IFRS INTELLIGENCE

BUSINESS COMBINATIONS

BDO

IFRS Intelligence: *Business Combinations*

This publication brings together and summarises key guidance that you need to know for the practical application of International Financial Reporting Standards (IFRS) as they apply to business combinations.

It is arranged in two main sections:

- BDO's popular IFRS at a Glance, which sets out a high level overview of IFRS 3 Business Combinations; and
- Agenda decisions relating to business combinations issued by the IFRS Interpretations Committee together with BDO's practical application guidance ('BDO Knows') for issues that are frequently encountered in practice.

BDO Knows covers issues which are drawn from our experience with the interpretation and application of IFRS in multiple jurisdictions worldwide.

IFRS Interpretations Committee Agenda Decisions

The IFRS Interpretations Committee (the Interpretations Committee) is the interpretative body of the International Accounting Standards Board (IASB). The role of the Interpretations Committee is to provide guidance on financial reporting issues which have been identified and which are not specifically addressed in IFRS, or where unsatisfactory or conflicting interpretations have either developed, or appear likely to develop.

At each of its meetings, the Interpretations Committee considers new issues that have been raised, and decides whether they should be added to its agenda. For those issues that are not added to the agenda, a tentative agenda decision is published in the IFRIC Update newsletter which is issued shortly after each of the Interpretations Committee's meetings. These tentative agenda decisions are open to public comment for a period of 60 days, after which point they are taken back to the Interpretations Committee for further consideration in the light of any comment letters which have been received and further analysis carried out by the Staff. The tentative agenda decision is then either confirmed and reported in the next IFRIC Update as a final agenda decision, considered further by the Interpretations Committee or referred to the IASB.

Interpretations Committee agenda decisions do not represent authoritative guidance. However, they do set out the Interpretations Committee's rationale for not taking an issue onto its agenda (or referring it to the IASB). It is noted on the IFRS Foundation's website that they 'should be seen as helpful, informative and persuasive'. In practice it is expected that entities reporting in accordance with IFRS will take account of and follow the agenda decisions, and this is the approach which is followed by securities regulators worldwide.

IFRS 3 *Business Combinations*

Effective Date
Periods beginning on or after 1 July 2009

SCOPE / IDENTIFYING A BUSINESS COMBINATION

A business combination is:

Transaction or event in which acquirer obtains **control** over a **business** (e.g. acquisition of shares or net assets, legal mergers, reverse acquisitions).

IFRS 3 does not apply to:

- The accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself.
- Acquisition of an asset or group of assets that is not a business.
- A combination of entities or businesses under common control.

Definition of "control of an investee"

An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Power: when existing rights give an investor the current ability to direct the relevant activities of an investee (ie the activities that significantly affect the investee's returns)

Rights to variable returns: an investor is exposed or has rights to returns that vary as a result of the investee's performance

Link between power and returns: control exists when an investor has power over an investee and exposure or rights to the investee's variable returns, and has the ability to use its power to affect the investee's returns.

Principal or agent: an investor with power over an investee determines whether it is a principal or an agent. An investor that is an agent does not control an investee when it exercises delegated rights.

Definition of a "Business"

- Integrated set of activities and assets
- Capable of being conducted and managed to provide return
- Returns include dividends and cost savings.

THE ACQUISITION METHOD

A business combination must be accounted for by applying the acquisition method.

STEP 1: IDENTIFYING THE ACQUIRER

IFRS 10 *Consolidated Financial Statements* is used to identify the acquirer – the entity that obtains control of the acquiree.

STEP 2: DETERMING THE ACQUISITION DATE

The date which the acquirer obtains control of the acquiree.

STEP 3: RECOGNISING AND MEASURING THE IDENTIFIABLE ASSETS ACQUIRED, THE LIABILITIES ASSUMED AND ANY NON-CONTROLLING INTEREST (NCI) IN THE ACQUIREE

- As of the acquisition date, the acquirer recognises, separately from goodwill:
  - The identifiable assets acquired
  - The liabilities assumed
  - Any NCI in the acquiree
- The acquired assets and liabilities are required to be measured at their acquisition-date fair values
- There are certain exceptions to the recognition and/or measurement principles which cover contingent liabilities, income taxes, employee benefits, indemnification assets, reacquired rights, share-based payments and assets held for sale.
- NCI that represent ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation (e.g. shares) are measured at acquisition-date fair value or at the NCI's proportionate share in net assets
- All other components of NCI (e.g. from IFRS 2 Share-*based payments* or calls) are required to be measured at their acquisition-date fair values.

STEP 4: RECOGNISING AND MEASURING GOODWILL OR A GAIN FROM BARGAIN PURCHASE

- Goodwill is recognised as the excess between:
  - The aggregate of the consideration transferred, any non-controlling interest in the acquiree and, in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree
  - The identifiable net assets acquired (including any deferred tax balances)
- Goodwill can be grossed up to include the amounts attributable to NCI, which is the case when NCI is measured at their acquisition date fair value.
- A gain from a bargain purchase is immediately recognised in profit or loss
- The consideration transferred in a business combination (including any contingent consideration) is measured at fair value
- Contingent consideration is either classified as a liability or an equity instrument on the basis of IAS 32 *Financial Instruments*
- Contingent consideration that is within the scope of IFRS 9 (classified as a financial liability) needs to be remeasured at fair value at each reporting date with changes reported in profit or loss.

MEASUREMENT PERIOD

Applies when initial accounting is incomplete at the end of the reporting period in which the business combination occurs

Measurement period ends when acquirer receives information seeking about facts and circumstances at acquisition date, not to exceed one year from acquisition date.

DETERMINING WHAT IS PART OF THE BUSINESS COMBINATION TRANSACTION

The acquirer should consider if the consideration includes amounts attributable to other transactions within the contract (pre-existing relationship, arrangements that remunerate employees etc.).

Acquisition and other costs

- Cannot be capitalised, must instead be expensed in the period they are incurred
- Costs to issue debt or equity are recognised in accordance with IAS 32 and IFRS 9.

ADDITIONAL GUIDANCE FOR APPLYING THE ACQUISITION METHOD TO PARTICULAR TYPES OF BUSINESS COMBINATIONS

BUSINESS COMBINATION ACHIEVED IN STAGES

- An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. This is known as a business combination achieved in stages or as a step acquisition
- Obtaining control triggers re-measurement of previous investments (equity interests)
- The acquirer remeasures its previously held equity interest in the acquiree at its acquisition-date fair value. Any resulting gain/loss is recognised in profit or loss.

BUSINESS COMBINATION ACHIEVED WITHOUT TRANSFER OF CONSIDERATION

- The acquisition method of accounting for a business combination also applies if no consideration is transferred.
- Such circumstances include:
  - The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control
  - Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights
  - The acquirer and the acquiree agree to combine their businesses by contract alone.

SUBSEQUENT MEASUREMENT AND ACCOUNTING

- In general, after the date of a business combination an acquirer measures and accounts for assets acquired and liabilities assumed or incurred in accordance with other applicable IFRSs.
- However, IFRS 3 includes accounting requirements for reacquired rights, contingent liabilities, contingent consideration and indemnification assets.

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1. SCOPE

1.1. IFRS 3.2(B): ACCOUNTING FOR REVERSE ACQUISITIONS THAT DO NOT CONSTITUTE A BUSINESS

(March 2013)

The Interpretations Committee received requests for guidance on how to account for transactions in which the former shareholders of a non-listed operating entity become the majority shareholders of the combined entity by exchanging their shares for new shares of a listed non-operating entity. However, the transaction is structured such that the listed non-operating entity acquires the entire share capital of the non-listed operating entity.

In the absence of a Standard that specifically applies to this transaction the Interpretations Committee observed that the analysed transaction has some features of a reverse acquisition under IFRS 3 because the former shareholders of the legal subsidiary obtain control of the legal parent. Consequently, it is appropriate to apply by analogy, in accordance with paragraphs 10–12 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, the guidance in paragraphs B19–B27 of IFRS 3 for reverse acquisitions. Application of the reverse acquisitions guidance by analogy results in the non-listed operating entity being identified as the accounting acquirer, and the listed non-operating entity being identified as the accounting acquiree. The Interpretations Committee noted that in applying the reverse acquisition guidance in paragraph B20 of IFRS 3 by analogy, the accounting acquirer is deemed to have issued shares to obtain control of the acquiree.

If the listed non-operating entity qualifies as a business on the basis of the guidance in paragraph B7 of IFRS 3, IFRS 3 would be applicable to the transaction. However, if the listed non-operating entity is not a business, the transaction is not a business combination and is therefore not within the scope of IFRS 3. Because the analysed transaction is not within the scope of IFRS 3, the Interpretations Committee noted that it is therefore a share-based payment transaction which should be accounted for in accordance with IFRS 2 *Share-based Payment*.

The Interpretations Committee observed that on the basis of the guidance in paragraph 13A of IFRS 2, any difference in the fair value of the shares deemed to have been issued by the accounting acquirer and the fair value of the accounting acquiree's identifiable net assets represents a service received by the accounting acquirer. The Interpretations Committee concluded that, regardless of the level of monetary or non-monetary assets owned by the non-listed operating entity, the entire difference should be considered to be payment for a service of a stock exchange listing for its shares, and that no amount should be considered a cost of raising capital. The Interpretations Committee observed that the service received in the form of a stock exchange listing does not meet the definition of an intangible asset because it is not 'identifiable' in accordance with paragraph 12 of IAS 38 *Intangible Assets* (ie it is not separable). The service received also does not meet the definition of an asset that should be recognised in accordance with other Standards and the *Conceptual Framework*.

The Interpretations Committee also observed that on the basis of the guidance in paragraph 8 of IFRS 2 which states that 'when the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognised as expenses', the cost of the service received is recognised as an expense.

On the basis of the analysis above, the Interpretations Committee determined that, in the light of the existing IFRS requirements, neither an interpretation nor an amendment to Standards was necessary and consequently decided not to add this issue to its agenda.

1.1.1. BDO Knows: reverse acquisition of a publicly listed shell company that does not constitute a business

The owners of a private company may arrange to have the company 'acquired' in a share for share transaction by a small listed company in order to take the private company public, but

avoiding the processes and costs of an initial public offering (IPO). The listed company is the legal acquirer and the private company is the legal acquiree. The private company will usually be identified as the accounting acquirer and the listed company as the accounting acquiree under IFRS 3, so that the transaction is considered a reverse acquisition. However, if the listed company does not meet the IFRS 3 definition of a business the transaction is not a business combination within the scope of IFRS 3. Instead, consistent with the agenda decision above, the transaction should be accounted for as a share based payment transaction.

Q: *What is the accounting guidance in practice for a reverse acquisition into a publicly listed shell company?*

The transaction is accounted for as if the legal acquiree (the private company) obtains the assets and liabilities (normally only assets) of the legal acquirer (listed shell) in return for its own equity instruments (its shares). In practice the fair value of the shares transferred to the shareholders of the listed company (based on the relative proportions held in the enlarged group) will exceed the fair value of the assets of the listed company that are acquired. The excess amount will be recorded as an expense in profit or loss, representing the costs of the listing acquired. As the transaction is not a business combination, goodwill is not recognised.

IFRS 2 requires the share based payment by the private company to be measured at the fair value of the goods or services received or, if this cannot be reliably measured, by reference to the fair value of the equity instruments granted. In practice valuing the equity interests of the private company that are deemed to have been transferred to the shareholders of the listed company will be a more reliable measure than valuing the goods and services acquired (the costs of the listing and the identifiable assets and liabilities of the listed company). Where the fair value of the equity instruments issued exceeds the fair value of identifiable goods and services acquired, IFRS 2 requires the excess to be expensed on the basis that other consideration (ie unidentifiable goods and services) has been, or will be, received (see IFRS 2.13A).

The consolidated financial statements will be issued under the name of the legal acquirer (the listed entity) but will be presented as a continuation of the financial statements of the private company (ie as if the private company had acquired the listed company). Similar considerations to those applied in 'true' reverse acquisition accounting will be relevant (see IFRS 3 B21 to B27).

The results of the comparative periods and up to the date of the transaction are those of the private company measured at their pre transaction amounts.

The assets and liabilities of the listed company will be recognised at their fair value at the transaction date, with any excess consideration being expensed immediately

EPS is calculated as if there has been a share issue by the private company with a subsequent share split/consolidation to produce the share structure of the listed company. This will give the same EPS adjustment as required by IFRS 3 paragraphs B25 to B27 on a reverse acquisition.

1.2. IFRS 3.2(B): IAS 12 *INCOME TAXES* - RECOGNITION OF DEFERRED TAXES WHEN ACQUIRING A SINGLE-ASSET ENTITY THAT IS NOT A BUSINESS

(March 2017)

The Committee received a submission questioning how, in its consolidated financial statements, an entity accounts for a transaction in which it acquires all the shares of another entity that has an investment property as its only asset. In the fact pattern submitted, the acquiree had recognised in its statement of financial position a deferred tax liability arising from measuring the investment property at fair value. The amount paid for the shares is less than the fair value of the investment property because of the associated deferred tax liability. The transaction described in the submission does not meet the definition of a business combination in IFRS 3 because the acquired entity is not a business. The acquiring entity applies the fair value model in IAS 40 *Investment Property*.

The submitter asked whether the requirements in paragraph 15(b) of IAS 12 *Income Taxes* permit the acquiring entity to recognise a deferred tax liability on initial recognition of the transaction. If this is not the case, the submitter asked the Committee to consider whether the requirements

in paragraph 15(b) of IAS 12 should be amended so that, in these circumstances, the acquiring entity would not recognise a gain on measuring the investment property at fair value immediately after initial recognition of the transaction.

IAS 12.15 requires that:

> *'A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:*
>
> *a) The initial recognition of goodwill; or*
>
> *b) The initial recognition of an asset or liability in a transaction which:*
>
> *i. It is not a business combination; and*
>
> *ii. At the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).'*

The Committee noted that:

- because the transaction is not a business combination, paragraph 2(b) of IFRS 3 requires the acquiring entity, in its consolidated financial statements, to allocate the purchase price to the assets acquired and liabilities assumed; and
- paragraph 15(b) of IAS 12 says that an entity does not recognise a deferred tax liability for taxable temporary differences that arise from the initial recognition of an asset or liability in a transaction that is not a business combination and that, at the time of the transaction, affects neither accounting profit or loss nor taxable profit (tax loss).

Accordingly, on acquisition, the acquiring entity recognises only the investment property and not a deferred tax liability in its consolidated financial statements. The acquiring entity therefore allocates the entire purchase price to the investment property.

The Committee concluded that the requirements in IFRS Standards provide an adequate basis for an entity to determine how to account for the transaction. The Committee also concluded that any reconsideration of the initial recognition exception in paragraph 15(b) of IAS 12 is something that would require a Board-level project. Consequently, the Committee decided not to add this matter to its standard-setting agenda.

The Committee noted that the Board had recently considered whether to add a project on IAS 12 to the Board's agenda but had decided not to do so. Consequently, the Committee did not recommend that the Board consider adding a project to its agenda on this topic.

1.3. IFRS 3.2(B): REMEASUREMENT OF PREVIOUSLY HELD INTERESTS

(January 2016)

The Interpretations Committee discussed whether previously held interests in the assets and liabilities of a joint operation should be remeasured in the following transactions when the asset or group of assets involved in such transactions do not meet the definition of a business in accordance with IFRS 3:

- obtaining control of a joint operation when the entity previously had joint control of, or was a party to, the joint operation before the transaction; and
- a change of interests resulting in a party to a joint operation obtaining joint control over the joint operation. The party to the joint operation had rights to the assets and obligations for the liabilities relating to the joint operation before the transaction.

The Interpretations Committee noted that paragraph 2(b) of IFRS 3 explains the requirements for accounting for an asset acquisition in which the asset or group of assets do not meet the definition of a business. The Interpretations Committee noted that paragraph 2(b) of IFRS 3 specifies that a cost-based approach should be used in accounting for an asset acquisition, and that in a cost-based approach the existing assets are generally not remeasured. The Interpretations Committee also observed that it was not aware of significant diversity in practice and, therefore, decided not to add this issue to its agenda.

1.4. IFRS 3.2(C): 'TRANSITORY' COMMON CONTROL

(March 2006)

The Interpretations Committee considered an issue regarding whether a reorganisation involving the formation of a new entity to facilitate the sale of part of an organisation is a business combination within the scope of IFRS 3.

IFRS 3 does not apply to business combinations in which all the combining entities or businesses are under common control both before and after the combination, unless that control is transitory. It was suggested to the Interpretations Committee that, because control of the new entity is transitory, a combination involving that newly formed entity would be within the scope of IFRS 3.

Paragraph 22 of IFRS 3 [now paragraph B18] states that when an entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination must be identified as the acquirer on the basis of the evidence available [now must be identified as the acquirer by applying the guidance in paragraphs B13–B17]. The Interpretations Committee noted that, to be consistent, the question of whether the entities or businesses are under common control applies to the combining entities that existed before the combination, excluding the newly formed entity. Accordingly, the Interpretations Committee decided not to add this topic to its agenda.

The Interpretations Committee also considered a request for guidance on how to apply IFRS 3 to reorganisations in which control remains within the original group. The Interpretations Committee decided not to add this topic to the agenda, since it was unlikely that it would reach agreement in a reasonable period, in the light of existing diversity in practice and the explicit exclusion of common control transactions from the scope of IFRS 3.

1.5. IFRS 3.2(C): ASSOCIATES AND COMMON CONTROL

(May 2013)

In October 2012, the Interpretations Committee received a request seeking clarification of the accounting for an acquisition of an interest in an associate or joint venture from an entity under common control. The submitter's question is whether it is appropriate to apply the scope exemption for business combinations under common control (BCUCC), which is set out in IFRS 3 *Business Combinations*, by analogy to the acquisition of an interest in an associate or joint venture under common control.

The Interpretations Committee observed that paragraph 32 of IAS 28 *Investments in Associates and Joint Ventures* has guidance on the acquisition of an interest in an associate or joint venture and does not distinguish between acquisition of an investment under common control and acquisition of an investment from an entity that is not under common control. The Interpretations Committee also observed that paragraph 10 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires management to use its judgement in developing and applying an accounting policy only in the absence of a Standard that specifically applies to a transaction.

The Interpretations Committee also observed that paragraph 26 of IAS 28 states that many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10 *Consolidated Financial Statements*. That paragraph further states that the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture. The Interpretations Committee also observed that paragraph 2(c) of IFRS 3 states that IFRS 3 does not apply to a combination of entities or businesses under common control. The Interpretations Committee observed that some might read these paragraphs as contradicting the guidance in paragraph 32 of IAS 28 (see previous paragraph), potentially leading to a lack of clarity.

The Interpretations Committee was specifically concerned that this lack of clarity has led to diversity in practice for the accounting of the acquisition of an interest in an associate or joint venture under common control.

The Interpretations Committee noted that accounting for the acquisition of an interest in an associate or joint venture under common control would be better considered within the context of broader projects on accounting for BCUCC and the equity method of accounting. The Interpretations Committee also noted that the IASB, in its May 2012 meeting, added a project on accounting for BCUCC as one of the priority research projects as well as a project on the equity method of accounting as one of the research activities to its future agenda. Consequently, the Interpretations Committee decided not to take this issue onto its agenda.

Subsequent developments

The IASB has subsequently discussed the question of accounting for BCUCC, and feedback from the Post-implementation Review (PIR) of IFRS 3. As a result of the PIR feedback, a number of issues were added to the IASB's research agenda, including how to clarify the definition of a business, which was to be addressed first before giving further consideration to BCUCC.

During the period from the end of 2015 to mid-2017, the IASB developed guidance to clarify the definition of a business, which was at the same time as the FASB was developing similar guidance for the purposes of the equivalent converged guidance in US GAAP for business combinations.

In the final quarter of 2017, the IASB recommenced its BCUCC project. It is anticipated that a discussion paper will be issued in the second half of 2018.

1.6. IFRS 3.2(C) AND IAS 27: BUSINESS COMBINATIONS INVOLVING ENTITIES UNDER COMMON CONTROL - PRESENTATION OF COMPARATIVES WHEN APPLYING THE 'POOLING OF INTERESTS' METHOD

(January 2010)

The Interpretations Committee received a request for guidance on the presentation of comparatives when applying the ‘pooling of interests’ method for business combinations between entities under common control when preparing financial statements in accordance with IFRS.

The request asked whether IAS 27 *Consolidated Financial Statements* restricts the application of the pooling of interests method of acocunting such that periods prior to the date of the common control transaction cannot be restated on a combined basis.

The Interpretations Committee noted that IFRS 3 (revised 2008) excludes from its scope ‘a combination of entities or businesses under common control’. The Interpretations Committee noted that resolving the issue would require interpreting the interaction of multiple IFRSs. The Interpretations Committee also noted that in December 2007 the Board added a project to its research agenda to examine the definition of common control and the methods of accounting for business combinations under common control in the acquirer's consolidated and separate financial statements. Consequently, the Interpretations Committee decided not to add this issue to its agenda.

1.6.1. BDO Knows: Business Combinations involving Entities Under Common Control

Q_1: Is the application of IFRS 3 by analogy, through application of the hierarchy in IAS 8.10-12 appropriate in respect of transactions involving business combinations under common control?

Business combinations under common control are scoped out of IFRS 3 (IFRS 3.2(c)).

In the absence of specific guidance, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8.10-12) require that management uses judgement to develop an accounting policy, drawing from sources based on the following hierarchy:

- The requirements within other IFRSs which deal with similar and related issues
- The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework
- Pronouncements from other similar standard-setting bodies as well as other accounting literature and industry practice (to the extent they do not conflict with the above).

Note: Local regulatory requirements may also be relevant when determining the appropriate accounting approach, and may be more restrictive than IFRS (see Q5 below).

Because IFRS does not specify the accounting approach to be followed, an entity should select one of the following two approaches as an accounting policy choice to be applied consistently to all similar transactions for business combinations involving entities under common control:

- The acquisition method (as set out in IFRS 3), or
- Book value accounting (often referred to as the 'pooling of interests' method).

However, the use of the acquisition method results in a reassessment of the carrying amounts of assets and liabilities, and the recognition of goodwill and certain intangible assets, which otherwise would not be permitted. Consequently, in our view, when selecting an appropriate acocunting policy it is necessary to consider whether the business combination involving entities under common control represents a substantive transaction. Factors to consider include:

- The purpose of the transaction
- Whether the transaction price is at fair value (when the transaction is not effected through the issue of equity shares)
- The activities of the entities involved in the transaction.

This links to the criteria in IAS 8.10, meaning that the financial statements need to be both relevant to the economic decision making needs of users, and reliable. IAS 8.10 notes that reliable means that the financial statements:

- Represent faithfully the financial position, financial performance and cash flows of the entity
- Reflect the economic substance of transactions, other events and conditions, and not merely the legal form
- Are neutral (ie free from bias)
- Are prudent, and
- Are complete in all material respects.

The rationale for applying IFRS 3 is that, although it is part of a group of entities under common control, the acquirer is still a separate entity in its own right. Consequently, from that entity's perspective there has been a substantive transaction.

The rationale for book value accounting is that the business has simply been moved from one part of a group of entities under common control to another. This view might be taken in circumstances in which businesses have been moved around a group as part of a restructuring or for tax planning purposes, or in preparation for the sale or listing of part of an existing group.

Q_2: If IFRS 3 is applied by analogy, is it necessary to apply all of its requirements?

Yes. Consequently, this would include consideration of whether acquisition, or reverse acquisition, accounting is appropriate. In both cases, the assets and liabilities of the accounting acquiree (whether this is the legal subsidiary or subgroup in the case of acquisition accounting, or the legal parent in the case of reverse acquisition accounting) will be remeasured to fair value.

Q_3: If book value accounting is applied, what is the level at which the book values are obtained?

An entity should select one of the following approaches as an accounting policy choice (to be applied consistently to all business combinations involving entities under common control), to obtain book values from the financial statements of:

- the entity transferred
- the immediate parent of the entity transferred
- any intermediate parent entity, or
- the ultimate parent entity.

When book values are taken from the financial statements of a parent entity, these will be the amounts included in the consolidated financial statements of that immediate, intermediate or ultimate parent entity (including goodwill). In order to enhance the consistency of the existence

and measurement of assets and liabilities attributable to each of the entities involved in a business combination under common control, an approach of looking to amounts recorded at ultimate parent entity level may be an appropriate approach.

Q_4: If book value accounting is applied, should comparatives be restated?

If book value accounting is applied, the acquirer is permitted (but not required) to restate its comparatives as if the combination had taken place at the start of the earliest period presented in its financial statements. However, this restatement needs to exclude any periods during which the combining entities were not under common control. Consequently, it will be necessary to review the dates from which each of the combining entities was controlled.

Q_4: What approaches are different regulators accepting?

In some jurisdictions, regulators may take a more restrictive approach for business combinations involving entities under common control than set out above (for example, only permitting book value accounting, or either requiring or prohibiting the inclusion of comparative amounts). Consequently, certain approaches that might otherwise be permitted by IFRS may not be available.

2. THE ACQUISITION METHOD

2.1. STEP 1: IDENTIFYING THE ACQUIRER

2.1.1. IFRS 3.7: Identification of the acquirer in accordance with IFRS 3 and the parent in accordance with IFRS 10 *Consolidated Financial Statements* in a stapling arrangement

(May 2014)

The Interpretations Committee received a request to clarify the interaction of the requirements in IFRS 3 (as revised in 2008) for identifying an acquirer with the requirements in IFRS 10 for deciding whether control exists. More specifically, the submitter is seeking clarification of whether an acquirer identified for the purpose of IFRS 3 (as revised in 2008) is a parent for the purpose of IFRS 10 in circumstances in which a business combination is achieved by contract alone, such as a stapling arrangement, with no combining entity obtaining control of the other combining entities.

IFRS 3 (as revised in 2008) defines a business combination as "a transaction or other event in which an acquirer obtains control of one or more businesses". In addition, IFRS 3 (as revised in 2008) refers to IFRS 10 for the meaning of the term 'control'. IFRS 10 states that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Hence, the Interpretations Committee observed that an investment is not needed in order for an entity to control another entity.

The definition of a business combination in IFRS 3 (as revised in 2008) includes transactions in which an acquirer obtains control of one or more businesses. It also includes transactions that are sometimes referred to as 'true mergers' or 'mergers of equals'. In other words, it includes transactions in which none of the combining entities obtains control of the other combining entities. The Interpretations Committee discussed a stapling arrangement and noted that if the stapling arrangement combines separate entities and businesses by the unification of ownership and voting interests in the combining entities, then such a transaction is a business combination as defined by IFRS 3 (as revised in 2008).

Notwithstanding the fact that IFRS 3 (as revised in 2008) includes business combinations in which none of the combining entities obtains control of the other combining entities, the Interpretations Committee noted that paragraph 6 of IFRS 3 (as revised in 2008) requires that one of the combining entities in a business combination must be identified as the acquirer. Paragraphs B14–B18 of IFRS 3 (as revised in 2008) provide additional guidance for identifying the acquirer if the guidance in IFRS 10 does not clearly indicate which combining entity is the acquirer.

The Interpretations Committee also noted that paragraph B15(a) of IFRS 3 (as revised in 2008) provides guidance on identifying the acquirer by assessing the relative voting rights in the combined entity after the combination—this guidance explains that the acquirer is usually the combining entity whose owners, as a group, receive the largest portion of the voting rights in the combined entity. This guidance is consistent with the Interpretations Committee's observation that the definition of a business combination includes transactions in which none of the combining entities or businesses are identified as having control of the other combining entities. The Interpretations Committee thought that this guidance would be relevant to identifying which of the combining entities is the acquirer in the stapling transaction considered.

The Interpretations Committee noted that the IASB stated in the IASB Update for September 2004 that the intended interaction between IFRS 3 (issued in 2004) and IAS 27 *Consolidated and Separate Financial Statements* (which dealt with consolidation prior to IFRS 10) is that an entity that is identified as the 'acquirer' of another entity in accordance with IFRS 3 (issued in 2004) is a 'parent' for the purposes of IAS 27. The Interpretations Committee noted that the meaning of the term 'acquirer' has not changed since 2004 and that the term 'control' is used consistently between IFRS 3 (as revised in 2008) and IFRS 10. It also noted that the notion in IFRS 3 (as

revised in 2008) that a business combination could occur even if none of the combining entities obtains control of the other combining entities has not changed from IFRS 3 (issued in 2004). Accordingly, the Interpretations Committee observed that the IASB's statement in the September 2004 IASB Update on the interaction between IFRS 3 (issued in 2004) and IAS 27 remains valid in respect of the interaction between IFRS 3 (as revised in 2008) and IFRS 10. Consequently, the Interpretations Committee observed that the combining entity in the stapling arrangement that is identified as the acquirer for the purpose of IFRS 3 (as revised in 2008) should prepare consolidated financial statements of the combined entity in accordance with IFRS 10.

The Interpretations Committee noted that there is little diversity in practice for the accounting for business combinations achieved by contract alone. It further noted that it does not expect diversity to emerge in the future on the basis of the analysis on the requirements and guidance in IFRS 3 (as revised in 2008) and IFRS 10.

Accordingly, the Interpretations Committee decided not to add this issue to its agenda.

2.1.2. IFRS 3.6-7: Identifying the Acquirer - Business Combinations Involving Newly Formed Entities: Business Combinations under Common Control

(September 2011)

The Interpretations Committee received two requests for guidance on accounting for transactions involving entities under common control in arrangements that involved the formation of a newly formed entity. In both cases, the Interpretations Committee observed that the fact pattern was too broad to be addressed through an interpretation or an annual improvement.

Consequently, the Interpretations Committee decided not to add either of the issues to its agenda and recommended the Board to consider the fact pattern described in the submission as part of its project on common control transactions.

See section 1.5 for the status of the IASB's project, and section 1.6.1 for BDO Knows: Business Combinations involving Entities Under Common Control.

2.1.3. IFRS 3.IE1-IE15: Reverse Acquisitions - Acquirer in a reverse acquisition

(September 2011)

The Interpretations Committee received a request for guidance asking whether a business that is not a legal entity could be considered to be the acquirer in a reverse acquisition under IFRS 3.

The Committee noted that in accordance with paragraph 7 of IFRS 3, the acquirer is 'the entity that obtains control of the acquiree' and, in accordance with Appendix A of IFRS 3, the acquiree is 'the business or businesses that the acquirer obtains control of in a business combination'. Paragraph B19 in IFRS 3 states that '...The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.'

The Committee observed that IFRSs and the current Conceptual Framework do not require a 'reporting entity' to be a legal entity. Consequently, the Committee noted that an acquirer that is a reporting entity, but not a legal entity, can be considered to be the acquirer in a reverse acquisition.

The Committee noted that this issue is not widespread. Consequently, the Committee decided not to add this issue to its agenda.

2.2. STEP 3: RECOGNITION AND MEASUREMENT OF ASSETS, LIABILITIES AND NON-CONTROLLING INTERESTS (NCI)

2.2.1. IFRS 3.10-13: Recognising Particular Assets Acquired and Liabilities Assumed - Customer-related intangible assets

(March 2009)

The Interpretations Committee received a request to add an item to its agenda to provide guidance on the circumstances in which a non-contractual customer relationship arises in a business combination. IFRS 3 (as revised in 2008) requires an acquirer to recognise the identifiable intangible assets of the acquiree separately from goodwill. An intangible asset is identifiable if it meets either the contractual-legal criterion or the separable criterion in IAS 38 *Intangible Assets*. Contractual customer relationships are always recognised separately from goodwill because they meet the contractual-legal criterion. However, non-contractual customer relationships are recognised separately from goodwill only if they meet the separable criterion.

The Interpretations Committee noted that the IFRS Glossary defines the term 'contract'. Paragraphs B31—B40 of IFRS 3 provide application guidance on the recognition of intangible assets and the different criteria related to whether they are established on the basis of a contract. The Interpretations Committee also noted that paragraph IE28 in the illustrative examples accompanying IFRS 3 provides indicators for identifying the existence of a customer relationship between an entity and its customer and states that a customer relationship 'may also arise through means other than contracts, such as through regular contact by sales or service representatives.'

The Interpretations Committee concluded that how the relationship is established helps to identify whether a customer relationship exists but should not be the primary basis for determining whether the acquirer recognises an intangible asset. The Interpretations Committee noted that the criteria in paragraph IE28 might be more relevant. The existence of contractual relationships and information about a customer's prior purchases would be important inputs in valuing a customer relationship intangible asset but should not determine whether it is recognised.

In the light of the explicit guidance in IFRS 3, the Interpretations Committee decided that developing an Interpretation reflecting its conclusion is not possible. Noting widespread confusion in practice on this issue, the Interpretations Committee decided that it could be best resolved by referring it to the IASB and the FASB with a recommendation to review and amend IFRS 3 by:

- removing the distinction between 'contractual' and 'non-contractual' customer-related intangible assets recognised in a business combination; and
- reviewing the indicators that identify the existence of a customer relationship in paragraph IE28 of IFRS 3 and including them in the standard.

Subsequent developments

The reference to referring the issue to the IASB and the FASB is relevant because the guidance in IFRS and US GAAP for business combinations is converged. However, no amendments to IFRS 3 for the two points above have been made to date as a result of the referral to the IASB and the FASB.

2.2.2. IFRS 3.52(b): Arrangements for Contingent Payments to Employees or Selling Shareholders - Continuing employment

(January 2013)

The Interpretations Committee received a request for guidance on the accounting in accordance with IFRS 3 Business Combinations for contingent payments to selling shareholders in circumstances in which those selling shareholders become, or continue as, employees. The submitter asked the Interpretations Committee to clarify whether paragraph B55(a) of IFRS 3 is conclusive in determining that payments to an employee that are forfeited upon termination of

employment are remuneration for post-combination services and not part of the consideration for an acquisition. The question arose because the submitter asserted that paragraph B55 introduces subparagraphs (a)-(h) as indicators, but paragraph B55(a) uses conclusive language stating that the arrangement described is remuneration for post-combination services.

The Interpretations Committee observed that an arrangement in which contingent payments are automatically forfeited if employment terminates would lead to a conclusion that the arrangement is compensation for post-combination services rather than additional consideration for an acquisition, unless the service condition is not substantive. The Interpretations Committee reached this conclusion on the basis of the conclusive language used in paragraph B55(a) of IFRS 3.

2.2.3. BDO Knows: Contingent consideration payable to former shareholders who become employees of the acquired entity

Q: In the Interpretations Committee Agenda Decision (January 2013) it was concluded that is there an automatic requirement for contingent payments to a former owner of an acquired business, who has become an employee of the acquired business, to be accounted for as post acquisition remuneration if they are automatically forfeited in the event that the former owner's employment is terminated. Are there any circumstances in which those payments could be regarded as being part of the cost of the acquired business?

Generally the contingent payments are required to be accounted for as post acquisition remuneration. IFRS 3.B55(a) is clear in its requirements for contingent payments that are automatically forfeited in the event that employment terminates.

Only in circumstances where there is clear evidence that a clause in a contract, stating that contingent payments are automatically forfeited in the event that employment terminates, is non-substantive can any consideration be given to the payments not being wholly for remuneration. Non-substantive means that the clause either would not, or cannot, be enforced in all circumstances or that the effect of the clause is negligible. The analysis of possible non-substantive clauses requires careful consideration of facts and circumstances, and only those which genuinely have no substance can be disregarded. For example, a very short period of required employment after the acquisition (say, 24 hours) indicates that the payments may not be associated with employment related services and may therefore not be remuneration.

2.2.4. BDO Knows: Treatment of expenses relating to a business combination effected by a subsidiary but paid by the parent company

Q: Is an acquirer in a business combination required to recognise an expense and a capital contribution in its consolidated financial statements for the costs relating to the acquisition of an acquiree borne by its parent company?

Company A is a listed entity which controls another listed entity, company B. Both prepare consolidated financial statements. Company B enters into negotiations to acquire company C, an unrelated entity. Company A agrees to bear all external third party costs resulting from the business combination (and these costs will not be recharged to Company B).

IFRS is not specific about the approach to be followed.

IFRS 2 *Share-based Payment* is clear that a share-based payment transaction entered into by a parent company with employees of a subsidiary in exchange for their work at the subsidiary is required to be recognised as an expense by the subsidiary, irrespective of the existence of any recharge arrangement between both entities. However, no other IFRS contains similar requirements.

Paragraph 6 of IAS 24 requires the disclosure of related party transactions, because such transactions could have an effect on the profit or loss and financial position of an entity, as 'they may not be made at the same amount as between unrelated parties'. This implies that not all transactions settled by a parent entity on behalf of a subsidiary are required to be recorded by the subsidiary.

Consequently, while in our view there is a preferred approach, there is also an alternative.

Preferred approach

Company B should recognise an expense and a capital contribution. Although the expenses are paid by company A and are not recharged to company B, company B has received the benefit of the services. This is similar to a share-based payment arrangement where a parent entity issued its own shares to employees of a subsidiary, for services that they have provided to the subsidiary. In those circumstances, the subsidiary recognises an expense and a capital contribution.

IFRS 2 sets out the rationale for this approach in paragraphs BC34 and BC35, noting that it is the subsidiary, not the parent, that receives the benefit of the services provided by the employees. This reasoning is consistent with the Framework (the recognition of an expense), and is therefore required to be followed by analogy.

Paragraph BC34 of IFRS 2 states:

> *'Some argue that the effect of employee share plans is that the existing shareholders transfer some of their ownership interests to the employees and that the entity is not a party to this transaction.'*

However, paragraph BC35 of IFRS 2 states:

> *'The Board did not accept this argument. Entities, not shareholders, set up employee share plans and entities, not shareholders, issue share options to their employees. Even if that were not the case, e.g. if shareholders transferred shares or share options direct to the employees, this would not mean that the entity is not a party to the transaction. The equity instruments are issued in return for services rendered by the employees and the entity, not the shareholders, receives those services. Therefore, the Board concluded that the entity should account for the services received in return for the equity instruments issued. The Board noted that this is no different from other situations in which equity instruments are issued. For example, if an entity issues warrants for cash, the entity recognises the cash received in return for the warrants issued. Although the effect of an issue, and subsequent exercise, of warrants might be described as a transfer of ownership interests from the existing shareholders to the warrant holders, the entity nevertheless is a party to the transaction because it receives resources (cash) for the issue of warrants and further resources (cash) for the issue of shares upon exercise of the warrants. Similarly, with employee share options, the entity receives resources (employee services) for the issue of the options and further resources (cash) for the issue of shares on the exercise of options.'*

It is acknowledged that IAS 24 *Related Party Disclosures* contemplates circumstances where transactions between related parties are not entered into at arm's length prices, and that IFRS is not clear about whether in those circumstances market prices are required to be imputed. However, in this case it is different as it is not a question of whether prices charged are at a market rate. Instead, it is the question of accounting for services that an entity has received, which have been paid for by its parent.

Alternative approach

There is no requirement for company B to include a capital contribution and expense for these transactions. While it is permissible for the approach set out in IFRS 2 to be followed by analogy, there is no requirement to do so.

In terms of the disclosure requirements of IAS 24, these apply whether an off market charge, or no charge, is made by a parent for items it has provided to a subsidiary. There is no substantive difference between the transfer of an asset or service for a price that is different from its fair value, and for the transfer of that asset or service for no consideration.

2.3. DETERMINING WHAT IS PART OF THE BUSINESS COMBINATION TRANSACTION

2.3.1. BDO Knows: Settlement of a pre-existing relationship through a business combination

Q: When does a business combination settle a pre-existing relationship?

In our view, where there is a pre-existing relationship between the acquiree and the acquirer, a business combination always includes settlement of the pre-existing relationship.

When a company enters into a business combination, the acquirer needs to identify any amounts of consideration paid (or payable) that do not relate specifically to the business combination, and account for them separately.

These amounts may include payments made to settle a pre-existing business relationship or other arrangements that existed before negotiations for the business combination began.

Paragraph 51 of IFRS 3.51 states:

> *'The acquirer and the acquiree may have a pre-existing relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer shall identify any amounts that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, ie amounts that are not part of the exchange for the acquiree. The acquirer shall recognise as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions shall be accounted for in accordance with the relevant IFRSs.'*

Paragraph B52 of IFRS 3 provides guidance on how to account for a pre-existing relationship in a business combination between the acquirer and acquire and states:

> *'If the business combination in effect settles a pre-existing relationship, the acquirer recognises a gain or loss, measured as follows:*
>
> *(a) for a pre-existing non-contractual relationship (such as a lawsuit), fair value.*
>
> *(b) for a pre-existing contractual relationship, the lesser of (i) and (ii):*
>
> *(i) the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with terms for current market transactions for the same or similar items. (An unfavourable contract is a contract that is unfavourable in terms of current market terms. It is not necessarily an onerous contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.)*
>
> *(ii) the amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavourable.'*
>
> *If (ii) is less than (i), the difference is included as part of the business combination accounting.*
>
> *The amount of gain or loss recognised may depend in part on whether the acquirer had previously recognised a related asset or liability, and the reported gain or loss therefore may differ from the amount calculated by applying the above requirements.'*

Pre-existing relationships include non-contractual relationships (such as a legal case), and contractual relationships (such as supply contracts). Paragraphs IE54-57 of IFRS 3 set out an illustrative example that shows the consequences of applying the guidance in IFRS 3 to a pre-existing supply contract between an acquirer and the acquiree. As a result of the business combination, the agreement between the acquirer and (previously separate) acquiree becomes an intra group arrangement. To the extent that there is a difference between amounts payable under the supply agreement and an open market rate at the acquisition date, part of the consideration paid for the acquiree is deemed to relate to the settlement of that difference. This is regardless of whether the supply agreement remains in place after the business combination..

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