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Technical Accounting Alert

Common control business combinations

Introduction

The purpose of this alert is to assist in deciding how a business combination involving entities under common control should be accounted for.

Relevant standards

References are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IFRS 3 Business Combinations	AASB 3 Business Combinations
IAS 8 Accounting policies, changes in accounting estimates and errors	AASB 108 Accounting policies, changes in accounting estimates and errors
IAS 38 Intangible Assets	AASB 138 Intangible Assets

Overview

Common control combinations

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

- the combining entities are ultimately controlled by the same party (or parties - see below) both before and after the combination; **and**
- common control is not transitory (IFRS 3.B1) - see below.

Common control combinations are widespread. Examples include:

- combinations between subsidiaries of the same parent;
- the acquisition of a business from an entity in the same group; and
- some transactions involving the insertion of a new parent company at the top of a group. (Some commentators would not regard a transaction in which a new parent company is added by means of a "shell" company issuing shares to the existing shareholders 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).

The intention of the reference in IFRS 3.B1 to transitory common control is to address concerns that the requirements of IFRS 3 might be avoided by creating artificial ("grooming") arrangements. For example, an acquirer and vendor might structure a transaction such that for a brief period before and after the combination, the entity to be acquired/sold is under common control. This transaction would fall within the scope of IFRS, 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.

Common control combinations are not restricted to combinations between entities that are part of the same group. Entities controlled by the same individual shareholder (or group of shareholders acting together in accordance with a contractual arrangement) are also regarded as under common control (IFRS 3.B3).

Business combinations involving entities under common control are outside the scope of IFRS 3 (IFRS 3.2(c)), and there is no other specific IFRS guidance. Accordingly, management should use its judgement to develop an accounting policy that is relevant and reliable, in accordance with IAS 8.10 - 12. In our view, the most relevant and reliable accounting policies are:

- a pooling of interests-type method (also referred to as merger accounting); **or**
- the purchase method in accordance with IFRS 3.

Pooling of interests-type method

A pooling of interests or merger accounting-type method is widely accepted in accounting for common control combinations under IFRS. Such a method is also prescribed under US generally accepted accounting practice (GAAP) (SFAS 141 *Business Combinations* paragraphs D11 - D18) and permitted under UK GAAP. We consider that this approach is therefore available through application of IAS 8.12 which allows management to consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework in developing an accounting policy (where IFRS has no specific requirements).

Under the SFAS 141 approach, the comparative periods are restated only for those periods in which common control existed.

Under a pooling of interests-type method, the acquirer accounts for the combination as follows:

- the assets and liabilities of the acquiree are recorded at **book value** not fair value (although adjustments should be recorded to achieve uniform accounting policies);

- **intangible assets** and **contingent liabilities** are recognised only to the extent that they were recognised by the acquiree in accordance with applicable IFRS (in particular IAS 38);

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- no **goodwill** is recorded. The difference between the acquirer's cost of investment and the acquiree's equity is presented separately within OCI on consolidation;

- any **non-controlling interest** is measured as a proportionate share of the book values of the related assets and liabilities (as adjusted to achieve uniform accounting policies);

- any **expenses** of the combination are written off immediately in the statement of comprehensive income;

- **comparative amounts** are restated as if the combination had taken place at the beginning of the earliest comparative period presented.

Some commentators also consider that:

- the comparative periods should also be restated 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; and

- the acquiree's book values to be used in the consolidation are those from **the perspective of the controlling party** rather than the amounts in the acquiree's separate financial statements.

These are refinements to the basic approach. We consider them to be acceptable but not mandatory.

Purchase method in accordance with IFRS 3

Accounting using the purchase method has some important differences compared to a pooling of interests-type approach. Features of the IFRS 3 purchase method include:

- identification of an **acquirer**;

- allocation of the cost of the combination based on the **fair values** at the acquisition date of the acquiree's identifiable assets, liabilities and contingent liabilities;

- separate recognition of the acquiree's **intangible assets** (if their fair value is reliably measurable and they are separable or arise from contractual or other legal rights);

- recognition of **goodwill**, initially measured as the excess of the cost of the combination over the acquirer's interest in the net fair values of the acquired assets, liabilities and contingent liabilities;

- no restatement of **comparatives**;

- inclusion of **transaction costs** directly attributable to the combination as part of the overall cost of the combination (in effect as part of goodwill).

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In common control transactions, the "IFRS 3 acquirer" is often not the "legal" acquirer. Determination of the correct acquirer involves identifying the entity that has, in substance, obtained control (IFRS 3.17). In an arm's length situation, one important factor is to identify which entitys' pre-combination owners hold the greater proportion of equity in the combined entity after the combination. This factor is not generally relevant in a common control situation (since the same party controls the combining entities both before and after). Hence other indicators should be used, including:

- the relative sizes of the combining entities; and
- the entity under whose direction the combination took place.

IFRS is also explicit in stating that a newly formed entity that issues shares cannot be the acquirer (IFRS 3.22). In our view, **any** newly formed (or previously dormant) entity used to effect a combination is unlikely to be the acquirer. A new ultimate parent entity added to an existing group is therefore unlikely to be the IFRS 3 acquirer. (The effect of identifying the new ultimate parent entity as the acquirer would be to "step-up" the reported values of the assets and liabilities of the existing group, including recognition of internally generated goodwill and other intangibles. This is inconsistent with the requirements of IAS 38).

When the IFRS acquirer is not the legal acquirer, the principles of reverse acquisition accounting should be applied - see IFRS 3.B19 and IE1 – IE15. When the legal acquirer is a new entity, "shell" or near-dormant entity, and the other combining entity is the IFRS 3 acquirer, the effect of reverse acquisition accounting is very similar to a pooling-type method.

This TA alert does not discuss the requirements of IFRS 3 in detail.

Examples

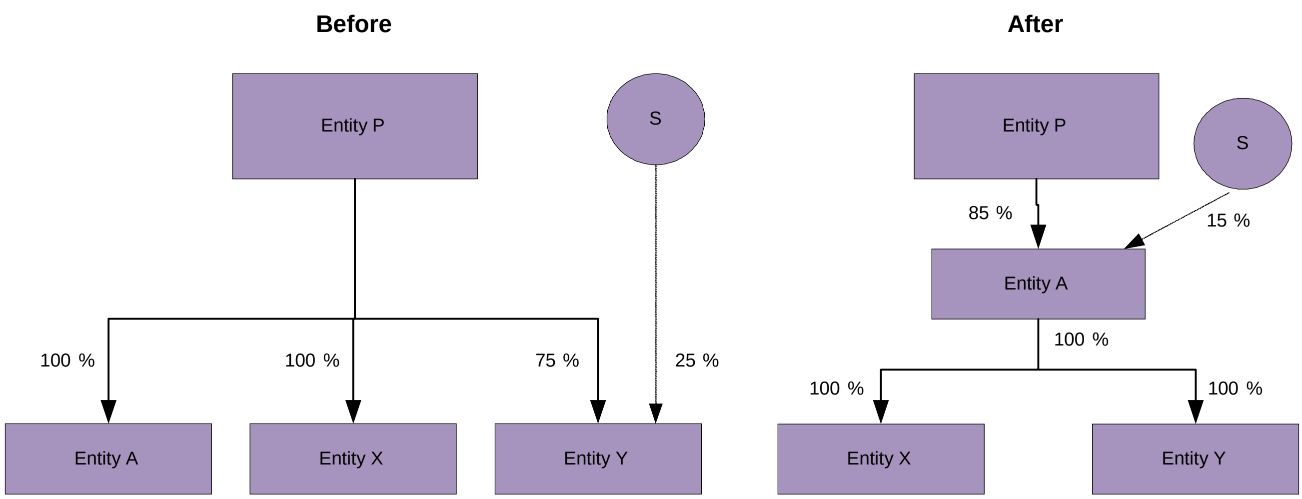
The following example illustrates the application of a pooling-of-interests type method.

Entity P has three subsidiaries, Entities X, Y and A. Entity P acquired 100% of Entity X for $18,000 many years ago. Entity's X's accumulated profits at that time were $5,000. Entity P recorded goodwill of $3,000 and fair value of identifiable assets acquired of $15,000. The goodwill continues to be carried at $3,000.

Entity P formed Entity Y with another investor, Shareholder S, also many years ago. Entity P's cost of investment in Entity Y was $15,000, being 75% of Y's share capital. On 1.1.20X0, Entity P formed Entity A with a share capital subscription of $10,000.

On 31.12.20X1, Entity A acquired Entity P's and Shareholder S's shareholdings in X and Y. The consideration was 7,000 and 3,000 of Entity A's shares with issue value of $1 each to Entity P and Shareholder S, respectively. Entity X and Entity Y have financial year ends of 31 December.

The "before" and after" structures are:



The income statements of Entities A, X and Y for the year ended 31.12.20X1 are:

	Entity A $	Entity X $	Entity Y $
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 31.12.20X1 are:

	Entity A (before issue of shares) $	Entity A (after issue of shares*) $	Entity X $	Entity Y $
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	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 ($223,000). The deemed cost of acquiring Entity X is $103,000, being the existing book values of net assets of Entity X as at 31.12.20X1 ($100,000) plus remaining goodwill arising on the acquisition of Entity X by Entity P ($3,000).

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The deemed cost of acquiring Entity Y is $120,000, being the existing book values of net assets of Entity Y as at 31.12.20X1.

The income statements of Entities A, X and Y for the year ended 31.12.20X0 are:

	Entity A $	Entity X $	Entity Y $
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 31.12.20X0 are:

	Entity A $	Entity X $	Entity Y $
Net assets	**9,000**	**80,000**	**100,000**
Capital	10,000	10,000	20,000
Accumulated profits (losses)	(1,000)	70,000	80,000
	9,000	**80,000**	**100,000**

Analysis

As Entity A, Entity X and Entity 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 pooling-of-interests type method. In applying this method, A also adopts a "controlling party perspective". The assets and liabilities of X and Y are therefore consolidated in the financial statements of A using the book values as stated 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. (If A does not adopt a controlling party perspective, the remaining goodwill on the original acquisition of X by P would not be recognised by A)

The consolidated income statement of Entity A for the year ended 31.12.20X1 is:

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

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Adjustment

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

The consolidated statement of financial position of Entity A as at 31.12.20X1 is:

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

Adjustments

Relating to Entity X:

(X1) Adjustment to record goodwill arising from the original acquisition of Entity X by Entity P, as stated in the consolidated financial statements of Entity P immediately prior to the combination ($3,000).

(X2) Adjustment to eliminate the accumulated profits of Entity X prior to the original acquisition of Entity X by Entity P ($5,000).

(X3) Adjustment to eliminate the share capital of Entity X against the related investment cost of Entity A. An adjustment of $85,000 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 $75,000 is made to a separate reserve in the consolidated financial statements of Entity A.

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The consolidated income statement of Entity A for the year ended 31.12.20X0 is:

	Entity A $	Entity X $	Entity Y $	Adjustments $ Adj	Consolidated $
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 31.12.20X0 is:

	Entity A $	Entity X $	Entity Y $	Adjustments $ Adj	Consolidated $
Goodwill				3,000 (X1)	3,000
Investments in X and Y	-	-	-	(193,000) (1)	-
				(103,000) (X3)	
				(90,000) (Y4)	
Other assets	9,000	80,000	100,000		189,000
Net assets	**9,000**	**80,000**	**100,000**		**192,000**
Capital (include share premium)	10,000	10,000	20,000	193,000 (1)	203,000
				(10,000) (X3)	
				(20,000) (Y4)	
Other reserve	-	-	-	(85,000) (X3)	(160,000)
				(75,000) (Y4)	
Non-controlling interests	-	-	-	25,000 (Y4)	25,000
Accumulated profits (losses)	(1,000)	70,000	80,000	(5,000) (X2)	124,000
				(20,000) (Y4)	
	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 period 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 ($193,000, of which $103,000 relates to X and $90,000 to 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 in issue.

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 ($3,000)).

(X2) Adjustment to eliminate the accumulated profits of Entity X earned prior to the original acquisition of Entity X by Entity P ($5,000).

(X3) Adjustment to eliminate the share capital of Entity X against the related cost of investment in Entity A. An adjustment of $85,000 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 $25,000 is therefore recognised as at 31.12.20X0. An adjustment of $75,000 is made to a separate reserve (within other comprehensive income).

FURTHER INFORMATION

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au