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Pearl Hock-neo TAN
Singapore Management University, pearltan@smu.edu.sg

Chu Yeong LIM

Tracey Chunqi ZHANG
Singapore Management University, traceyzhang@smu.edu.sg

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Business combinations under common control (Part 1)

TAN, Pearl; LIM, Chu Yeong; and ZHANG, Tracey

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A CONTEXTUAL APPROACH

In a business combination under common control (BCUCC), the same party (or parties) ultimately controls the combining entities both before and after the business combination and this control is not transitory. BCUCC is not governed by any International Financial Reporting Standard (IFRS) issued by the International Accounting Standards Board (IASB). The IASB released a Discussion Paper in November 2020 to deal with an urgent need to resolve the divergent accounting practices. Two main methods are the acquisition method which has a fair value focus, and the predecessor method which has a historical cost focus (refer to Part 1 of our article).

In Part 1 of the article, published in the March issue of this ***IS C**hartered **A**ccountant Journal*, we explained the conditions for a BCUCC and the two methods of accounting for BCUCC. We also explained how accounting standards need to address the gap in accounting for the BCUCC from the receiving entity's perspective.

In this Part 2 of the article, we propose a contextual approach in determining the accounting method on BCUCC for the receiving entity (that is, the entity which receives control of the transferred entity from another group entity). We propose that a BCUCC that has commercial substance and which results in a change in the timing, amount and variability of cashflows of the receiving entity and its subsidiaries should be accounted as an acquisition under IFRS 3. The acquisition method better serves the information needs of the non-controlling interests and external stakeholders of the receiving entity when there is a real economic change of the receiving entity and its sub-group. We illustrate this point in the case study below. The lack of arm's-length pricing does not pose insurmountable measurement issues and should not be the basis for the accounting choice.

Although the principles in IAS 8 *Accounting Policies, Changes in Accounting Estimates, and Errors* and the Conceptual Framework require the reporting entity to apply the approach that most faithfully represents the BCUCC transaction and which provides relevant information to users, most entities are likely to choose the predecessor method for the more favourable reporting effects. Hence, the spirit of IAS 8 may be compromised when there are strong incentives to select one policy over another. We need to question if users are being provided with relevant information about the BCUCC. Our concern lies particularly with the non-controlling interests and other external stakeholders of the receiving entity. The predecessor method ignores the perspective of the reporting entity who obtains control of another entity. By reporting a minimal-change or no-change scenario, the predecessor method emphasises the information needs of the stakeholders of the ultimate parent over the information needs of the receiving entity's stakeholders.

In this article, we propose that a contextual approach is necessary to determine the appropriate accounting method. It is unlikely that a "one size fits all"[1] accounting treatment is the optimal solution for conveying information on the economic substance of a BCUCC to external stakeholders. However, typically, the predecessor method will not report the information that best reflects the impact of the BCUCC on the receiving entity. We explain the different motivations and strategic considerations for initiating BCUCC, how the motivation and strategy convey information on the question of transitory control by the ultimate parent, the commercial substance of a BCUCC and likelihood of change in the timing, amount and variability of cashflows of the receiving entity and the acquired entity or entities. We then propose the type of accounting for each strategy based on the fundamental principle of whether control exists and whether an acquirer can be identified.

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ECONOMICS OF BCUCC

What is the economic rationale of a BCUCC? In neoclassical economics, firms exist because they can allocate resources more efficiently than markets.[2] In the same manner, internal markets exist within a group of firms which may allocate resources more efficiently than external markets. The BCUCC is potentially a strategic means of capitalising on the efficiency of internal markets. If, indeed, there is a real change in cashflows brought about by the BCUCC, it would be inappropriate to account for the BCUCC for the receiving entity using a no-change or minimal-change scenario assumed by the predecessor method.

Understanding the motivations for a BCUCC is therefore necessary in determining the commercial substance of the arrangement. The motivations for a BCUCC provide us with inferences on:

- whether control is transitory from the perspective of the ultimate controlling party (or parties), and
- the impact on the amount, timing and uncertainty of cashflows of the receiving entity and the subsidiaries.

We discuss common examples of the motivation for BCUCC. In each scenario, we analyse if there is a change in the amount, timing and cashflows of the receiving entity and the information that should be reported for the benefit of the receiving entity's stakeholders. In reality, the motivational reasons for a BCUCC are not mutually exclusive and more than one reason may apply to a BCUCC. If multiple motivations exist, the primary motivation should be identified to provide clarity on the accounting treatment.

1) Enhancing synergies and efficiency

To enhance value creation, a group may engage in restructuring activities to improve internal synergies and efficiencies. For example, sub-groups may be formed within a large conglomerate to enable greater focus on core competencies and enhancement of economies of scale and scope. In this scenario, it is not uncommon for entities to be transferred within a sub-group for value enhancement. Typically, these arrangements are not transitory and are probably long term, and the receiving entities would actively manage the acquired entities. The commercial substance of the arrangement results in changes in cashflows of the receiving entity. Showing a no-change or minimal-change scenario for the receiving entity under the predecessor method would deprive stakeholders of vital information of the acquisition and thus, the acquisition method would be more appropriate.

2) Tax reasons

Tax reasons explain many restructuring activities within a group. For example, a loss-making unit may be injected into a profitable business to minimise tax. As with efficiency reasons, BCUCC arrangements motivated for tax purposes are typically long term and would meet the "not transitory" criterion. However, the commercial substance of the arrangement should be evaluated. For example, companies may be put together purely for tax purposes without any real operational interdependencies. Further evaluation is required to assess if the acquisition benefits the receiving entity or the ultimate parent. Is the receiving entity an active investor or simply a passive investment vehicle? If the commercial substance of the BCUCC is such that the arrangement has minimal or no impact on the amount, timing and uncertainty of cashflows of the receiving entity, the predecessor method is more appropriately applied.

3) Listing or divestment plans

Securitising a sub-group (for example, “spinning off” or “hiving” a sub-group often occurs in a public listing) is a strong motivation for a BCUCC arrangement. Many groups or conglomerates apply this strategy to unlock the value within the group and to realise internally generated goodwill from their component units. Divestment plans are often the result of a long-term strategic process of developing core businesses within a group. The concept of duration of control is critical in determining the accounting treatment in a BCUCC formed for this purpose. If control by the ultimate parent either before or after the business combination is transitory, it will not be a BCUCC. If it is not a BCUCC, the receiving entity would have to account for the transaction as an acquisition under IFRS 3. If control by the ultimate parent before and after the business combination is not transitory, the transaction qualifies as a BCUCC.

All things being equal, we assume that a BCUCC formed for this reason would result in changes in the timing, amount and variability of cashflows for the receiving entity and its subsidiaries. Information about the consequences of this business combination is best conveyed using the acquisition method.

However, in a securitisation plan, the ultimate parent would often set up a new parent and transfer the investments of the entities in the divested group to the new parent. The new parent is a shell company at incorporation. Such a transaction would not be deemed as a BCUCC. Besides failing the duration test for a BCUCC, the acquired entities are merely moved from the ultimate parent to the new parent. As the new parent is set up by the ultimate parent, the arrangement is a transaction under common control[3] rather than a business combination under common control. If the transfer was made to an existing receiving entity (and not a new shell company), acquisition accounting would best present the information on the timing, amount and variability of cashflows for the receiving entity.

MEASUREMENT ISSUES IN BCUCC ACCOUNTING

In practice, the predecessor method is often justified on the basis of a lack of arm’s-length pricing in a BCUCC transaction. Nonetheless, existing accounting requirements on the acquisition of control without transfer of consideration provide an analogy where there is no arm’s-length pricing. In a business combination achieved without the transfer of consideration, the IASB requires the acquirer to substitute the acquisition-date fair value of its interest in the acquiree for the acquisition-date fair value of consideration transferred to measure goodwill or a gain on a bargain purchase.[4] In substance, transferring consideration at non-arm’s-length pricing presents the same measurement concerns as acquiring control without transfer of consideration. If the acquirer’s interest in the acquisition-date fair value of its interest in the acquiree can be substituted for the acquisition-date fair value of consideration transferred to measure goodwill in IFRS 3, this principle can be applied to a BCUCC transaction in which the consideration transferred is not reflective of arm’s-length pricing. However, this is understandably a complex area and requires careful consideration in the practical implementation in future standards. The use of the predecessor method to deal with the measurement issues is a convenient but not appropriate way to resolve the issue.

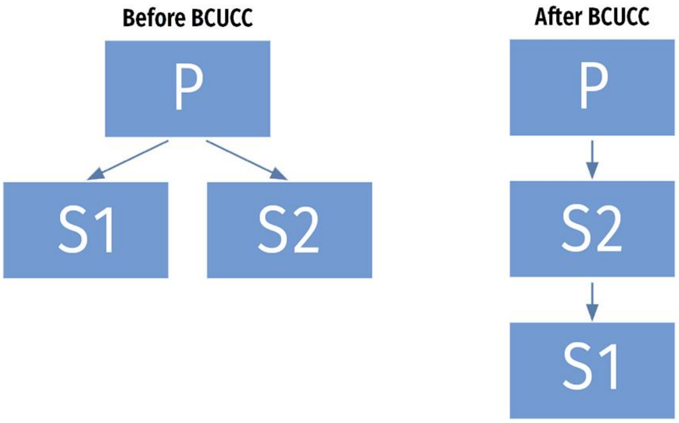
CONCLUSIONS

It is only after understanding the economics of the arrangement that we can establish if and whether there is a real change in the cashflows of the receiving entity and its subsidiaries before and after the business combination. We propose that a BCUCC that contains commercial substance and which results in a change in the timing, amount and variability of cashflows to the receiving entity and its subsidiaries should be accounted for under acquisition accounting. The absence of arm's-length pricing complicates the measurement process but should not be the primary basis to determine the method of accounting. Understanding the fact pattern and the economic rationale in a BCUCC is an essential prerequisite to determining the accounting treatment that would best provide the information that meets the needs of external stakeholders.

CASE STUDY

We explain the impact of the predecessor method and the acquisition method on the consolidated financial statements of the *receiving entity* and the ultimate parent. In the illustration below, P, the ultimate parent, sells its incorporated subsidiary S1 to S2, another subsidiary. For this illustration, we assume that S2 is partly owned by P and there are non-controlling interests of S2 for whom consolidated financial statements of S2 are prepared (Figure 1).

Figure 1 Relationship among the entities

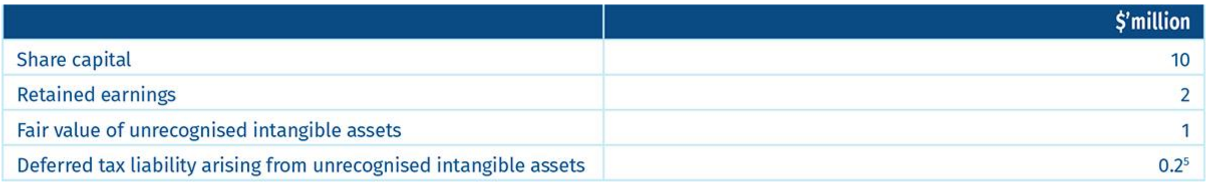


Before BCUCC

On incorporating S1, P records investment of $10 million in its separate financial statements. S1 records share capital of $10 million.

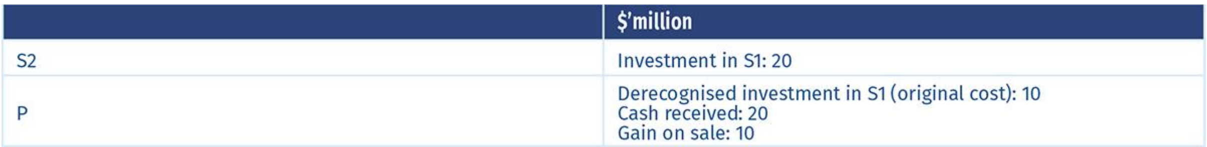
After BCUCC

S2 acquired S1 by paying the purchase price of $20 million to P. S1's financial information at acquisition by S2 is as follows:



	$'million
Share capital	10
Retained earnings	2
Fair value of unrecognised intangible assets	1
Deferred tax liability arising from unrecognised intangible assets	0.2[5]

Effects on separate financial statements:



	$'million
S2	Investment in S1: 20
P	Derecognised investment in S1 (original cost): 10 Cash received: 20 Gain on sale: 10

Under the predecessor method

In consolidating S1, S2 eliminates its investment of $20 million against S1's share capital of $10 million and retained earnings of $2 million. The difference of $8 million is written off against the consolidated reserves of S2.

From the perspective of P as the ultimate parent of the group, there is no change in control. In consolidating the sub-group of S2, P will reverse the $8 million written off to S2's reserves and the gain on sale of $10 million in P's separate financial statements.

From the perspective of S2 as the receiving entity, there is a net decrease of reserves of $8 million in the sub-group's consolidated financial statements. Goodwill and the intangible assets are not recognised. The implicit assumption is that the acquisition of S1 by S2 does not create economic value for the receiving entity. This assumption may not be valid if the restructuring process creates synergies between S1 and S2. Non-controlling interests in S2 would not be able to assess the impact of the acquisition of S1 under the predecessor method.

Under the acquisition method of IFRS 3

In consolidating S1, S2 would eliminate the investment of $20 million against S1's share capital of $10 million and retained earnings of $2 million. The fair value of intangible assets of $1 million and deferred tax liability of $0.2 million are also recognised by S2 as the acquirer. The remaining difference of $7.2 million is recognised as goodwill.

From the perspective of P as the ultimate parent, the consolidated financial statements should not be changed as there is no loss of control. P eliminates the gain of sale of $10 million and the fair value of intangible asset of $1 million, the deferred tax liability of $0.2 million and goodwill of $7.2 million. The retained earnings of $2 million of S1 are also reinstated.

From the perspective of S2 as the receiving entity, the sub-consolidation should recognise the profits of S1 only from acquisition date. Non-controlling interests of S2 would be able to assess the impact of S1 on the financial performance of S2. When the restructuring event impacts the synergies between S1 and S2, the acquisition method reflects the economics of the transaction on the consolidated financial statements of the receiving entity.

Pearl Tan is Associate Professor of Accounting (Education), Singapore Management University (SMU); Lim Chu Yeong is Senior Lecturer of Accounting, Nanyang Business School, Nanyang Technological University, and Tracey Zhang is Assistant Professor of Accounting (Education), SMU.
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[1] This is also the view expressed by IASB. June 2020. “In Brief: Combinations of businesses under common control – one size does not fit all”. Project update by Gary Kabureck.

[2] This theory is attributed to Nobel Laureate Ronald Coase in his paper, “The Nature of the Firm”. *Economica* 4(16) 386-405, 1937.

[3] Refer to examples in the Staff Paper, Agenda Paper 23 (October 2017). IASB.

[4] IASB. January 2008. IFRS 3 *Business Combinations* paragraph B46.

[5] IAS 12 *Income Taxes*, paragraph 19.