Grant Thornton

Technical Accounting Alert

Acquisitions and disposals of assets held in a corporate shell

Introduction

The purpose of this alert is to address the accounting in the consolidated financial statements for the:

- acquisition of assets held in a corporate shell, in particular, how to recognise any non-controlling interests; and
- disposal of assets held in a corporate shell, in particular, should IAS 18 or IAS 27 apply to the sale transaction?

Relevant Australian standards

References in this TA alert 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
IAS 18 Revenue	AASB 118 Revenue
IAS 27 Consolidated Financial Statements	AASB 127 Consolidated Financial Statements
IFRS 3 Business Combinations	AASB 3 Business Combinations

Overview

Acquisition of assets held in a corporate shell

Assets are often held in a separate legal entity for legal or tax reasons. The acquisition of a controlling interest in such an entity may not meet the definition of a business combination. In such cases, the accounting by the acquirer will be the same as for an asset purchase. The acquisition method is not applied and no goodwill is recognised.

The identifiable assets acquired are initially recognised by allocating the cost of acquiring those assets between them in proportion to their fair values. A parent entity should prepare consolidated financial statements which include all of its subsidiaries (IAS 27.12). A parent must therefore consolidate an acquired corporate shell. In a 100% acquisition the accounting is straightforward. The assets acquired in the corporate shell will initially be recognised in the consolidated financial statements at the cost of acquiring those assets. Cost will include the fair value of the consideration paid or payable and any directly attributable costs.

However, where there is a non-controlling interest in the corporate shell the accounting requires further consideration. In our view the parent entity is required to consolidate a 100% interest in the asset(s) held in the corporate shell and also recognise the non-controlling interest. However, a question arises in relation to the measurement of the 100% interest in the acquired asset(s) and also the amount at which to recognise the non-controlling interest. IFRS does not include any specific guidance on these issues.

When there is a non-controlling interest complications arise in relation to how to measure that interest and the 100% interest in the acquired asset(s). Grant Thornton's preferred view is:

- when the acquired asset(s) are recognised initially at cost in accordance with applicable IFRSs (e.g. property), recognise the non-controlling interest at its fair value at the date of the transaction and include the non-controlling interest in measuring the cost of the 100% interest in the asset(s); or
- if the acquired asset(s) are recognised initially at fair value in accordance with applicable IFRSs (e.g. financial assets), record the non-controlling interest at its proportionate share of that fair value.

When the acquired asset(s) are recognised IFRS 3 also allows an alternative method of measuring the non-controlling interest in a business combination - at the proportionate share of the subsidiary's identifiable net assets. However, in a business combination the identifiable net assets are mostly measured at fair value. The non-controlling interest is therefore measured primarily as a share of that fair value. In an acquisition of asset(s) in a corporate shell that is not a business, we consider that the proportionate share basis is appropriate only if the acquired asset(s) are recorded at fair value in accordance with applicable IFRSs. This would be the case, for example, with financial or biological assets.

Some commentators also argue that a simpler 'grossing-up' approach is acceptable. This involves recording the 100% interest in the acquired asset(s) at the grossed-up acquisition cost for the controlling interest. The non-controlling interest is recognised at its proportionate share of the grossed-up cost. In our view, this approach is supportable only: (i) if there are no significant 'distorting' factors that would result in a gross-up approach giving an inappropriate measure of the non-controlling interests and/or the acquired asset(s); or (ii) if adjustments are made for such factors. These distorting factors might include a control premium, transaction costs, a bargain purchase and complex capital structures.

Consider for example transaction costs. The cost of the underlying assets will include directly attributable transaction costs incurred by the group in acquiring the controlling interest. It will not be appropriate to gross up these transaction costs in determining the amount to be attributed to the non-controlling interest. Similarly, it would not be appropriate to gross up amounts attributable to a control premium or a bargain purchase. In making adjustments for these and similar factors, the objective is to attribute to the non-controlling interest their share of the fair value of the acquired asset(s), not to allocate a proportion of the parent's acquisition cost.
Judgment will be required to determine whether this approach is appropriate in the particular circumstances of the transaction (or how to make the appropriate adjustments).

The preferred approach and also the gross-up approach (with adjustments) are illustrated in the example below.

Example 1: Acquisition of assets held in a corporate shell

Overview	How should Entity A account for its controlling interest in Entity B?
Entity A builds and manages hospitals. Entity B owns a single intangible asset, being a permit to build and operate a new hospital in a specific geographic location. Entity B holds no other assets and does not trade. Accordingly, Entity B does not meet the definition of a business in IFRS 3. Entity A acquires an 80% interest in Entity B from Entity C, an unrelated third party for $400,000. Transaction costs are immaterial. The fair value of the 20% non-controlling interest in Entity B is $80,000, determined using a valuation technique. Entity B has only one class of share capital and all shares have identical rights. The purchase consideration paid for the controlling interest was negotiated on arm's-length terms and represents its fair value.	In accordance with IAS 27, Entity A must consolidate Entity B and recognise a non-controlling interest at the date of acquisition calculated in accordance with IFRS 3. That standard allows the non-controlling interest to be measured at fair value or at the non-controlling interest's share of the acquiree's identifiable net assets.

Option 1: Measure non-controlling interest at fair value

In accordance with IFRS 3, the acquisition of an asset or group of assets that is not a business does not give rise to goodwill. The cost is allocated to the individual identifiable assets on the basis of their relative fair values at the date of purchase. Entity A will recognise 100% of the intangible asset held by Entity B and the cost of that asset will be calculated as the sum of the cost of acquiring the controlling interest and the fair value of the non-controlling interest.

Entity A will record the following entries in its consolidated financial statements:

	Debit	Credit
	$	$
Intangible asset	480,000	
Cash		400,000
Non-controlling interest		80,000

Option 2: Measure non-controlling interest at the proportion of the identifiable net assets

If Entity A had determined or was otherwise required to determine the fair value of the permit to build and operate a hospital, the amount of the non-controlling interest could be measured at 20% of that fair value. However, Entity B consists of only a single asset which is not otherwise required to be measured at fair value; therefore, Entity A considers whether the purchase consideration paid for the 80% controlling interest would provide a reasonable basis for measuring the non-controlling interest. Entity A considers the following factors which appear to support a conclusion that purchase consideration paid could provide a reasonable basis for measuring the non-controlling interest in the asset acquired:

(i) Entity B has only one class of share capital and all shares have identical rights
(ii) Entity A acquired control of Entity B by purchasing a significant majority of Entity B's equity shares
(iii) The purchase consideration paid for the controlling interest is the fair value of that interest
(iv) Transaction costs are not material.

Entity A determines that the purchase price paid for its 80% interest included a control premium because Entity A expects that control of the acquired asset will deliver synergy benefits that the non-controlling interests will not share in. Accordingly, Entity A concludes that it would not be appropriate for the measure of the non-controlling interest in Entity B to include any portion of a control premium. As a result it would be inappropriate to measure the non-controlling interest by grossing up the unadjusted purchase consideration paid for the acquisition of the 80% controlling interest.

Option 2 Continued

Entity A determines that its purchase of the controlling interest in Entity B includes a control premium of $80,000 and that the purchase consideration paid for its 80% controlling interest, adjusted to remove the control premium ($400,000 – 80,000 = $320,000), provides a reasonable basis for measuring the non-controlling interest. Therefore, Entity A will measure the non-controlling interest in the asset/entity and determine the full amount recognised for the asset/entity as follows:

(i) gross up the purchase consideration paid for the 80% controlling interest in that asset, after adjusting to remove the control premium paid ($320,000 x 100/80)

(ii) measure the non-controlling interest as a proportionate share (20%) of the amount determined in (i)

(iii) measure the asset recognised as the sum of the purchase price paid for the controlling interest ($400,000) and the non-controlling interests' proportionate share of the grossed up amount ($80,000).

Entity A will record the following entries in its consolidated financial statements:

	Debit	Credit
	$	$
Intangible asset ($400,000 + 80,000)	480,000	
Cash (includes payment of $80,000 control premium		400,000
Non-controlling interest ($320,000 x 100/80 x 20%)		80,000

Disposal of assets held in a corporate shell

Disposal of the assets by selling the shares in the separate legal entity will normally be accounted for in accordance with IAS 27 because a parent/subsidiary relationship exists. If control is lost a net gain or loss is recognised in profit or loss calculated as the difference between the consideration received (plus any non-controlling interests and retained investment where applicable) and the carrying amount of the assets (IAS 27.34). Any retained investment is recognised at its fair value (IAS 27.36).

Any change in ownership interests that does not result in a loss of control is accounted for as an equity transaction.

However, in very rare circumstances, it may be more appropriate to recognise gross revenue and costs in accordance with IAS 18. IFRS requires that transactions should be accounted for in accordance with their substance and economic reality and not merely their legal form (Framework paragraph 35). Where the assets held in the corporate shell are classified as inventory in the consolidated accounts, the sale of those assets may in substance represent revenue of the group, which should be recognised in accordance with IAS 18. This can be described as a 'gross accounting' approach.

In other cases (for example, sale of investment properties, property, plant and equipment or intangible assets), applying IAS 27 rather than treating the transaction as an asset sale will give substantially the same answer as in both instances a (net) gain or loss would be recognised rather than gross revenue and expenses.

The determination of whether such a transaction should result in the recognition of revenue in the consolidated accounts is a matter of judgement based on the specific facts and circumstances of the business and the transaction. However, taking a gross accounting approach appears to involve overriding an explicit requirement of IAS 27 (or arguing that IAS 18 is the more specific standard). Accordingly, such an approach should be treated with caution. Nonetheless, there may be circumstances in which recognition of revenue and cost of sales (gross accounting) better reflects the substance of the transaction and ordinary activities of the group. This will usually involve consideration of whether the group normally sells the assets concerned as part of its ordinary revenue generating activities and whether the legal form of selling such assets in the ordinary course of business in the relevant jurisdiction is to sell them in a corporate shell. Consider the following example:

Example 2: Disposal of assets held in a corporate shell
Entity D is a property developer. Its business involves acquiring land, making short-term improvements and selling the land in smaller parcels. Entity D has concluded that this land is classified as inventory rather than as investment property. It is common practice in Entity D's jurisdiction to put parcels of land into a separate legal entity and then sell the shares in that entity to customers. Entity D owns 100% of a subsidiary Entity E, which holds a parcel of land. Entity D also has other wholly owned subsidiaries E1, E2, etc. that each hold different parcels of land. Entity D proposes to sell the shares in Entity E to an unrelated third party. Similar arrangements are in place for E1, E2, etc.
Does the transaction represent the disposal of an investment in a subsidiary or the sale of an item of inventory?
Entity D is in the business of selling developed land. Selling such land is part of Entity D's ordinary revenue generating activities. Parcels of land are commonly sold in a corporate shell in Entity D's jurisdiction. Accordingly, the sale of the land held in Entity E can be argued to be within the scope of IAS 18 and to represent revenue in Entity D's consolidated financial statements.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact member or a member of the National Audit Support team via the GTAL IT Service Desk http://gtassist.au.gt.local/