP identifies two methods for accounting for BCUCC - the acquisition method and a single book-value method.
- The acquisition method is proposed to apply to BCUCC involving non-controlling shareholders.
- A single book-value method is proposed to apply to all other BCUCC.
- Comments are due by 1 September 2021.

Background

On 30 November 2020, the International Accounting Standards Board (the IASB or the Board) issued Discussion Paper DP/2020/2 *Business Combinations under Common Control* (the DP), in which it identifies two methods of accounting for business combinations under common control (BCUCC), by a receiving entity. BCUCC are combinations in which all of the combining entities are ultimately controlled by the same party, both before and after the combination. The DP proposes to clarify that the acquisition method (as described in IFRS 3 *Business Combinations)* should generally be applied if the BCUCC affects non-controlling shareholders of the receiving entity, but that a single book-value method should be applied to all other BCUCC. The scope of transactions considered in the project is limited only to those in which a business (as defined in IFRS 3) is transferred, and not, for example, the transfer of assets.

The Board's objective in the project was to explore whether it could develop reporting requirements for a receiving entity in a BCUCC that would reduce diversity in practice. A receiving entity is the one to which control over a business has been transferred in the combination. Currently, in the absence of specific requirements, IFRS Standards require entities to develop an accounting policy for BCUCC using the guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This has resulted in diversity in practice, with the acquisition method being applied in some BCUCC and a book-value method in other BCUCC. Furthermore, there are variations in practice as to how a book-value method is interpreted and applied.

Building a better working world

The Board's preliminary view is that there is no single method that can be applied to all scenarios, so the Board proposes that the acquisition method should be applied to those BCUCC that affect non-controlling shareholders

Selecting the measurement method

Notwithstanding that an alternative way to reduce diversity in practice would be to require a single method for all business combinations, as is described in IFRS 3, whether the entities are under common control or not, the Board's preliminary view is that there is no single method that can be applied to all scenarios, because some BCUCC are similar to combinations covered by IFRS 3, whilst others are not.

Consequently, the DP proposes that the acquisition method should, in principle, be applied to those BCUCC that affect non-controlling shareholders of the receiving entity and that a single book-value method should be applied to all other BCUCC. This is because the Board believes there should be a differentiation between BCUCC affecting non-controlling shareholders, whether publicly traded or privately held, and BCUCC not involving non-controlling shareholders. If the receiving entity's equity instruments are traded in a public market, the Board's preliminary view is that the receiving entity should be required to apply the acquisition method. However, when the receiving entity's equity instruments are privately held, the Board proposes that an optional exemption and an exception from the acquisition method will be available, as follows:

- *The optional exemption from the acquisition method*: A receiving entity should be permitted to use a single book-value method if it has informed all of its non-controlling shareholders that it proposes to use this method, and they have not objected.
- *The exception from the acquisition method*: A receiving entity should be required to use a single book-value method if all of its non-controlling shareholders are the entity's related parties as defined in IAS 24 *Related Party Disclosures*.

Although the DP does not propose a single approach to accounting for BCUCC by the receiving entity, it is expected that it will reduce diversity in practice by specifying which method should be applied and when. Furthermore, the proposal of a single book-value method will help reduce the current diversity in practice.

Applying the acquisition method

As mentioned above, the DP proposes that the acquisition method should be applied to those BCUCC that affect non-controlling shareholders of the receiving entity, giving consideration to the above-mentioned optional exemption and exception. The proposal goes on to note that in BCUCC, the consideration paid might be directed by a controlling party and, therefore, could differ from consideration that would have been paid to an unrelated party, that is, determined at 'arm's length'.

The acquisition method requires recognition of goodwill as the amount of consideration paid in excess of the fair value of the net identifiable assets acquired in an arm's length transaction, or recognition of a gain on a bargain purchase if the consideration paid is less than the fair value of the net identifiable assets. In BCUCC, to mitigate the situation where a controlling party may have determined a consideration which is not at arm's length, the DP proposes that the difference between the determined consideration and the arm's length consideration, in effect, represents a transaction with owners acting in their capacity as owners.

If the consideration paid is higher than the consideration in an arm's length transaction, the excess constitutes a distribution of equity from the receiving entity to the transferring entity (and, ultimately, to the controlling party). Conversely, if the consideration paid is lower than the consideration in an arm's length transaction, that difference constitutes a contribution to equity of the receiving entity from the transferring entity and, ultimately, from the controlling party. Applying IAS 1 *Presentation of Financial Statements*, transactions with owners acting in their capacity as owners should be reported in the receiving entity's statement of changes in equity.

Distributions of equity

A distribution would transfer wealth from the shareholders of the transferring company and ultimately to the controlling party. Input received during the project suggested that distributions to the controlling party are unlikely to occur in such combinations. Therefore, the Board reached the preliminary view that it should not develop additional guidance that would require the receiving entity to identify, measure and recognise a distribution to the controlling party, when applying the acquisition method. In the unlikely event that an overpayment occurs in BCUCC that affect non-controlling shareholders, it would initially be included in goodwill and subsequently tested for impairment, similar to the requirements in IFRS 3 and IAS 36 *Impairment of Assets*.

Contributions to equity

Contributions to the receiving entity would transfer wealth from the controlling party to the non-controlling shareholders. However, this is unlikely to occur in practice. There would also be no adverse impact on those non-controlling shareholders. Despite this fact, the Board reached the preliminary view that it should develop a requirement for the receiving entity to recognise any excess fair value of the identifiable assets and liabilities over the consideration paid as a contribution to equity and not as a gain on a bargain purchase in the statement of profit or loss, when applying the acquisition method.

The Board has proposed that the book-value method should be applied to all BCUCC that do not affect non-controlling shareholders

Applying the book-value method

As noted above, the Board has proposed that a single book-value method should be applied to all BCUCC that do not affect non-controlling shareholders. There is diversity in application of a single book-value method, between using the transferred entity's book values or using the controlling party's book values. In some cases, these may deliver the same result, but in others, they may differ. A single book-value method provides useful information to potential shareholders, because it does not depend on the legal structure and avoids the need to identify an acquirer in cases where this might be difficult and it does not rely on this identification for useful information.

The Board reached the preliminary view that, when applying a single book-value method, the receiving entity should measure the assets and liabilities received using the transferred entity's book values. Such an approach would provide similar information about the assets and liabilities of the combining entities. The Board considered that this approach is more consistent with the reason for applying a book-value method.

The consideration in BCUCC can take the form of cash, shares, non-cash assets or assuming liabilities. The Board considered how each of these should be measured when applying the book-value method and reached the following preliminary views:

- It should not prescribe how the receiving entity should measure consideration paid in own shares when applying the book-value method; and
- When applying the book-value method, the receiving entity should measure consideration paid:
  - If paid in assets — at the receiving entity's book values of those assets at the combination date
  - If by assuming liabilities - at the amount determined at the combination date using the IFRS Standards applicable for initial recognition of a liability of that type

The Board reached the preliminary view that when applying the book-value method, the receiving entity should recognise within equity any difference between the consideration paid and the book value of the assets and liabilities received. However, the component of equity to be recognised for this difference is not prescribed in the DP.

Disclosure requirements

When the acquisition method applies

The Board proposed that the disclosure requirements of IFRS 3 should apply when the acquisition method is used. The Board noted that it has an active project, the Discussion Paper, *Business Combinations - Disclosures, Goodwill and Impairment*, and its preliminary view is that any changes to the disclosure requirements in IFRS 3 that might result from that project should also apply to BCUCC. The Board furthermore proposed that it should provide application guidance on how to apply these disclosures.

BCUCC will involve related parties and the Board's preliminary view is, therefore, that it should provide application guidance to assist with application of IAS 24 disclosure requirements.

When book-value method applies

The Board is of the view that the disclosure objectives of IFRS 3 apply equally to BCUCC that do not involve non-controlling shareholders, but that not all the disclosure requirements of IFRS 3 may be suitable. As a result, the Board's preliminary view is that for BCUCC to which the book-value method applies:

- Some, but not all, of the disclosure requirements in IFRS 3, and any improvements from the Discussion Paper, *Business Combinations - Disclosures, Goodwill and Impairment* are appropriate
- The Board should not require the disclosure of pre-combination information
- The receiving entity should disclose the amount recognised in equity, if relevant, of the difference between the consideration paid and the book values of the assets and liabilities received, together with the component(s) of equity within which that difference is presented

Next Steps

The comment period for the DP ends on 1 September 2021.

How we see it

We encourage stakeholders to provide feedback to the IASB in the form of comment letters, to contribute to a well-grounded and robust discussion when the Board considers making final amendments to the requirements in the next phase. Given the pervasiveness of the topic, the DP deserves the attention of all relevant stakeholders, including preparers, users, auditors and regulators.