Accounting View of Business Combinations under Common Control

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Abstract: *Combinations of the entities or business that are controlled by the same entity, both before and after the combination and this control is not transitory, are business combinations under common control. Business combinations under common control are excluded from the scope of IFRS 3 Business Combinations (2008), as amended. These transactions are not regulated by any other standard, and therefore the receiving company must establish its own accounting policy. The practice has shown that these transactions are approached differently, either by applying the acquisition method in accordance with IFRS 3 (2008) or by applying the book-value method. The IASB is currently leading a project focusing on business combinations under common control.*

Keywords: *business combinations under common control, IFRS 3 (2008), financial statements, acquistion method, book-value method*

JEL codes: M40, M41

1 Introduction

Application IFRSs (SUBAČIENĖ, ALVER, BRŪNA, HLADIKA, MOKOŠOVÁ, MOLÍN. 2018. *Evaluation of Accounting Regulation Evolution in Selected Countries,* vol. 6, no. 1, pp. 139-175 online) adopted by European Union is regulated by Act.no. 431/2002 on accounting, as amended in the Slovak Republic. Selected accounting entities prepare their individual financial statements in accordance to IFRSs adopted by the European Union (§ 17a) and parent accounting units (§ 22), which prepare consolidated financial statements in accordance to IFRSs adopted by the European Union, too.

Merger and acquisition transactions known as business combinations under IFRSs and their accounting presentation are set out in IFRS 3 *Business Combinations* (2008), as amended (further only ˝IFRS 3 (2008)”). This standard regulates the areas associated to the financial reporting of a business combination: the definition of the business combination, the accounting method in the financial statements of the acquirer and the disclosure of information about the financial effects of the business combination. For each business combination according to IFRS 3 (2008), the acquirer must be identified.

The basic requirement for the application of IFRS 3 (2008) is identification of a business combination (IFRS 3.3). A business combination is a transaction or other event in which the acquirer obtains control of one or more businesses (acquiree (s)). The transactions sometimes referred to as ˝true mergers˝ or ˝mergers of equals” are also business combinations. It results from the definition of a business combination that the acquiring of control of a business or businesses of another entity is important for its identifying. An entity that acquires control of the acquiree is the acquirer. The standard contains provisions regarding the identification of the acquirer and provisions containing the definition of the business and its application (Appendix B).

The acquirer applies the acquisition method in its general purpose financial statements (in individual financial statements or consolidated financial statements), depending on the economic substance of the business combination. The acquirer recognises and measures the assets acquired and liabilities assumed of the acquiree and non-controlling interests (if any), recognises and measures goodwill or gain from a bargain purchase (if any) as acquisition date.

The basic condition for identifying a business combination under IFRS 3 (2008) is to meet the definition of a business combination. Transactions that do not meet the definition of a business combination are not within the scope of this standard. IFRS 3

(2008) also contains special provisions for transactions excluded from its scope (IFRS 3.2 – 3.2A). These transactions also include combinations of entities or business under the common control. We will refer to these transactions as business combinations under common control.

The aim of this paper is to explain the nature of business combinations under common control, to point out the problems associated to the accounting presentation of such business combinations and to state the objective and focus of the IASB project on business combinations under common control.

2 Methodology and Data

The subject of the research of the presented paper is combinations of entities or businesses which are controlled by the same party before and after the business combination and this control is not transitory. These business combinations are referred to as business combinations under common control.

From the historical development view of accounting for business combinations, it should be noted that business combinations under common control have always been excluded from the scope of the standards regulating business combinations in the past and are also excluded from the scope of IFRS 3 (2008) in the present.

In 2007, a project focused on these transactions was by IASB opened and subsequently closed. In 2014, the IASB began to address this issue again, and in 2016, a project focusing on business combinations under common control was confirmed on the active research agenda. In November 2020 discussion paper DP/2020/2 *Business combinations under common control* was issued. IASB accepts related comments by September 1st 2021.

The paper uses the characteristics while explaining the nature of business combinations under common control and presentation and analysis of the individual accounting approaches to them in practice. The paper also contains a presentation of the focus and objective of the Business combinations under common control project.

3 Results and Discussion

Combinations of entities or businesses under common control are excluded from the scope of IFRS 3 (2008). To this exception, IFRS 3 (2008) contains additional provisions regarding its application (Appendix B, B1-B4). Business combinations under common control are business combinations involving entities or businesses that are controlled by the same entity before and after the business combination and this control is not transitory.

3. 1 Accounting view of business combinations under common control

In the issued discussion paper, the IASB defined the participated parties in a business combination under common control. While assessing this transaction, it is important to identify the controlling party, the acquiring company, the transferring company, and the transferred company (IFRS Foundation, Discussion Paper, Business Combinations under Common Control, Appendix A, 2020, p. 74-75).

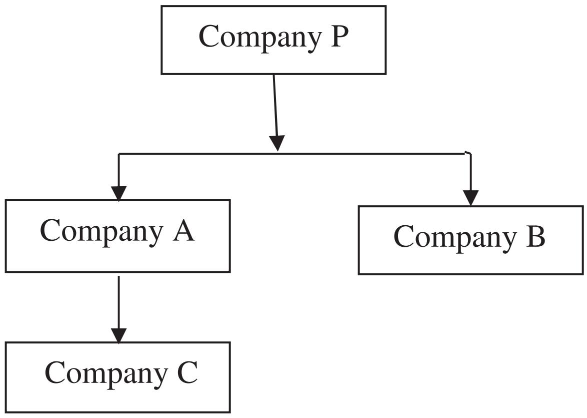
Controlling party is the party or parties that control all the combining companies both before and after the business combination under common control. From the point of view of the controlling party, nothing changes during the transaction.

Receiving company is the company to which control of a company (or business) is transferred in a business combination under common control. A new situation arises for the acquiring company, acquiring control of the company (or business), which it did not have before.

Transferring company is the company that loses control of one or more companies or businesses) in a business combination under common control. Transferred company is the company (or business) that is transferred from one company to another in a business combination under common control.

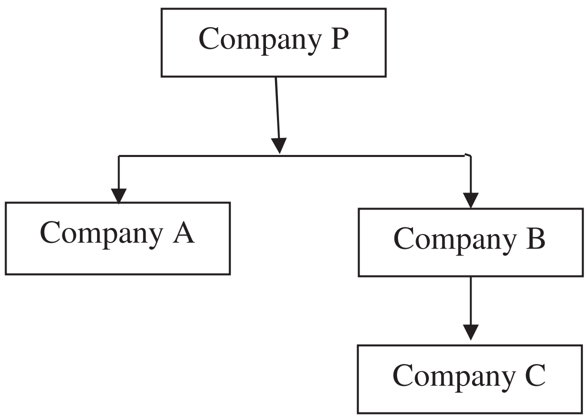
Business combination under common control is illustrated by the IASB on the following simple example (IFRS Foundation, Discussion Paper B*usiness Combinations under Common Control,* 2020, p.5) in which we can see situation before and after business combination:

Situation before business combination:



Before business combination is company P ultimately controlling company (party). The company P has control in the companies A, B, C. The company P has direct control in the company A and in the company B. At the same has company P indirect control through company A in the company C.

Situation after business combination:



After business combination is still company P ultimately controlling company. The company P controls direct companies A, B and indirect through company B controls company C. The company P is controlling party before and after business combination.

The company A becomes a transferring company, which transfers company C to company B. The company B is a receiving company, and the company C is the transferred company. Company B, as the acquiring company, must account for a combination with

Company C. This transaction is excluded from the scope of IFRS 3 (2008) and is not a regulated by any other standard.

In such a situation, Company B needs to prepare its own accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The application of its own accounting policy should result in accounting information that is relevant and reliable in accordance to IAS 8 (IAS 8.10-8.11).

Resources for developing such an accounting policy should be the requirements of other IFRSs that deal with similar issues and definitions, reporting criteria assets, liabilities, revenues, and expenses measurement concepts, as set out in the Conceptual Framework for Financial Reporting.

In practice, a diversified approach to the accounting treatment of these transactions has proved (Gary Kabureck, In Brief, Combinations of businesses under common control, 2020, p.3). Some prepares have applied the acquisition method in the financial reporting of these transactions and some have applied the book-value method.

At the acquisition method in accordance to IFRS 3 (2008), the assets acquired, and liabilities assumed are measured at fair values. In cases where the acquisition method was used, accounting entities argued that most, if not all, business combinations under common control are like business combinations within the scope of IFRS 3 (2008). From the point of the acquiring company view (not from the point of the controlling party view), this is a transfer of control of the transferred company to the acquiring company. Acquisition method according to this approach is appropriate for the accounting solution of these transactions.

In other cases, the book-value method was used, which was applied in different ways (the pooling of interests method or merger accounting). At the book-value method, the assets acquired and liabilities assumed are measured at carrying amounts, determined by applying IFRS Standards. In these cases, accounting entities have argued that all business combinations under common control are different from business combinations within the scope of IFRS 3 (2008). According to this approach, there is only a transfer of economic resources in a group from one location to another, and therefore the book-value method is appropriate.

Different approach to similar transactions results users of the information from the financial statements of the acquiring company (non-controlling shareholders, potential investors, banks, other creditors) do not obtain information about the financial effect of the business combination under common control on the acquiring company. The application of different accounting approaches also makes it difficult to compare financial statements.

3. 2 IASB project focused on business combinations under common control

The objective of project focused on business combinations under common control is to set out the requirements for the presentation of these business combinations in the general purpose financial statements of the acquiring company (usually consolidated financial statements, in some cases other types of financial statements are possible). The IASB effort is to make sure information from the financial statements of acquiring companies about business combinations under common control are relevant and comparable. The aim is also to reduce the diversity in the financial reporting of these transactions in practice and to make their financial reporting transparent. It is important that primary users of this information, referring only to publicly available information, obtain useful information.

In November 2020, the IASB issued a discussion paper (DP/2020/2) *Business combination under Common Control*. The IASB will accept comments related to this paper by 1 September 2021.

The discussion paper contains 5 parts: the objective, scope and focus of the project, the selecting the measurement method, the applying of the acquisition method, the applying of the book-value method and disclosure requirements. The discussion paper presents the IASB's preliminary view of this issue and the questions for respondents (total 12 questions). The IASB's view expressed in the discussion paper may change based on respondent's comments.

According to the discussion paper, the IASB is preliminary considering the use of two methods for this type of transaction, the acquisition method or the book-value method. The IASB's research has shown that neither the acquisition method nor the book-value method can be applied to all business combinations under common control, simply one method is just not sufficient. The basic (objective) criterion for choosing an accounting method should be to assess whether the business combination under common control affects the non-controlling interests of the acquiring company. In a discussion paper, the IASB clarifies the principle for an acquiring company to apply the acquisition method under IFRS (2008) to business combinations under common control and how to apply the book-value method to business combinations under common control.

Conclusion

The problems associated to the accounting presentation of business combinations under common control are related to the fact that they are excluded from the scope of IFRS 3 (2008) and their accounting solution is not regulated by any other standard. The acquiring accounting entity (acquiring company) prepares its financial statements in accordance to IFRSs and shall apply its own accounting policy accordance to IAS 8. This results in similar transactions accounted for in different ways in practice, either by applying the acquisition method in accordance with IFRS 3 (2008) or by applying the book-value method. It is difficult for users of information from financial statements to understand how a business combination under common control affects the accounting entity and the comparability of financial statements is impaired.

The IASB is currently leading a project focusing on business combinations under common control. The objective of the project is to set out the requirements for the financial reporting of business combinations under common control in the financial statements of the acquiring accounting entity (acquiring company). In November 2020, the IASB published a discussion paper on a business combination under common control, presenting a preliminary view on the accounting treatment of these transactions. Related comments can be sent until 1 September 2021. The IASB's view is preliminary and can by change. The discussion paper deals with the following areas: the selection of the measurement methods, how to apply each measurement method and the disclosure of information about these combinations.

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