Grant Thornton
An instinct for growth™

# IFRS Viewpoint

## Common control business combinations

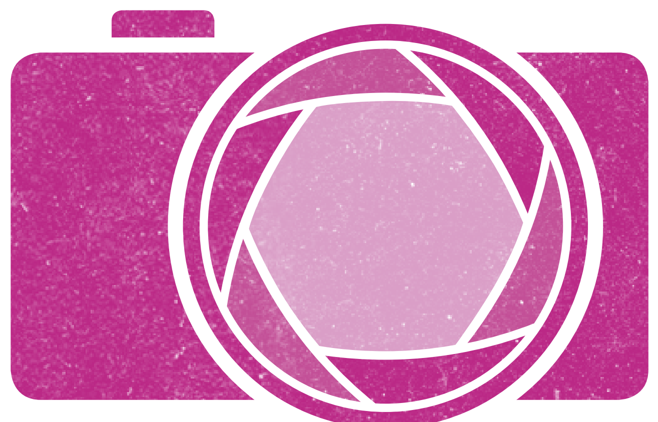
**Our 'IFRS Viewpoint' series provides insights from our global IFRS team on applying IFRSs in challenging situations. Each issue will focus on an area where the Standards have proved difficult to apply or lack guidance. This issue considers how to account for a common control business combination.**

## What's the issue?

How should an entity account for a business combination involving entities under common control? This is an important issue because common control combinations occur frequently but are excluded from the scope of IFRS 3 – the IASB's standard on business combination accounting.

This IFRS Viewpoint gives you our views on how to account for common control combinations.

**Relevant IFRSs**
IFRS 3 Business Combinations
IFRS 10 Consolidated Financial Statements
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors



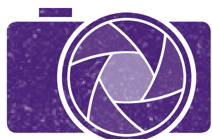
# Our view

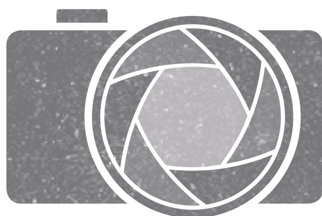
Most business combinations are governed by IFRS 3. However, those involving entities under common control are outside the scope of this Standard. There is no other specific guidance on this topic elsewhere in IFRS. Management therefore needs to use judgement to develop an accounting policy that provides relevant and reliable information in accordance with IAS 8.

In our view, the most suitable accounting policies are to apply:

- a predecessor value method; or
- the acquisition method in accordance with IFRS 3.

Whichever accounting policy is chosen, it should be applied consistently to similar transactions. The accounting policy should also be disclosed if material.





### A predecessor value method

A predecessor value method involves accounting for the assets and liabilities of the acquired business using existing carrying values. The detailed application sometimes differs but the general features of this approach are that:

- the acquired assets and liabilities are recorded at their existing carrying values rather than at fair value
- no goodwill is recorded
- comparative periods are sometimes restated as if the combination had taken place at the beginning of the earliest comparative period presented. Note, alternative methods are seen in practice – see 'variations on predecessor value methods' section on page 5.

Terms such as 'pooling of interests', 'merger accounting' and 'carryover basis' are used in some jurisdictions to describe specific applications of a predecessor value method. When such methods are prescribed in local GAAP they might be referred to in accordance with IAS 8's principles for developing accounting policies.

### Acquisition method in accordance with IFRS 3

Although common control combinations are outside the scope of IFRS 3, in our view IFRS 3's principles can be applied by analogy. In that case we believe that IFRS 3's principles should be applied in full. This includes identifying the correct 'accounting acquirer', which is not always the legal acquirer. As a general indication, if one of the pre-combination entities has significantly greater net assets or revenues than the other, the larger entity is probably the accounting acquirer. This is discussed in more detail under the 'Who is the acquirer?' section on page 6.

When the accounting acquirer is not the legal acquirer, the principles of reverse acquisition accounting should be applied. IFRS 3 provides guidance on accounting for reverse acquisitions (IFRS 3.B19-B27). When the legal acquirer is a new (or 'shell') entity or a near-dormant entity, and the other combining entity is the accounting acquirer, the effect of reverse acquisition accounting is very similar to a predecessor value method.

# More analysis

### What is a common control combination?

A business combination is a 'common control combination' if:

- the combining entities are ultimately controlled by the same party (or parties) both before and after the combination and
- common control is not transitory (see page 4).

### Examples of common control combinations

- combinations between subsidiaries of the same parent
- the acquisition of a business from an entity in the same group
- some transactions that involve inserting a new parent company at the top of a group. Sometimes a new parent company is added through a 'shell' company issuing shares to the existing shareholders. Some commentators wouldn't regard this as a business combination at all. This is because there is no substantive change in the reporting entity or its assets and liabilities. Under this view, the purchase method is inappropriate because, in substance, there is no purchase.

**IFRS 3 Appendix B provides application guidance relating to business combinations under common control. Paragraphs B1-B4 state that:**

B1 This IFRS does not apply to a business combination of entities or businesses under common control. A business combination involving entities or businesses under common control is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

B2 A group of individuals shall be regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities. Therefore, a business combination is outside the scope of this IFRS when the same group of individuals has, as a result of contractual arrangements, ultimate collective power to govern the financial and operating policies of each of the combining entities so as to obtain benefits from their activities, and that ultimate collective power is not transitory.

B3 An entity may be controlled by an individual or by a group of individuals acting together under a contractual arrangement, and that individual or group of individuals may not be subject to the financial reporting requirements of IFRSs. Therefore, it is not necessary for combining entities to be included as part of the same consolidated financial statements for a business combination to be regarded as one involving entities under common control.

B4 The extent of non-controlling interests in each of the combining entities before and after the business combination is not relevant to determining whether the combination involves entities under common control. Similarly, the fact that one of the combining entities is a subsidiary that has been excluded from the consolidated financial statements is not relevant to determining whether a combination involves entities under common control.

## Is common control transitory?

IFRS 3 excludes common control business combinations from its scope only if common control is not 'transitory'. 'Transitory' is not defined by IFRS but its general meaning is 'brief' or 'short-lived'.

IFRS includes the 'transitory' assessment so that acquisition accounting cannot be avoided simply by structuring transactions to include a brief common control phase. For example, a transaction might be structured such that for a brief period before and after the combination, two combining entities are both controlled by the same special purpose vehicle. This transaction would fall within the scope of IFRS 3 because common control is transitory. However, common control should not be considered transitory simply because a combination is carried out in contemplation of an initial public offering or sale of the combining entities.

Judgement may be required to assess whether or not common control is transitory.

**Acquisition method compared to a predecessor value method**

| Accounting topic | Predecessor value method | Acquisition method |
|---|---|---|
| **Assets and liabilities** | • recorded at previous carrying value and no fair value adjustments made<br>• adjustments are made to achieve uniform accounting policies | • all identifiable assets and liabilities are recognised at their acquisition date fair value (limited exceptions apply) |
| **Intangible assets and contingent liabilities** | • recognised only to the extent that they were recognised by the acquiree in accordance with applicable IFRS (in particular, IAS 38 'Intangible Assets') | • recognised if separable and/or arise from contractual or legal rights and fair value is reliably measurable |
| **Goodwill** | • no new goodwill is recorded<br>• the difference between the acquirer's cost of investment and the acquiree's equity is presented as a separate reserve within equity on consolidation | • goodwill or a gain from a bargain purchase is recognised and measured as the difference between the consideration transferred and the net acquisition-date amounts of identifiable assets acquired and liabilities assumed (and value of non-controlling interest, if applicable) |
| **Non-controlling interest** | • measured as a proportionate share of the book values of the related assets and liabilities | • measured either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets |
| **Cost of the combination** | • written-off immediately in profit or loss | • written-off immediately in profit or loss |
| **Profit or loss** | • includes results of the combining entities for the full year, regardless of when the combination took place (subject to variations noted below) | • includes results of the combining entities from the date of the business combination |
| **Comparatives** | • amounts are restated as if the combination had taken place at the beginning of the earliest comparative period presented (subject to variations noted page 5) | • no restatement of comparatives |

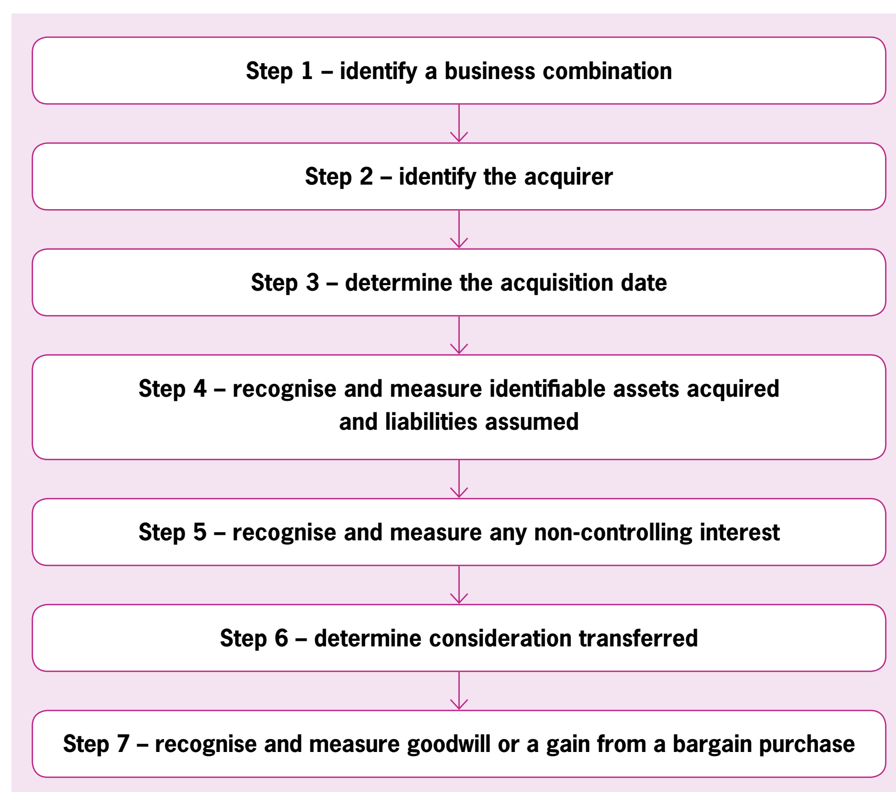
### Variations on predecessor value methods

The basic approach is outlined in the table above. However, a predecessor value method is not described anywhere in IFRS and variations on this basic approach are seen in practice. Some of these variations are to:

- restate comparative periods only to the later of the beginning of the earliest comparative period and the date on which the combining entities first came under common control
- consolidating the results of the acquiree only from the date of the combination and
- using the carrying values of the acquiree's assets and liabilities from the controlling party's consolidated financial statements (if applicable) instead of the acquiree's separate financial statements (referred to in our example as the 'controlling party perspective').

### Acquisition method in accordance with IFRS 3

IFRS 3 establishes the accounting and reporting requirements (known as 'the acquisition method') for the acquirer in a business combination. The key steps in applying the acquisition method are summarised below:



## Who is the acquirer?

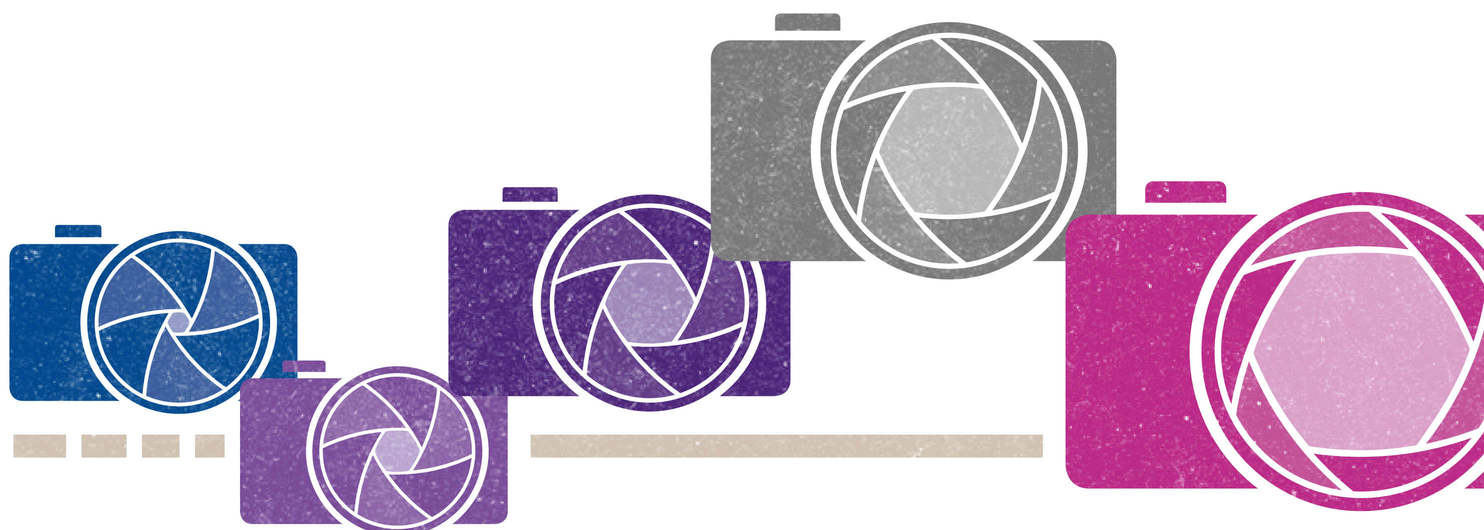
In any business combination it is important to identify the acquirer for accounting purposes (the 'accounting acquirer'). This involves identifying the combining entity that has, in substance, obtained control of the other. The consolidated financial statements for the combined group are then prepared as a continuation of the accounting acquirer's financial statements. The fair value exercise is performed on the assets and liabilities of the accounting acquiree.

IFRS 3 refers to the guidance in IFRS 10 to determine which of the combining entities obtains control. This entity is the accounting acquirer. If, after applying the guidance in IFRS 10, it is still not clear which of the combining entities is the acquirer, IFRS 3 provides some additional application guidance on this topic.

IFRS 3 also states that a new entity formed to effect a business combination is not necessarily the acquirer. If the new entity effects the acquisition by issuing only equity instruments, it cannot be the acquirer. If the new entity transfers cash or other assets or incurs liabilities it might or might not be the acquirer.

Identifying the accounting acquirer can be particularly challenging in common control situations, because ultimate control of both combining entities stays with the same third party. The relative sizes of the combining entities can be a particularly important factor.

Our detailed guide to IFRS 3 'Navigating the accounting for business combinations' provides more guidance on this area.



# Example

The following example illustrates the application of a predecessor value method.

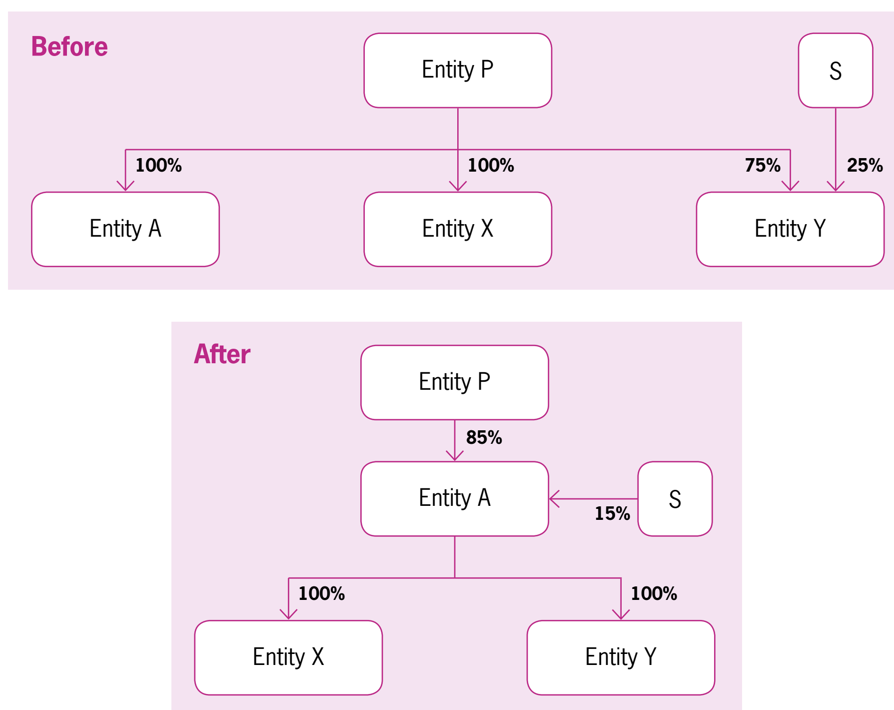
Entity P has three subsidiaries, Entities X, Y and A. Entity P acquired 100% of Entity X for CU18,000 many years ago. Entity's X's accumulated profits at that time were CU5,000. Entity P recorded X's identifiable net assets at their fair value of CU15,000 and recognised goodwill of CU3,000. The goodwill continues to be carried at CU3,000.

Entity P formed Entity Y with another investor, Shareholder S, also many years ago. Entity P's cost of investment in Entity Y was CU15,000, being 75% of Y's share capital.

On 1 January 20X0, Entity P formed Entity A with a share capital subscription of CU10,000.

On 31 December 20X1, Entity A acquired Entity P's and Shareholder S's shareholdings in X and Y. Entity A's consideration was 7,000 and 3,000 of its own shares of par value CU1, paid to Entity P and Shareholder S respectively. Entity X's and Entity Y's financial year end is 31 December.

The 'before' and 'after' structures are:




The income statements of Entities A, X and Y for the years ended 31 December 20X1 are:

| | Entity A<br>CU | Entity X<br>CU | Entity Y<br>CU |
|---|---|---|---|
| Revenue | 2,000 | 40,000 | 50,000 |
| **Profit (loss)** | **(4,000)** | **20,000** | **20,000** |

The statements of financial position of Entities A, X and Y at 31 December 20X1 are:

| | Entity A (before issue of shares) CU | Entity A (after issue of shares*) CU | Entity X CU | Entity Y CU |
|---|---|---|---|---|
| Investment in subsidiaries | – | 223,000 | – | – |
| Other assets | 5,000 | 5,000 | 100,000 | 120,000 |
| **Net assets** | **5,000** | **228,000** | **100,000** | **120,000** |
| | | | | |
| Capital (including share premium) | 10,000 | 233,000 | 10,000 | 20,000 |
| Accumulated profits (losses) | (5,000) | (5,000) | 90,000 | 100,000 |
| | **5,000** | **228,000** | **100,000** | **120,000** |

*The 10,000 new shares issued by Entity A as consideration are recorded at a value equal to the deemed cost of acquiring Entity X and Entity Y (CU223,000). The deemed cost of acquiring Entity X is CU103,000, being the existing book values of net assets of Entity X as at 31 December 20X1 (CU100,000) plus remaining goodwill arising on the acquisition of Entity X by Entity P (CU3,000) (see analysis below for explanation). The deemed cost of acquiring Entity Y is CU120,000, being the existing book values of net assets of Entity Y as at 31 December 20X1.

The income statements of Entities A, X and Y for the year ended 31 December 20X0 are:

| | Entity A CU | Entity X CU | Entity Y CU |
|---|---|---|---|
| Revenue | 1,000 | 38,000 | 45,000 |
| **Profit (loss)** | **(2,000)** | **15,000** | **12,000** |

The statements of financial position of Entities A, X and Y at 31 December 20X0 are:

| | Entity A CU | Entity X CU | Entity Y CU |
|---|---|---|---|
| **Net assets** | **9,000** | **80,000** | **100,000** |
| Capital (including share premium) | 10,000 | 10,000 | 20,000 |
| Accumulated profits (losses) | (1,000) | 70,000 | 80,000 |
| | **9,000** | **80,000** | **100,000** |

## Analysis

As Entities A, X and Y are under the common control of Entity P before and after the business combination, the business combination is scoped out of IFRS 3. Entity A's accounting policy for common control business combinations is to apply a predecessor value method. In applying this method, Entity A also adopts a 'controlling party perspective'. The assets and liabilities of Entities X and Y are therefore consolidated in the financial statements of Entity A using carrying values in the consolidated financial statements of Entity P. This requires recognition of the remaining goodwill on the original acquisition of Entity X by Entity P and non-controlling interests in Entity Y, as stated in the consolidated financial statements of Entity P. There is no recognition of any additional goodwill. Note: If Entity A does not adopt a controlling party perspective, the remaining goodwill on the original acquisition of Entity X by Entity P would not be recognised by Entity A.

The consolidated income statement of Entity A for the year ended 31 December 20X1 is:

| | Entity A CU | Entity X CU | Entity Y CU | Adjustments CU | Consolidated CU |
|---|---|---|---|---|---|
| Revenue | 2,000 | 40,000 | 50,000 | – | 92,000 |
| **Profit (loss)** | **(4,000)** | **20,000** | **20,000** | **–** | **36,000** |
| Attributable to the former NCI | | | | 5,000 (Y1) | (5,000) |
| **Attributable to the equity holders of A** | | | | **–** | **31,000** |

**Adjustment**

(Y1) Adjustment to reflect the profit attributable to the non-controlling interest (NCI) in Entity Y prior to the combination.

The consolidated statement of financial position of Entity A as at 31 December 20X1 is:

| | Entity A CU | Entity X CU | Entity Y CU | Adjustments CU | Consolidated CU |
|---|---|---|---|---|---|
| Goodwill | – | – | – | 3,000 (X1) | 3,000 |
| Investments in X and Y | 223,000 | – | – | (103,000) (X3)<br>(120,000) (Y5) | – |
| Other assets | 5,000 | 100,000 | 120,000 | – | 225,000 |
| **Net assets** | **228,000** | **100,000** | **120,000** | | **228,000** |
| Capital (including share premium) | 233,000 | 10,000 | 20,000 | (10,000) (X3)<br>(20,000) (Y5) | 233,000 |
| Other reserve | – | – | – | (85,000) (X3)<br>(75,000) (Y5) | (160,000) |
| Accumulated profits (losses) | (5,000) | 90,000 | 100,000 | (5,000) (X2)<br>(25,000) (Y4) | 155,000 |
| | **228,000** | **100,000** | **120,000** | | **228,000** |

**Adjustments**

Relating to Entity X:

(X1) Adjustment to record goodwill arising on the original acquisition of Entity X by Entity P as stated in the consolidated financial statements of Entity P immediately prior to the combination (CU3,000).

(X2) Adjustment to eliminate the accumulated profits of Entity X prior to the original acquisition of Entity X by Entity P (CU5,000).

(X3) Adjustment to eliminate the share capital of Entity X against the related investment cost of Entity A. An adjustment of CU85,000 is made to a separate reserve in the consolidated financial statements of Entity A.

Relating to Entity Y:

(Y4) Adjustment to reflect the profits attributable to the non-controlling interest in Entity Y prior to the combination.

(Y5) Adjustment to eliminate the share capital of Entity Y against the related investment cost of Entity A. An adjustment of CU75,000 is made to a separate reserve in the consolidated financial statements of Entity A.

The consolidated income statement of Entity A for the year ended 31 December 20X0 is:

| | Entity A<br>CU | Entity X<br>CU | Entity Y<br>CU | Adjustments<br>CU | Consolidated<br>CU |
|---|---|---|---|---|---|
| Revenue | 1,000 | 38,000 | 45,000 | – | 84,000 |
| **Profit (loss)** | **(2,000)** | **15,000** | **12,000** | **–** | **25,000** |
| Attributable to the former NCI | | | | 3,000 (Y1) | (3,000) |
| **Attributable to the equity holders of A** | | | | **–** | **22,000** |

### Adjustment

(Y1) Adjustment to reflect the profit attributable to the non-controlling interest in Entity Y.

The consolidated statement of financial position of Entity A as at 31 December 20X0 is:

| | Entity A<br>CU | Entity X<br>CU | Entity Y<br>CU | Adjustments<br>CU | Consolidated<br>CU |
|---|---|---|---|---|---|
| Goodwill | – | – | – | 3,000 (X1) | 3,000 |
| Investments in X and Y | – | – | – | 193,000 (1)<br>(103,000) (X3)<br>(90,000) (Y4) | – |
| Other assets | 9,000 | 80,000 | 100,000 | | 189,000 |
| **Net assets** | **9,000** | **80,000** | **100,000** | | **192,000** |
| Capital (including share premium) | 10,000 | 10,000 | 20,000 | 193,000 (1)<br>(10,000) (X3)<br>(20,000) (Y4) | 203,000 |
| Other reserve | – | – | – | (85,000) (X3)<br>(75,000) (Y4) | (160,000) |
| Non-controlling interests | – | – | – | 25,000 (Y4) | 25,000 |
| Accumulated profits (losses) | (1,000) | 70,000 | 80,000 | (5,000) (X2)<br>(20,000) (Y4) | 124,000 |
| | **9,000** | **80,000** | **100,000** | | **192,000** |

Note: The comparative figures are restated as if the entities had been combined at the previous reporting date. The consolidated share capital represents the share capital of Entity A adjusted for the share capital issued for the purposes of the business combination.

**Adjustments**

1. Adjustment to push back the capital issued for the purposes of the business combination (CU193,000 of which CU103,000 relates to Entity X and CU90,000 to Entity Y). The aim of the consolidated financial statements in a pooling-type method is to show the combining entities' results and financial positions as if they had always been combined. Consequently, the 7,000 shares issued for the purposes of the business combination are presented as if they had always been outstanding.

Relating to Entity X:

(X1) Adjustment to record remaining goodwill that arose on the original acquisition of Entity X by Entity P (as stated in the consolidated financial statements of Entity P immediately prior to the combination (CU3,000)).

(X2) Adjustment to eliminate the accumulated profits of Entity X earned prior to the original acquisition of Entity X by Entity P (CU5,000).

(X3) Adjustment to eliminate the share capital of Entity X against the related cost of investment in Entity A. An adjustment of CU85,000 is made to a separate reserve in the consolidated financial statements of Entity A.

Relating to Entity Y:

(Y4) Adjustment to eliminate the share capital of Entity Y against the cost of investment in Entity A. Prior to the business combination, Entity P had a 75% equity interest in Entity Y. Non-controlling interest of CU25,000 is therefore recognised as at 31 December 20X0. An adjustment of CU75,000 is made to a separate reserve (within equity).

# Future developments

At the time of writing the IASB is conducting a research project on business combinations under common control. The IASB has acknowledged that the absence of specific requirements has led to diversity in practice and anticipates issuing a discussion paper in 2016.

**www.grantthornton.global**

© 2015 Grant Thornton International Ltd. All rights reserved.
"Grant Thornton" refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. Grant Thornton International Ltd (GTIL) and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.