Grant Thornton
An instinct for growth™

MFRS Hot Topics

Common control business combinations

AUGUST 2016

Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This publication will provide guidance on how should a business combination involving entities under common control be accounted for.

Guidance

Business combinations involving entities under common control are outside the scope of MFRS 3 Business Combinations (MFRS 3.2(c)), and there is no other specific MFRS guidance. Accordingly, management should use its judgement to develop an accounting policy that is relevant and reliable, in accordance with Paragraphs 10 to 12 of MFRS 108 Accounting Policies, Changes in Accounting Estimates and Errors.

In our view, the most relevant and reliable accounting policies are:
- a predecessor value method (including a pooling of interests-type method and merger accounting); or
- the acquisition method in accordance with MFRS 3.

Contents

1 Guidance
3 Discussion
4 Example

Predecessor value method

Under a predecessor value method, the acquirer accounts for the combination as follows:

- the assets and liabilities of the acquiree are recorded at book value, not fair value (although adjustments should be recorded to achieve uniform accounting policies)
- intangible assets and contingent liabilities are recognised only to the extent that they were recognised by the acquiree in accordance with applicable MFRS (in particular, MFRS 138 Intangible Assets)
- no goodwill is recorded. The difference between the acquirer's cost of investment and the acquiree's equity is presented as a separate reserve within equity on consolidation
- any non-controlling interest is measured as a proportionate share of the book values of the related assets and liabilities (as adjusted to achieve uniform accounting policies)
- any expenses of the combination are written off immediately in the income statement
- comparative amounts are restated as if the combination had taken place at the beginning of the earliest comparative period presented.

Some commentators also consider that:

- the comparative periods should also be restated only to the later of the beginning of the earliest comparative period and the date on which the combining entities first came under common control, or
- the comparatives should not be restated and the results of the acquiree are recognised only from the date of the combination, and
- the acquiree's book values to be used in the consolidation are those from the perspective of the controlling party rather than the amounts in the acquiree's separate financial statements.

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

Acquisition method in accordance with MFRS 3

Although common control combinations are outside the scope of MFRS 3, we consider MFRS 3's principles can be applied by analogy. If an entity adopts this policy, MFRS 3's principles should be applied in full. This includes identification of the correct acquirer. As a general indication, if one of the pre-combination entities has significantly greater net assets or revenues than the other, the larger entity is probably the acquirer for MFRS 3 purposes. In a common control combination, the acquirer for MFRS 3 purposes is often not the legal acquirer.

When the IFRS acquirer is not the legal acquirer, the principles of reverse acquisition accounting should be applied - see MFRS 3.B19-B27 and MFRS 3.IE1-IE15. When the legal acquirer is a new entity, 'shell' or near-dormant entity, and the other combining entity is the MFRS 3 acquirer, the effect of reverse acquisition accounting is very similar to a pooling-type method.

This Hot Topic does not discuss the requirements of MFRS 3 in detail.

Discussion

Common control combinations

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

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

Common control combinations are widespread. Examples include:

- combinations between subsidiaries of the same parent
- the acquisition of a business from an entity in the same group
- some transactions involving the insertion of a new parent company at the top of a group. (Some commentators would not regard a transaction in which a new parent company is added by means of a 'shell' company issuing shares to the existing shareholders as a business combination at all. This is because there is no substantive change in the reporting entity or its assets and liabilities.

MFRS 3.B1 specifies that to qualify as a common control transaction, common control is not transitory. This means that the same party should have the ultimate control over the combining entities both before and after the business combination. Judgement is required to assess whether the common control is transitory or not. The conclusion that common control is transitory may lead to the inclusion of the business combination in the scope of MFRS 3 so that it may be accounted for using the acquisition method rather than an alternative method. For example, an acquirer and vendor might structure a transaction such that for a brief period before and after the combination, the entity to be acquired/sold is under common control. This transaction would fall within the scope of MFRS 3, because common control is transitory. However, common control should not be considered transitory simply because a combination is carried out in contemplation of an initial public offering or sale of the combining entities.

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

Predecessor value method

Some form of predecessor value method is widely accepted in accounting for common control combinations under MFRS. A carryover basis method (using historical cost from a parent entity perspective, where applicable) is prescribed under US GAAP. Merger accounting is permitted under UK GAAP. We consider that these approaches are therefore available through application of MFRS 108.12. This allows management to consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework in developing an accounting policy (where MFRS has no specific requirements).

Under a predecessor value method, the comparative periods are commonly restated as if the combination had taken place at the beginning of the earliest comparative period presented. However, alternative methods are seen in practice (see guidance section above).

Acquisition method in accordance with MFRS 3

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

- identification of an **acquirer**
- determination of the **acquisition date**
- recognition and measurement of the identifiable assets (including **intangible assets** that are either separable and/or arise from contractual or legal rights and fair value is reliably measurable) acquired and the liabilities assumed at the **acquisition-date fair value** (with few exceptions)
- any non-controlling interest in the acquiree is measured either at **fair value** or at the non-controlling interest's **proportionate share** of the acquiree's identifiable assets
- recognition as of the acquisition date of the fair value of a **contingent liability** assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably
- recognition and measurement of **goodwill** or **a gain from a bargain purchase**, measured as the difference between the consideration transferred and the net acquisition-date amounts of identifiable assets acquired and liabilities assumed (and value of non-controlling interest, if applicable)
- no restatement of **comparatives**

In any business combination it is important to identify an acquirer for accounting purposes in order to determine which entity prepares consolidated financial statements for the combined group and so accounts for the business combination in those financial statements (MFRS 3.6-7, MFRS 3.B13-18).

In common control transactions, the 'accounting acquirer' is often not the 'legal acquirer'. Determination of the correct acquirer involves identifying the entity that has, in substance, obtained control of the acquiree (MFRS 3.7).

MFRS 3 refers to the guidance in MFRS 10 in determining control.

MFRS 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 (MFRS 10.6). Thus, an investor controls an investee if and only if the investor has all the following:

- power over the investee
- exposure, or rights, to variable returns
- ability to use power to affect returns (MFRS 10.7).

In addition, if after applying the guidance above, it is still not clear which of the combining entities is the acquirer, MFRS 3.B14-B18 provides factors that should be considered in making such determination. In an arm's length situation where equity interests are exchanged, the factors that will assist in identifying the acquirer include:

- the acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of voting rights in the combined entity (MFRS 3.B15(a))
- if there is a large minority voting interest in the combined entity and no other owner or organised group of owners has a significant voting interest, the acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity (MFRS 3.B15(b))
- the acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity (MFRS 3.B15(c))
- the acquirer is usually the combining entity whose former management dominates the management of the combined entity (MFRS 3.B15(d)) and
- the acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining equity or entities (MFRS 3.B15(e)).

These factors may not be generally relevant in a common control situation (since the same party controls the combining entities both before and after). Hence other indicators should be used, including:

- the relative sizes of the combining entities
- the combining entity who initiated the combination, together with the relative size of the combining entities.

MFRS 3 is also explicit in stating that a new entity formed to effect a business combination is not necessarily the acquirer. In this situation, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in MFRS 3.B13-B17 (MFRS 3.B18). *In our view,* **any** newly formed (or previously dormant) entity used to effect a combination is unlikely to be the acquirer. A new ultimate parent entity added to an existing group is therefore unlikely to be the MFRS 3 acquirer. The effect of identifying the new ultimate parent entity as the acquirer would be to 'step-up' the reported values of the assets and liabilities of the existing group, including recognition of internally generated goodwill and other intangibles. This is inconsistent with the requirements of MFRS 138.

Example

The following example illustrates the application of a predecessor value method.

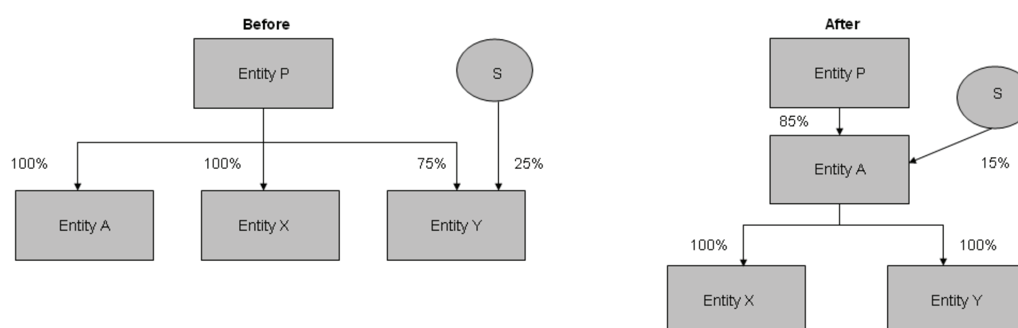
Entity P has three subsidiaries, Entities X, Y and A. Entity P acquired 100% of Entity X for CU18,000 many years ago. Entity's X's accumulated profits at that time were CU5,000. Entity P recorded goodwill of CU3,000 and fair value of identifiable assets acquired of CU15,000. The goodwill continues to be carried at CU3,000.

Entity P formed Entity Y with another investor, Shareholder S, also many years ago. Entity P's cost of investment in Entity Y was CU15,000, being 75% of Y's share capital.

On 1 Jan 20X0, Entity P formed Entity A with a share capital subscription of CU10,000.

On 31 Dec 20X1, Entity A acquired Entity P's and Shareholder S's shareholdings in X and Y. The consideration was 7,000 and 3,000 of Entity A's shares with issue value of CU1 each to Entity P and Shareholder S, respectively. Entity X and Entity Y have financial year ends of 31 December.

The 'before' and 'after' structures are:



The income statements of Entities A, X and Y for the year ended 31 Dec 20X1 are:

	Entity A CU	Entity X CU	Entity Y CU
Revenue	2,000	40,000	50,000
Profit (loss)	(4,000)	20,000	20,000

The statements of financial position of Entities A, X and Y at 31 Dec 20X1 are:

	Entity A (before issue of shares) CU	Entity A (after issue of shares) CU	Entity X CU	Entity Y CU
Investment in subsidiaries	-	223,000	-	-
Other assets	5,000	5,000	100,000	120,000
Net assets	**5,000**	**228,000**	**100,000**	**120,000**
Capital (including share premium)	10,000	233,000	10,000	20,000
Accumulated profits (losses)	(5,000)	(5,000)	90,000	100,000
	5,000	**228,000**	**100,000**	**120,000**

*The 10,000 new shares issued by Entity A as consideration are recorded at a value equal to the deemed cost of acquiring Entity X and Entity Y (CU223,000). The deemed cost of acquiring Entity X is CU103,000, being the existing book values of net assets of Entity X as at 31 Dec 20X1 (CU100,000) plus remaining goodwill arising on the acquisition of Entity X by Entity P (CU3,000). The deemed cost of acquiring Entity Y is CU120,000, being the existing book values of net assets of Entity Y as at 31 Dec 20X1.

The income statements of Entities A, X and Y for the year ended 31 Dec 20X0 are:

	Entity A CU	Entity X CU	Entity Y CU
Revenue	1,000	38,000	45,000
Profit (loss)	**(2,000)**	**15,000**	**12,000**

The statements of financial position of Entities A, X and Y at 31 Dec 20X0 are:

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

Analysis
As Entity A, Entity X and Entity Y are under the common control of Entity P before and after the business combination, the business combination is scoped out of MFRS 3. Entity A's accounting policy for common control business combinations is to apply a pooling-of-interests type method. In applying this method, A also adopts a 'controlling party perspective'. The assets and liabilities of X and Y are therefore consolidated in the financial statements of A using the book values as stated in the consolidated financial statements of Entity P. This requires recognition of the remaining goodwill on the original acquisition of Entity X by Entity P and non-controlling interests in Entity Y, as stated in the consolidated financial statements of Entity P. There is no recognition of any additional goodwill. (If A does not adopt a controlling party perspective, the remaining goodwill on the original acquisition of X by P would not be recognised by A.)

The consolidated income statement of Entity A for the year ended 31 Dec 20X1 is:

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

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

The consolidated statement of financial position of Entity A as at 31 Dec 20X1 is:

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

Adjustments
Relating to Entity X:
(X1) Adjustment to record goodwill arising on the original acquisition of Entity X by Entity P as stated in the consolidated financial statements of Entity P immediately prior to the combination (CU3,000).
(X2) Adjustment to eliminate the accumulated profits of Entity X prior to the original acquisition of Entity X by Entity P (CU5,000).
(X3) Adjustment to eliminate the share capital of Entity X against the related investment cost of Entity A. An adjustment of CU85,000 is made to a separate reserve in the consolidated financial statements of Entity A.

Relating to Entity Y:
(Y4) Adjustment to reflect the profits attributable to the non-controlling interest in Entity Y prior to the combination.
(Y5) Adjustment to eliminate the share capital of Entity Y against the related investment cost of Entity A. An adjustment of CU75,000 is made to a separate reserve in the consolidated financial statements of Entity A.

The consolidated income statement of Entity A for the year ended 31 Dec 20X0 is:

	Entity A CU	Entity X CU	Entity Y CU	Adjustments CU Adj	Consolidated CU
Revenue	1,000	38,000	45,000		84,000
Profit (loss)	**(2,000)**	**15,000**	**12,000**		**25,000**
Attributable to the former NCI				3,000 (Y1)	(3,000)
Attributable to the equity holders of A					22,000

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

The consolidated statement of financial position of Entity A as at 31 Dec 20X0 is:

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

Note: The comparative figures are restated as if the entities had been combined at the previous reporting date. The consolidated share capital represents the share capital of Entity A adjusted for the share capital issued for the purposes of the business combination.

Adjustments:

1. Adjustment to push back the capital issued for the purposes of the business combination (CU193,000 of which CU103,000 relates to X and CU90,000 to Y). The aim of the consolidated financial statements in a pooling-type method is to show the combining entities' results and financial positions as if they had always been combined. Consequently, the 7,000 shares issued for the purposes of the business combination are presented as if they had always been in issue.

Relating to Entity X:
(X1) Adjustment to record remaining goodwill that arose on the original acquisition of Entity X by Entity P (as stated in the consolidated financial statements of Entity P immediately prior to the combination (CU3,000)).
(X2) Adjustment to eliminate the accumulated profits of Entity X earned prior to the original acquisition of Entity X by Entity P (CU5,000).
(X3) Adjustment to eliminate the share capital of Entity X against the related cost of investment in Entity A. An adjustment of CU85,000 is made to a separate reserve in the consolidated financial statements of Entity A.

Relating to Entity Y:
(Y4) Adjustment to eliminate the share capital of Entity Y against the cost of investment in Entity A. Prior to the business combination, Entity P had a 75% equity interest in Entity Y. Non-controlling interest of CU25,000 is therefore recognised as at 31.12.20X0. An adjustment of CU75,000 is made to a separate reserve (within equity).

KUALA LUMPUR

Levels 11,15 & 8
Sheraton Imperial Court
Jalan Sultan Ismail
50250 Kuala Lumpur

T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

PENANG

51-8-A,
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang

T +604 228 7828
F +604 227 9828

JOHOR BAHRU

Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor

T +607 223 11848
F +607 224 9848

KUANTAN

A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang

T +609 515 6124
F +609 515 6126

© 2016 Grant Thornton International Ltd. All rights reserved. "Grant Thornton" refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. SJ Grant Thornton is a member firm of Grant Thornton International Ltd (GTIL). GTIL and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.

www.grantthornton.com.my