



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

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## Agenda Item 4

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**Date:** June 4, 2010  
**Memo to:** Members of the IPSASB  
**From:** Annette Davis  
**Subject:** Entity Combinations

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### Objective of this Session

- To **review** and **provide** feedback on the Staff analysis of entity combinations in the public sector.

### Agenda Material

- 4.1 Memo: Entity Combinations under Common Control
- 4.2 Draft Exposure Draft (ED) 4X, “Transfers of Operations: Entity Combinations under Common Control”
- 4.3 Memo: Entity Combinations Not under Common Control: Reorganizations and Acquisitions
- 4.4 Project Brief
- 4.5 UK ASB FRS 6, “Acquisitions and Mergers”
- 4.6 Minutes from Previous Meetings

### Introduction

1. At earlier stages of this project, the Board had split entity combinations between exchange and non-exchange entity combinations so that a limited convergence project with IFRS 3, “Business Combinations” could be undertaken. However, at its April 2010 meeting, the Board considered that this distinction cannot be clearly articulated and so agreed to reconsider entity combinations.
2. The purpose of this session is to obtain feedback on the Staff’s analysis of entity combinations in the public sector. This memo defines “entity combination” and “operation,” and explains the structure of the public sector.

### Definitions

3. The IPSASB approved the Project Brief for the Entity Combinations project in March 2007. The phrase “entity combinations” is derived from the IASB’s definition of a business combination from IFRS 3, “Business Combinations” issued in March 2004. The IPSASB agreed that the term “entity” should replace “business” because the public sector primarily undertakes activities for

- community or social benefit, rather than for a commercial return. This means that most combinations will involve non-cash-generating operations. Only occasionally are there combinations involving cash-generating operations.
4. The definition of a business combination in the March 2004 version of IFRS 3 is:  

“The bringing together of separate entities or businesses into one reporting entity.”<sup>1</sup>
  5. The IASB subsequently issued a revised version of IFRS 3 in January 2008 which included a new definition of business combination, as follows:  

“A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as ‘true mergers’ or ‘mergers of equals’ are also business combinations as that term is used in the IFRS.”
  6. The change in the definition from the 2004 version of IFRS 3 to the 2008 version of that Standard has narrowed the meaning of the term “business combination.” For users of IFRSs this means that an entity combination is only considered to be an acquisition, where an acquirer gains control of an acquiree.
  7. However, for the purposes of this Paper, it is the wider notion of bringing together separate entities into one reporting entity that this project wishes to address, because the majority of the transactions or events that are entity combinations in the public sector will not be acquisitions. Hence, the term “entity combination” means:  

**“The bringing together of separate entities or operations into one reporting entity.”**
  8. In IFRS 3, an acquirer acquires a business. At its February 2009 meeting, the Staff had proposed to differentiate between the acquisition of a business (a cash-generating activity) and the acquisition of a function (a non-cash-generating activity). The Board agreed that this differentiation was unnecessary and considered that the term “business” should be replaced with “operation”, with the meaning being based on the definition of business. Thus, operation is defined as follows:  

**“An operation is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of achieving an entity’s objectives, either by providing economic benefits or service potential.”**
  9. For ease of reference, set out below are the IPSASB’s definitions of control, controlled entity, controlling entity, and economic entity.

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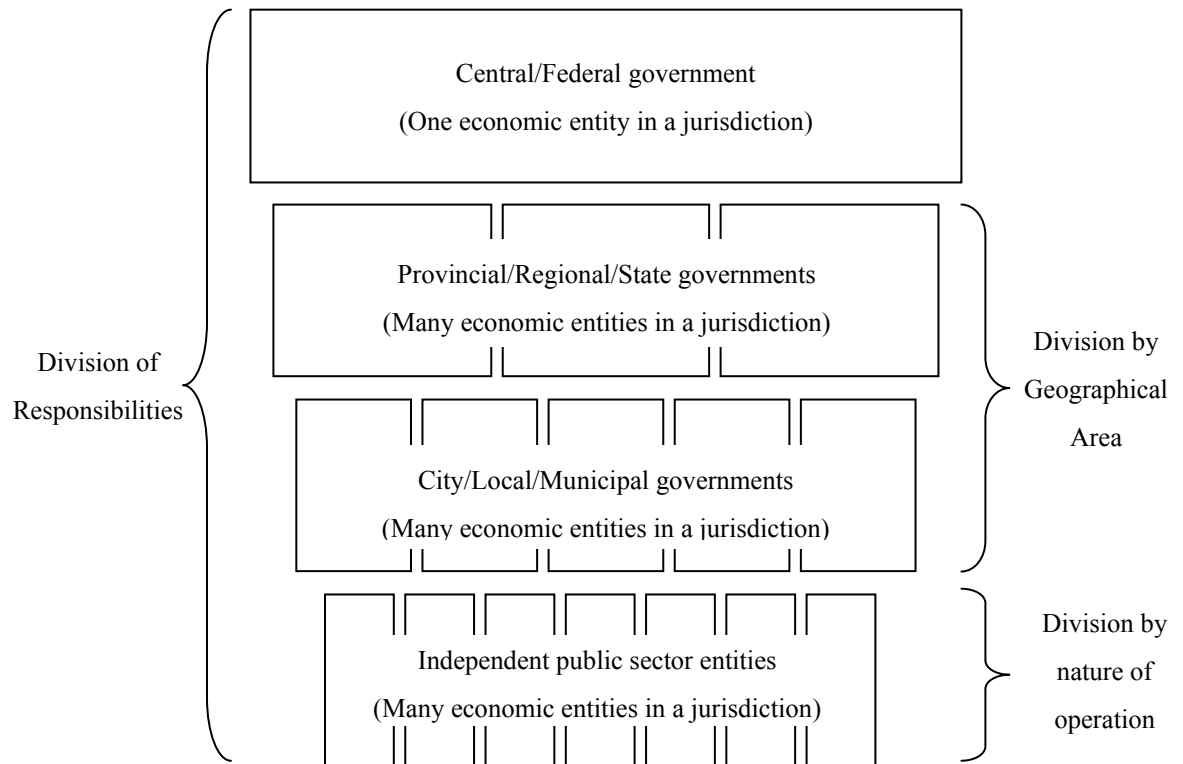
<sup>1</sup> IFRS 3 (March 2004), Appendix A.

<b>Term</b>	<b>Definition</b>	<b>Location</b>
<b>control</b>	The power to govern the financial and operating policies of another entity so as to benefit from its activities.	2.8
<b>controlled entity</b>	An entity, including an unincorporated entity such as a partnership, which is under the control of another entity (known as the controlling entity).	6.7
<b>controlling entity</b>	An entity that has one or more controlled entities.	6.7
<b>economic entity</b>	A group of entities comprising a controlling entity and one or more controlled entities.	1.7

### Overview of the Structure of the Public Sector

10. Before considering specific types of entity combinations in the public sector, this section “sets the scene” by giving an overview of the structure of the public sector. Governments and other public sector entities raise resources from taxpayers, ratepayers and other resource providers for use in the provision of services to citizens and other service recipients. Which level of government or other public sector entity provides the service is determined by jurisdiction. Generally, the allocation of responsibilities to different levels of government and other public sector entities is set out in a jurisdiction’s constitution or legislative framework.
11. Following are factors that are dependent on jurisdiction:
  - (a) The number of levels of government;
  - (b) The allocation of responsibilities and the resulting activities; and
  - (c) Whether or not there are intra-government transfers.
12. The diagram below illustrates the potential structure of the public sector in a jurisdiction.

**Diagram: All Public Sector Entities in a Jurisdiction**



13. The diagram highlights that a Central or Federal government is one economic entity within a jurisdiction. However, it may comprise many entities in order to fulfill its responsibilities.
14. Where a jurisdiction has a State level of government, there will be more than one economic entity in the jurisdiction. Each State government will have the same responsibilities within that jurisdiction, but these responsibilities will be limited by geographical boundaries.
15. Local government has a similar structure to State government in that a jurisdiction will have a number of economic entities that comprise local government and each will be responsible for a specific geographical area. The responsibilities of local government may be set out in a jurisdiction's constitution or be the responsibility of the relevant State government.
16. In most jurisdictions there will also be public sector entities that are independent of any level of government in that jurisdiction. These entities have usually been created by legislation to fulfill a specific area of responsibility.
17. Set out below are examples of different levels of government and the allocation of responsibilities.

### Example of Different Levels of Government

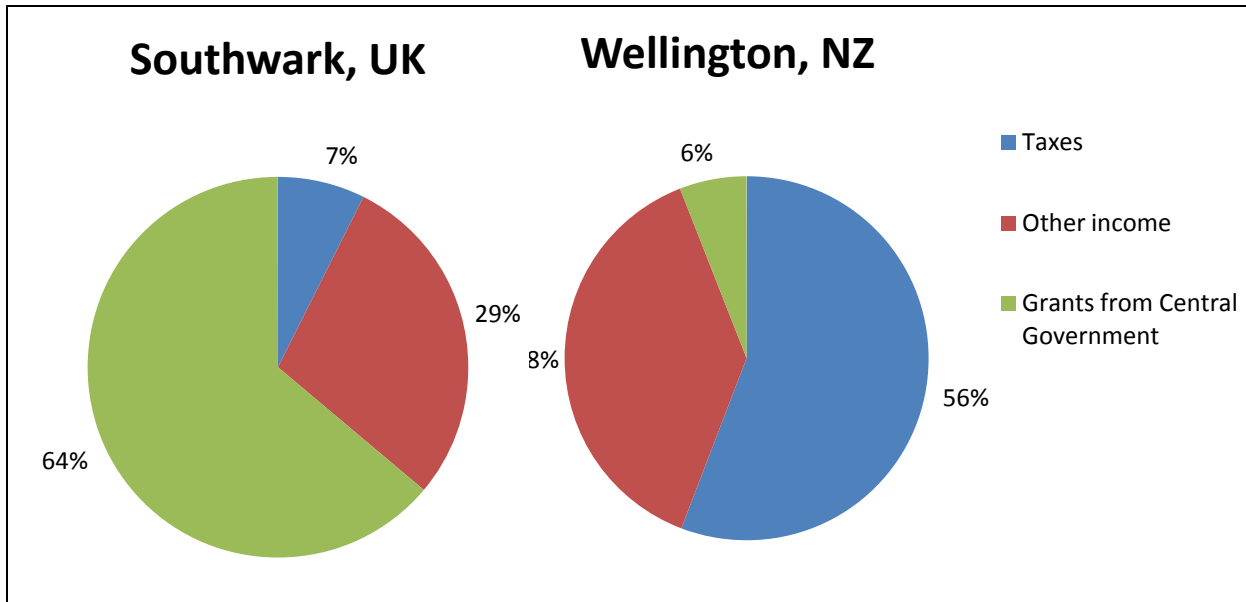
18. The table below sets out the relative sizes of each government sub-sector within the overall General Government Sector (GGS) for five European countries, calculated by output. Output is composed of production costs, i.e., wages, non-capital procurement, and depreciation. It has been used as an indicator of government activity rather than expenditure because expenditure includes intra-government transfers.

2009 Output %	France	Germany	Italy	Netherlands	UK
Central	42.9%	18.9%	45.5%	32.3%	57.8%
State	-	40.0%	-	-	-
Local	34.9%	32.5%	52.2%	64.0%	42.2%
Social security funds	22.2%	8.6%	2.3%	3.7%	-
<b>General Government Sector</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

19. The table highlights that where a country has a federal structure, the federal government is generally of a smaller size as the state government fulfills those responsibilities, e.g., Germany. Where social security funds are not shown separately, they are included in the central government output.
20. The General Government Sector (GGS) comes from the statistical sector. It comprises government controlled entities primarily engaged in nonmarket activities and can be described as comprising those entities that fulfill the core functions of government as their primary activity. The GGS does not include public corporations, even when all the equity of such corporations is owned by the government or government entities. This is where GGS differs from financial reporting as consolidated financial statements, such as Whole of Government Accounts (WGA), which are required by IPSAS 6 to include the controlling entity and all its controlled entities in the consolidated financial statements of the economic entity. For statistical purposes, public corporations are government controlled entities, e.g., that trade in goods and services or financial services such as banks.

### Example of Different Allocation of Responsibilities

21. Other differences in the types of government structure can be found in the allocation of responsibilities. So, comparing two countries which have similar structures, i.e., with a central and local government structure, the responsibilities can be distributed differently. For example, comparing one council in New Zealand and one in the United Kingdom, the pie charts below set out how their revenue is derived.



22. Southwark receives 64% of its revenue from government grants to provide education, housing and adult social care. Wellington only receives 6% of its revenue from government grants as the responsibility for education, most housing and adult social care lies with the central government. Three-quarters of the government grant Wellington received is for the maintenance of local roads, with the other quarter for upgrading housing stock.

### Overview of Proposed Approach to Entity Combinations in the Public Sector

23. Staff has divided the types of entity combinations occurring in the public sector into two categories so that it is easier to assess the specific issues related to each category. The categories are:
- (a) Entity combinations under common control (AP 4.1 and 4.2); and
  - (b) Entity combinations not under common control: reorganizations and acquisitions (AP 4.3); and
24. Appendix 1 has a table showing how these categories relate to entity combinations in the public sector. Further details for each of these categories are included in separate agenda papers.

### Proposed Work Plan for the Entity Combinations Project

25. Appendix 2 is a proposed schedule for the entity combinations project. It has been split into the above two categories and includes proposed revisions to IPSAS 6, "Consolidated and Separate Financial Statements," IPSAS 7, "Investments in Associates," and IPSAS 8, "Interests in Joint Ventures." The proposed start date of the revisions to IPSAS 6–8 is influenced both by possible decisions from the entity combinations project having an effect on the existing requirements of these standards and from the IASB's expected completion dates of revisions to its standards in this area.

**Appendix 1: Overview of Entity Combinations in the Public Sector**

<b>Recipient / Acquirer</b>	<b>Type of control</b>	<b>Entities involved in combination</b>	<b>Termed</b>	<b>Comments</b>
Public Sector controlling entity, other than GBE	Under common control		Transfers of Operations	<ul style="list-style-type: none"> <li>• Agenda Paper 4.1 Memo</li> <li>• Agenda Paper 4.2 Draft ED</li> <li>• Staff proposal to use “reconstruction” accounting, i.e., the recipient recognizes the existing net assets of the transferee at carrying amount</li> </ul>
	Not under common control	Public sector	Reorganizations	<ul style="list-style-type: none"> <li>• Agenda Paper 4.3 Issues</li> </ul>
		Public and private sector	Acquisitions	<ul style="list-style-type: none"> <li>• Agenda Paper 4.3 Issues</li> </ul>
GBE				<ul style="list-style-type: none"> <li>• Apply IFRS 3 “Business Combinations”</li> </ul>

## Appendix 2: Entity Combinations Schedule 2010–2012

	April 2010	June 2010	Nov 2010	Mar 2011	June 2011	Sept 2011	Dec 2011	March 2012	Jun 2012	Sep 2012	Dec 2012	First Half 2013	Second Half 2013
Entity Combinations under Common Control: Transfers of Operations	DI / ED <i>discuss</i>		ED <i>approve</i>	RR	IPSAS <i>discuss</i>	IPSAS <i>approve</i>							
Entity Combinations Not under Common Control: Reorganizations and Acquisitions	DI	CP <i>discuss</i>	CP <i>approve</i>		RR	ED <i>discuss</i>	ED <i>approve</i>		RR	RR	IPSAS <i>discuss</i>	IPSAS <i>approve</i>	
Revision of IPSAS 6, “Consolidated and Separate Financial Statements” <sup>2</sup>						DI	ED <i>discuss</i>	ED <i>approve</i>		RR	RR	IPSAS <i>discuss</i>	IPSAS <i>approve</i>
Revision of IPSAS 7, “Investments in Associates” <sup>3</sup>						DI	ED <i>discuss</i>	ED <i>approve</i>		RR	RR	IPSAS <i>discuss</i>	IPSAS <i>approve</i>
Revision of IPSAS 8, “Interests in Joint Ventures” <sup>4</sup>						DI	ED <i>discuss</i>	ED <i>approve</i>		RR	RR	IPSAS <i>discuss</i>	IPSAS <i>approve</i>

Key: ED Exposure Draft, DI Discussion of Issues, RR Review of Responses, CP Consultation Paper, IPSAS Final Standard

### Assumptions

1. The revision of IPSASs 6–8 needs to be informed by the review of responses to the Consultation Paper, “Entity Combinations Not under Common Control.” This is why the commencement of the revision is delayed until September 2011.
2. The timeline for the CP assumes a consultation period of four months. If a six month consultation period is adopted the timeline will move out by one meeting.

<sup>2</sup> The IASB has a project to issue a single IFRS on consolidation replacing the IAS 27, “Consolidated and Separate Financial Statements” and the interpretation SIC-12, “Consolidation – Special Purpose Entities.” It is expected to be issued in Quarter 4, 2010. IPSAS 6 is based upon the December 2003 version of IAS 27. There was a subsequent revision to IAS 27 issued in January 2008, and, subsequent to that, further consequential amendments from revisions to other IFRSs.

<sup>3</sup> IPSAS 7 is based upon the December 2003 version of IAS 28, “Investments in Associates.” There have been further consequential amendments from revisions to other IFRSs.

<sup>4</sup> The IASB has a project to improve the accounting and reporting of joint arrangements, which includes joint operations, joint assets and joint ventures. A new IFRS will replace IAS 31, “Interests in Joint Ventures.” It is expected to be issued in June 2010. IPSAS 8 is based upon the December 2003 version of IAS 31. There have been further consequential amendments from revisions to other IFRSs.



## ENTITY COMBINATIONS UNDER COMMON CONTROL

### Objective of this Session

- To **review** the Staff analysis of entity combinations under common control.
- To **approve** the next steps for this component of the project.

### Introduction

1. The purpose of this Paper is to set out examples of transactions or events which are considered to be entity combinations under common control and to consider an appropriate accounting treatment. Other Papers will consider entity combinations not under common control.

### Background

2. At the IPSASB meeting in February 2009, the Board expressed the following views regarding entity combinations arising from non-exchange transactions and under common control:
  - (a) That the measurement basis for the recipient in an entity combination from a non-exchange transaction under common control should be at carrying amount. And that the difference arising from a non-exchange entity combination under common control is a contribution from owners or a distribution to owners, as the combination is undertaken within the economic entity as a whole.
  - (b) That the parties to the entity combination are more appropriately described as “recipient,” “transferee,” and “transferor” instead of “acquirer,” “acquire,” and “former owner,” respectively.
3. Extracts of the minutes from meetings where this project has been discussed are in Agenda Paper 4.6.

### Entity Combinations under Common Control

#### The Meaning of Common Control

4. IPSAS 6, “Consolidated and Separate Financial Statements” defines control as “the power to govern the financial and operating policies of another entity so as to benefit from its activities.” IPSAS 6 includes guidance on how to determine whether control for financial reporting purposes exists and explains that regulatory power does not constitute control for the purposes of financial reporting.
5. The IPSASB does not have a definition or description of an entity combination under common control. IFRS 3 describes this type of combination as “a business combination in which all of the combining entities or businesses are ultimately

controlled by the same party or parties both before and after the entity combination, and that control is not transitory”.

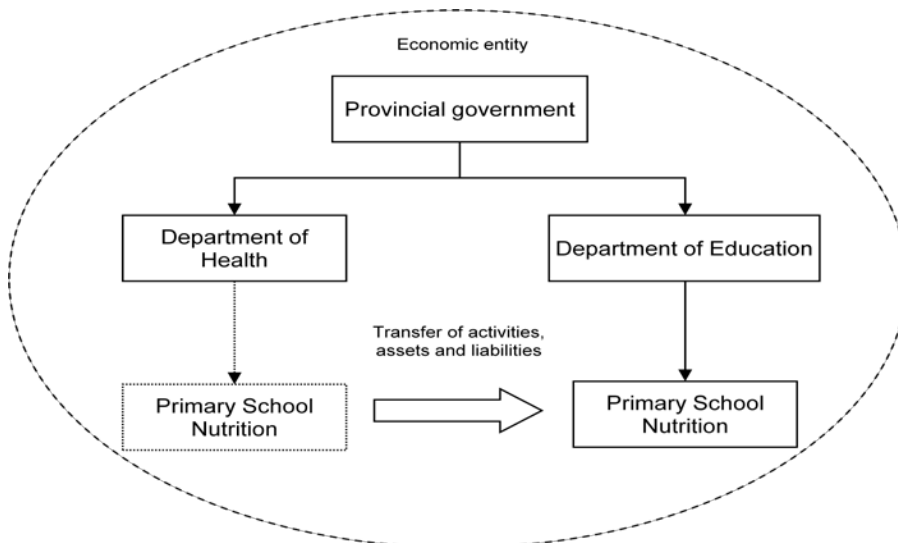
6. Given that the IPSASB’s definition of control is similar to that of the IASB’s definition, it appears that the description of an entity combination under common control could be:

**“An entity combination in which all of the combining entities or operations are ultimately controlled by the same party or parties both before and after the entity combination, and that control is not transitory.”**

7. Because the entity combination is occurring under common control, i.e., within an economic entity, Staff proposes to call this type of entity combination a “transfer of operations.”

#### Example 1: Entity Combination under Common Control using Existing Entities

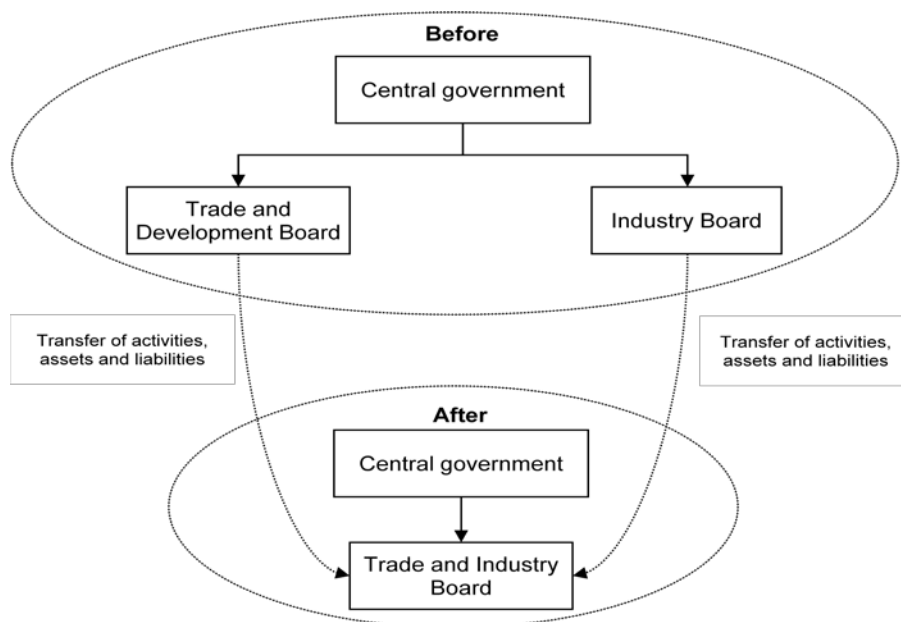
8. A Provincial government restructures by transferring its Primary School Nutrition Program from the Department of Health to the Department of Education. Because the ultimate controlling entity is the Provincial government, this is a combination under common control. The Department of Health is the transferor and the Department of Education is the recipient.



#### Example 2: Entity Combination under Common Control using a New Entity

9. A Central government restructures by closing down the Trade and Development Board and the Industry Board, both of which are separate government entities and transferring the operations, assets and liabilities to a newly created government entity, the Trade and Industry Board. Because the ultimate controlling entity is the Central government, this is a combination under common control. The Trade

and Development Board and the Industry Board are the transferors and the Trade and Industry Board is the recipient.



### Importance of having Guidance for these Types of Combinations

10. Transfers of operations are prevalent in the public sector as governments and public sector entities undertake reorganizations and reconstructions to increase the efficiency and effectiveness of the services they provide. However, limited guidance exists on how to account for transfers of operations.

### International Guidance on this Topic

11. IFRS 3 excludes from its scope combinations of entities or businesses under common control. The IASB has an item “Common Control Transactions” on the Research and Other Projects section of its Work Plan. The project will 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. The project will also consider the accounting for demergers, such as the spin-off of a subsidiary or business. This project is currently deferred and is unlikely to be placed on the active agenda for some time.

### National Guidance on this Topic

12. Some NSS have guidance on transactions or other events in which two or more businesses combine and before the combination took place these businesses were not under common control. Merger accounting or the pooling of interests method is usually required for these types of combinations. This guidance is sometimes applied to the restructuring of entities or businesses within a group (economic entity), i.e., entities under common control. In the private sector, the focus of information for users is centred on the financial performance and financial

position of the entire group (economic entity) and so guidance on accounting for combinations within the group has not received much attention from an accounting standard-setting viewpoint. The UK Accounting Standards Board (ASB) has guidance on this topic: FRS 6, “Acquisitions and Mergers.” It is reproduced at Agenda Item 4.5.

### Importance of Guidance on this Topic for the IPSASB

13. IPSAS 6 includes requirements as to when a controlling entity need not present consolidated financial statements, set out below.

16. **A controlling entity need not present consolidated financial statements if and only if:**
- (a) **The controlling entity is:**
    - (i) **Itself a wholly-owned controlled entity, and users of such financial statements are unlikely to exist or their information needs are met by its controlling entity’s consolidated financial statements; or**
    - (ii) **A partially-owned controlled entity of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the controlling entity not presenting consolidated financial statements;**
  - (b) **The controlling entity’s debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);**
  - (c) **The controlling entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and**
  - (d) **The ultimate or any intermediate controlling entity of the controlling entity produces consolidated financial statements available for public use that comply with IPSASs.**

14. The exemption from producing consolidated financial statements in IPSAS 6 is only available if certain conditions are met. An intermediate controlling entity will not be able to use this exemption unless it does not have users of its financial statements. An intermediate controlling entity, such as a Department of Justice within a central government, represents one of the key activities of a government. The users of its financial statements are unlikely to have their information needs met solely by the consolidated financial statements at the whole of government level. Thus, this information need of users for intermediate entity consolidated financial statements of public sector entities differs from the information need of users of private sector entities consolidated financial statements.
15. Because there are many intermediate controlling entities in the public sector which are required to produce consolidated financial statements, guidance is required on how to account for transfers of operations within the economic entity. Set out below is a proposed accounting treatment for such combinations.

### **Proposed Accounting Treatment**

16. Both Example 1 and Example 2 above, illustrate different types of transfers of operations within an economic entity. The difference between Example 1 and Example 2 is that, in Example 1, the transfer of the operation is to a recipient that is an existing entity. In Example 2, the Central government creates a new entity to be the recipient entity. There does not appear to be any difference of economic substance between using an existing entity or creating a new entity because the structure relates to the form of a transaction rather than the substance of it.
17. At both its February 2009 and June 2008 meetings, the Board held the preliminary view that the measurement basis for an entity combination under common control from a non-exchange transaction should be the carrying amount of the assets and liabilities recognized by the transferor. The rationale for this accounting treatment is that no combination has taken place external to the economic entity and thus any requirement for remeasurement does not appear appropriate.
18. The Board also held the preliminary view that the difference arising on this type of combination is a contribution from owners or a distribution to owners as it is the ultimate controlling entity that determines the restructuring.
19. Staff considers that the Board's decision at its April 2010 meeting to remove the distinction between a combination that is an exchange transaction or a non-exchange transaction will not affect the Board's preliminary decision on the accounting treatment of an entity combination under common control. However, where consideration is transferred, it will affect the amount recognized in net assets/equity as a contribution from owners or a distribution to owners. Because the combination has taken place within an economic entity, Staff does not consider that this is an issue.

### **Other Issues**

20. Staff considers that one of the issues arising from these two examples is whether any unrecognised assets or liabilities, such as an internally-generated intangible asset, e.g., software, should be recognised by the recipient entity. On consideration, recognition of unrecognized assets or liabilities would not seem to be necessary because the combination takes place within the same economic entity, i.e., under common control.
21. Another issue arising from the two examples is whether or not the comparative amounts should be restated. Existing NSS guidance on transactions or other events in which two or more businesses combine and before the combination occurred these businesses were not under common control usually requires that the comparative amounts are restated as if the combined entity had always been combined. A rationale for the restatement of comparative amounts is that it is the joint history of the entities that will be relevant to the combined group's shareholders (owners).

22. A difference between a transfer of operations and two or more businesses combining is that a transfer of operations involves entities under common control. Thus, in the ultimate controlling entity's consolidated financial statements, the comparative amounts remain the same. In the intermediate controlling entity's consolidated financial statements a user needs to know that a transfer of operations has occurred, but there does not appear to be any information value in restating comparative amounts given that the ultimate controlling entity's consolidated financial statements comparative amounts remain the same. Thus, Staff considers that the restatement of comparative amounts is not necessary.

#### Potential Consequences of the Proposed Accounting Treatment on Other IPSASs

23. The IPSASB currently does not have any guidance on entity combinations. The Staff does not consider that the proposed treatment for transfers of operations will alter any recognition and measurement requirements in other IPSASs.

#### Summary of Proposed Accounting Treatment

24. Set out below is a table which summarizes the accounting treatment of a transfer of operations, i.e., an entity combination under common control, for the recipient entity, in its consolidated financial statements.

Recipient Entity	
Recognition:	Existing assets and liabilities
Measurement:	At carrying amount
Difference arising:	Contribution from owners (distribution to owners)
Comparatives:	Not restated

**Does the Board agree that the accounting treatment for the recipient in a transfer of operations, set out in summary form above, is appropriate?**

#### Next Steps

25. To progress this component of the entity combinations project in a timely manner, and because the Board appears to be in agreement on the accounting treatment, the Staff has presented a draft Exposure Draft in Agenda Paper 4.2 for the Board's consideration.

## **(ED 4X)—TRANSFERS OF OPERATIONS: ENTITY COMBINATIONS UNDER COMMON CONTROL**

### **Objective**

1. The objective of this Standard is to establish principles and requirements for transfers of operations, specifically how the recipient:
  - (a) Recognizes and measures in its financial statements the assets acquired, the liabilities assumed and any minority interest in the transferee; and
  - (b) Recognizes and measures the contribution from owners in the combination or a distribution to owners; and
  - (c) Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of transfers of operations.

**Comment [ad1]:** Based on IFRS 3.1.

### **Scope**

2. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard to a transaction or other event that meets the definition of a transfer of operations. This Standard does not apply to:**
  - (a) **A combination of entities or operations that are not under common control.**
  - (b) **The formation of a joint venture.**
  - (c) **The transfer of an asset or a group of assets that does not constitute an operation. In such cases the recipient shall identify and recognize the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in IPSAS 31, “Intangible Assets”) and liabilities assumed. The cost of the group of assets shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase.**
3. **This Standard applies to all public sector entities other than Government Business Enterprises.**
4. The “Preface to International Public Sector Accounting Standards” issued by the IPSASB explains that Government Business Enterprises (GBEs) apply IFRSs issued by the IASB. GBEs are defined in IPSAS 1, “Presentation of Financial Statements.”
5. This Standard establishes requirements for the accounting by the recipient of a transfer of operations. Although GBEs are not required to comply with this Standard in their own financial statements, the provisions of this Standard will apply where a public sector entity that is not a GBE is the recipient in a transfer of operations where the transferee is a GBE.

**Comment [ad2]:** Based on IFRS 3.2 and the standard wording in IPSAS regarding the application of IPSAS by public sector entities that apply accrual accounting.

**Comment [ad3]:** Standard GBE wording.

**Comment [ad4]:** Standard GBE wording.

**Comment [ad5]:** Based on IPSAS 6.6.

## Definitions

6. The following terms are used in this Standard with the meanings specified:

An **operation** is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of achieving an entity's objectives, either by providing economic benefits or service **potential**.

A **recipient** is the entity that obtains control of the **transferee**.

The **transfer date** is the date on which the recipient obtains control of the **transferee**.

A **transfer of operations** is a transaction or other event where all of the combining entities or operations are ultimately controlled by the same party or parties both before and after the entity combination and that control is not **transitory**.

A **transferee** is the operation or operations that the recipient obtains control of in a transfer of **operations**.

A **transferor** is the entity that relinquishes control of the transferee.

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the Glossary of Defined Terms published separately.

**Comment [ad6]:** Based on IFRS definition of a business.

**Comment [ad7]:** Based on IFRS definition of an acquirer.

**Comment [ad8]:** Based on IFRS definition of acquisition date.

**Comment [ad9]:** Based on IFRS 3.B1 description of a combination under common control.

**Comment [ad10]:** Based on IFRS definition of an acquiree.

## Identifying a Transfer of Operations

7. An entity shall determine whether a transaction or other event is a transfer of operations by applying the definition in this Standard, which requires that:

- (a) The assets acquired and liabilities assumed constitute an operation. If the assets acquired are not an operation, the reporting entity shall account for the transaction or other event as an asset **acquisition**; and
- (b) The entities or operations involved in the transfer of operations are ultimately controlled by the same party or parties both before and after the entity combination and that control is not transitory.

**Comment [ad11]:** Based on IFRS 3.3.

8. A transfer of operations may be structured in a variety of ways for legislative, policy or other purposes, which include, but are not limited to:

- (a) The transfer of ownership in an operation or a controlled entity from one entity within the economic entity to another entity within the economic entity;
- (b) The addition of a new controlling entity to an economic entity; or
- (c) All of the combining entities transfer their operations to a new intermediate controlling entity within the economic entity.

**Comment [A12]:** Based on IFRS 3.B6 and IFRS 6.2.

## The Reconstruction Method

9. An entity shall account for each transfer of operations by applying the reconstruction **method**.

**Comment [ad13]:** Based on IFRS 3.4.



10. Applying the reconstruction method requires:
- (a) Identifying the recipient;
  - (b) Determining the transfer date;
  - (c) Recognizing and measuring the assets acquired, the liabilities assumed and any minority interest in the transferee; and
  - (d) Recognizing and measuring the contribution from owners or distribution to owners.

Comment [ad14]: Based on IFRS 3.5.

#### Identifying the Recipient

11. For each transfer of operations, one of the combining entities shall be identified as the recipient.
12. The guidance in IPSAS 6, “Consolidated and Separate Financial Statements” shall be used to identify the recipient—the entity that obtains control of the transferee. If transfer of operations has occurred but applying the guidance in IPSAS 6 does not clearly indicate which of the combining entities is the recipient, the factors in paragraph 13 below shall be considered in making that determination.
13. The terms and conditions of a transfer of operations undertaken by a recipient and transferor are usually set out in a binding arrangement. This arrangement may be evidenced in a number of ways and may encompass a formal written agreement between the entities, legislation passed in parliament or a provincial legislature, cabinet decision, ministerial order, a decision made by a municipal council, regulation or a notice or other official means. These are collectively referred to as a binding arrangement. The binding arrangement usually sets out which party is the transferor(s), and which party is the recipient. Where the binding arrangement does not clearly identify the recipient or the transferor, the behaviour or actions of the entities may indicate which entity is the recipient and which entity is the transferor. Additional evidence may be that an entity no longer receives funding to carry out certain activities.

Comment [ad15]: Based on IFRS 3.6.

Comment [ad16]: Based on IFRS 3.7.

Comment [ad17]: Based on SthA draft ED Transfer of Functions, .14 and .15.

#### Determining the Transfer Date

14. The recipient shall identify the transfer date, which is the date on which it obtains control of the transferee.
15. The date on which the recipient obtains control of the transferee is generally the date on which the recipient receives the assets and assumes the liabilities of the transferee, and the legally transfers the consideration, if any—the closing date. However, the recipient might obtain control on a date that is either earlier or later than the closing date. For example, the assets and liabilities are received by the recipient before it obtains control of those assets, the transfer date is the date on which the recipient obtains control. A recipient shall consider all pertinent facts and circumstances in identifying the transfer date.

Comment [ad18]: Based on IFRS 3.8.

Comment [ad19]: Based on IFRS 3.9.

**Recognizing, Measuring, and Presenting the Assets Received, the Liabilities Assumed and any Minority Interest in the Transferee**

*Recognition Principle*

16. As of the transfer date, the recipient shall recognize the assets received, the liabilities assumed and any minority interest in the transferee.

Comment [ad20]: Based on IFRS 3.10.

*Recognition Conditions*

17. To qualify for recognition as part of applying the reconstruction method, the assets received and liabilities assumed must meet the definitions of assets and liabilities in IPSAS 1, "Presentation of Financial Statements" at the transfer date. For example, costs the recipient expects but is not obliged to incur in the future to effect its plan to exit an activity of a transferee or to terminate the employment of or relocate a transferee's employees are not liabilities at the transfer date. Therefore, the recipient does not recognize those costs as part of applying the reconstruction method. Instead, the recipient recognizes those costs in its post-combination financial statements in accordance with other IPSASs.
18. In addition, to qualify for recognition as part of applying the reconstruction method, the assets acquired and liabilities assumed must be part of what the recipient and the transferee (or the transferor) exchanged in the transfer of operations transaction rather than the result of separate transactions. The recipient shall apply the guidance in paragraphs 26 and 27 to determine which assets acquired or liabilities assumed are part of the exchange for the transferee and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable IPSASs.

Comment [ad21]: Based on IFRS 3.11.

Comment [ad22]: Based on IFRS 3.12.

*Measurement Principle*

19. The recipient shall measure the assets received and the liabilities assumed at their transfer date carrying amounts. If the transferee uses accounting policies other than those adopted by the recipient, appropriate adjustments are made to the transferee's assets and liabilities.
20. The recipient shall measure any minority interest in the transferee at the minority interest's proportionate share of the transferee's net assets.

Comment [ad23]: Based on FRS 6.16.

Comment [ad24]: Based on IPSAS 6.50.

Comment [A25]: Based on IFRS 3.19.

*Presentation*

21. Comparative amounts shall not be restated.

**Recognizing and Measuring Contributions from Owners or Distributions to Owners**

22. The recipient shall recognize the difference between the consideration transferred, if any, and the net of the transfer date carrying amounts of the assets received and liabilities assumed, as a contribution from owners.

Comment [ad26]: Based on FRS6.18.

*Distribution to Owners*

23. Occasionally, a recipient will make a distribution to owners, which is a transfer of operations where the carrying amount of the liabilities assumed is greater than the carrying amount of the assets received. The recipient shall recognize the resulting debit as a distribution to owners.

*Consideration Transferred (if Any)*

24. Any consideration transferred in a transfer of operations shall be measured at carrying amount at the transfer date. Examples of potential forms of consideration include cash, other assets, an operation or a controlled entity of the recipient, etc.
25. Any contingent consideration is not recognized as it would contradict paragraph 19 regarding the measurement of assets received and liabilities assumed at their transfer date carrying amounts.

Comment [ad27]: Based on IFRS 3.37.

**Determining What is Part of the Transfer of Operations Transaction**

26. **The recipient and the transferee may have a pre-existing relationship or other arrangement before arrangement for the transfer of operations began, or they may enter into an arrangement in the interim that is separate from the transfer of operations. In either situation, the recipient shall identify any amounts that are not part of what the recipient and the transferee (or the transferor) exchanged in the transfer of operations, i.e., amounts that are not part of the exchange for the transferee. The recipient shall recognize as part of applying the reconstruction method only the consideration transferred for the transferee, if any, and the assets received and liabilities assumed in the exchange for the transferee. Separate transactions shall be accounted for in accordance with the relevant IPSASs.**
27. A transaction entered into by or on behalf of the recipient or primarily for the benefit of the recipient or the combined entity, rather than primarily for the benefit of the transferee (or the transferor) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the reconstruction method:
- (a) A transaction that in effect settles pre-existing relationships between the recipient and transferee;
  - (b) A transaction that remunerates employees or the transferor of the transferee for future services; and
  - (c) A transaction that reimburses the transferee or the transferor for paying the recipients reconstruction-related costs.

*Reconstruction-Related Costs*

28. Reconstruction-related costs are costs the recipient incurs to effect a transfer of operations. Those costs include advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of a

department which oversees the transfer of operations; and costs of registering and issuing debt and equity securities, if any. The recipient shall account for reconstruction-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with IPSAS 28, “Financial Instruments: Presentation” and IPSAS 29, “Financial Instruments: Recognition and Measurement.”

**Comment [ad28]:** Based on IFRS 3.53 and FRS 6.19.

## Disclosures

29. **The recipient shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a transfer of operations that occurs during the current reporting period.**

30. To meet the objective in paragraph 29, the recipient shall disclose the following information for each transfer of operations that occurs during the reporting period:

- (a) The names and descriptions of the combining entities or operations (other than the reporting entity).
- (b) The transfer date.
- (c) The primary reasons for the transfer of operations.
- (d) The transfer date amount of consideration transferred, if any.
- (e) The amounts of the principal components of the current reporting period’s statement of financial performance of the transferee.

**Comment [A29]:** Based on FRS 6.21(a).

**Comment [A30]:** Based on FRS 6.21(c).

**Comment [A31]:** Based on IFRS 3.B64(d).

**Comment [ad32]:** Based on IFRS 3.B64(f).

If disclosure of any of the information required by this subparagraph is impracticable, the recipient shall disclose that fact and explain why the disclosure is impracticable. This Standard uses the term “impracticable” with the same meaning as in IPSAS 3, “Accounting Policies, Changes in Accounting Estimates and Errors.”

**Comment [ad33]:** Based on IFRS 3.B64(q).

- (f) The carrying amounts recognized as of the transfer date for each major class of assets received and liabilities assumed.
- (g) The amount of the contribution from owners or distribution to owners and the line item in the net assets/equity in which it is recognized.
- (h) For transactions that are recognized separately from the receipt of assets and assumption of liabilities in the transfer of operations in accordance with paragraph 26:
  - (i) A description of each transaction;
  - (ii) How the recipient accounted for each transaction;
  - (iii) The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized; and

**Comment [ad34]:** Based on IFRS 3.B64(i) and FRS 6.22(d).

**Comment [ad35]:** Based on FRS 6.22(f).

- (i) If the transaction is the effective settlement of a pre-existing relationship, the method used to determine the settlement **amount**.

**Comment [ad36]:** Based on IFRS 3.B64(l).

31. The disclosure of separately recognized transactions required by (h) shall include the amount of reconstruction-related costs and, separately, the amount of those costs recognized as an expense and the line item or items in the statement of financial performance in which those expenses are recognized. The amount of any issue costs not recognized as an expense and how they were recognized shall also be **disclosed**.

**Comment [ad37]:** Based on IFRS 3.B64(m).

32. For individually immaterial transfers of operations occurring during the reporting period that are material collectively, the recipient shall disclose in aggregate the information required by paragraph 30(d)–(i).

**Comment [A38]:** Based on IFRS 3.B65.

33. If the transfer date of a transfer of operations is after the end of the reporting period but before the financial statements are authorized for issue, the recipient shall disclose the information required by paragraph 30 unless the initial accounting for the transfer of operations is incomplete at the time the financial statements are authorized for issue. In that situation, the recipient shall describe which disclosures could not be made and the reasons why they cannot be **made**.

**Comment [A39]:** Based on IFRS 3B66.

34. If the specific disclosures required by this and other IPSASs do not meet the objective set out in paragraph 29, the recipient shall disclose whatever additional information is necessary to meet that **objective**.

**Comment [A40]:** Based on IFRS 3.63.

### Effective date

35. **An entity shall apply this Standard for annual financial statements covering periods beginning on or after Month Day, Year. Earlier application is encouraged. If an entity applies this Standard for a period beginning before Month Day, Year, it shall disclose that **fact**.**

**Comment [ad41]:** Standard effective date paragraph.

36. When an entity adopts the accrual basis of accounting as defined by IPSASs for financial reporting purposes subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of **adoption**.

**Comment [ad42]:** Standard effective date paragraph.

### Transition

37. **An entity shall apply this Standard prospectively on first time application.**
38. **Assets and liabilities that arose from transfers of operations which transfer dates preceded the application of this Standard shall not be adjusted upon application of this Standard.**

**(ED 4X)—TRANSFERS OF OPERATIONS: ENTITY COMBINATIONS UNDER  
COMMON CONTROL**

**ILLUSTRATIVE EXAMPLES**

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	Paragraph
Identifying a Transfer of Operations within the Scope of this Standard .....	IE1–IE2
Disclosure Requirements .....	IE3

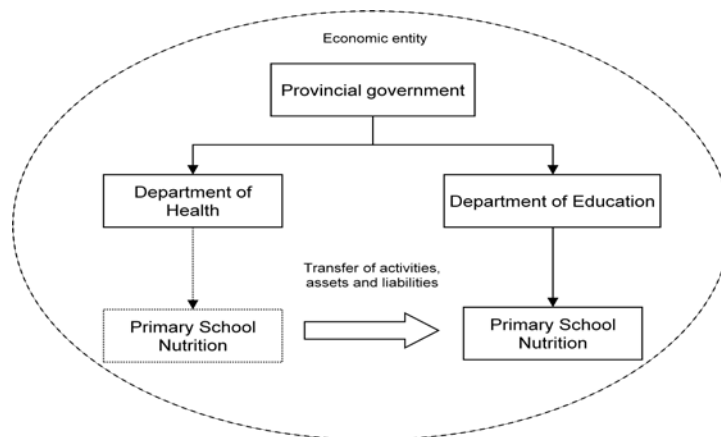
## Illustrative Examples

*These examples accompany, but are not part of, IPSAS XX (ED 4X).*

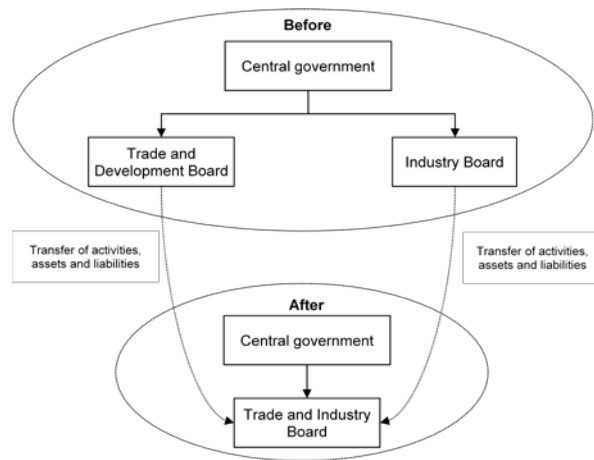
### Identifying a Transfer of Operations

*Illustrating an Entity Combination within the Scope of this Standard.*

- IE1. The following example illustrates one type of transfer of operations. A Provincial government restructures by transferring its Primary School Nutrition Program from the Department of Health to the Department of Education. Because the ultimate controlling entity is the Provincial government, this is a transfer of operations. The Department of Health is the transferor and the Department of Education is the recipient.



- IE2. The following example illustrates another form of transfer of operations. A Central government restructures by closing down the Trade and Development Board and the Industry Board, both of which are separate government entities and transferring the operations, assets and liabilities to a newly created government entity, the Trade and Industry Board. Because the ultimate controlling entity is the Central government, this is a transfer of operations. The Trade and Development Board and the Industry Board are the transferors and the Trade and Industry Board is the recipient.



### Disclosure Requirements

*Illustrating the consequences of applying the disclosure requirements in paragraph XX of IPSAS XX (ED 4X).*

IE3. The following example illustrates some of the disclosure requirements of IPSAS XX (ED 4X); it is not based on an actual transaction. The illustration presents the disclosures in a tabular format that refers to the specific disclosure requirements illustrated. An actual footnote might present many of the disclosures illustrated in a simple narrative format.

### Footnote X: Transfer of Operations

[To do]



## ENTITY COMBINATIONS NOT UNDER COMMON CONTROL: REORGANIZATIONS AND ACQUISITIONS

### Objective of this Session

- To **review** and **provide** feedback on the Staff analysis of entity combinations not under common control: reorganizations and acquisitions.

### Introduction

1. This purpose of this Paper is to set out examples of transactions or events which could be considered to be entity combinations not under common control. The examples have been divided into two categories:
  - (a) **Reorganizations**: where the nature and/or the size of the public sector in the jurisdiction where the entity combination is undertaken remains the same both before and after the combination takes place; and
  - (b) **Acquisitions**: where the nature and/or the size of the public sector changes as a result of the entity combination.

### Background

2. At the IPSASB meeting in February 2009, the Board expressed the following views regarding entity combinations arising from non-exchange transactions:
  - (a) That the parties to the entity combination are more appropriately described as “recipient” instead of “acquirer” and “transferee” instead of “acquiree.”
  - (b) That whether or not an entity combination mandated by, say, the central government and applying to local government entities, takes place between entities under common control is dependent upon the jurisdiction.
3. At the IPSASB meeting in June 2008, the Board expressed the following views regarding entity combinations arising from non-exchange transactions:
  - (a) That the difference arising from a non-exchange entity combination not under common control is likely to be revenue/expense because the combination is undertaken with an entity outside of the economic entity.
  - (b) That fresh start accounting may be appropriate for mergers.
4. At the June 2008 meeting, the IPSASB also expressed the view that the measurement basis for entity combinations arising from non-exchange transactions should be at carrying value, irrespective of whether the combination is under common control or not under common control. This view was acknowledged to be inconsistent with other IPSASs, such as IPSAS 23 “Revenue from Non-Exchange Transactions (Taxes and Transfers)”, where initial measurement is at fair value. This view was further discussed at the February 2009 meeting where the Board expressed the view that the practical decision taken in IPSAS 23 to require assets acquired from a non-exchange transaction to be measured at fair value on initial recognition should not limit the development

- of an accounting treatment for entity combinations from non-exchange transactions.
5. Extracts of the minutes from the meetings where this project has been discussed are in Agenda Paper 4.6.

## **Reorganizations**

### **Structure of the Public Sector**

6. Agenda Paper 4.0 explains how the public sector in a jurisdiction can be structured in different ways. For example, in some jurisdictions there are three levels of government, including federal or central government, regional, provincial or state government, and local government. In some jurisdictions there are only two levels of government, central and local. From time to time these responsibilities, activities, assets and liabilities are reorganized.
7. In some jurisdictions, each level of the public sector is autonomous and so control for financial reporting purposes does not typically exist, e.g., a Federal government does not usually “control” State governments. Further, within a jurisdiction, the individual State governments are autonomous of each other, each having the same responsibilities but limited to a specific geographical area. The structure of local governments is usually similar to that of state governments in that they have certain responsibilities which are limited to a specific geographical area. The different levels of government will have non-voluntary relationships between each other to ensure that services are not duplicated or that services are not inappropriately abandoned.
8. In contrast, the private sector is not usually divided into different levels. An economic entity (group) determines what its activities are, the geographical area in which it operates, and its legal structure, i.e., how many entities it uses to operate its activities. An economic entity (group) is not limited by the jurisdiction’s constitution or legislative framework, with the exception that entities must operate within the law of the jurisdiction. Thus, each private sector group (economic entity) is autonomous and there does not appear to be any non-voluntary relationship between groups.
9. Staff considers that the structure of the public sector, i.e., different levels of government which are autonomous and have specified responsibilities, is a unique difference from the private sector. This means that entity combinations undertaken to reorganize, restructure, or enforce public policy in the public sector need to be further analyzed to determine the appropriate accounting treatment.

### **Purpose of Reorganizations**

10. The goals of government are to provide public goods and services and to redistribute wealth for a variety of social and economic purposes. Governments undertake these activities using resources raised from taxpayers, ratepayers, and other resource providers. Reorganizations are generally undertaken to achieve a more effective distribution of responsibilities and associated activities within a jurisdiction. This includes changes to design and implement measures to enable

the delivery of higher and/or better public services or goods. These can be mandated, directed or forced onto a lower level of government by a higher level of government. For example, legislation is enacted by a Central government to reduce the number of local government entities, say councils, in order to improve services and reduce costs. Another example occurs where an entity loses its subsidy and therefore has to join with another entity.

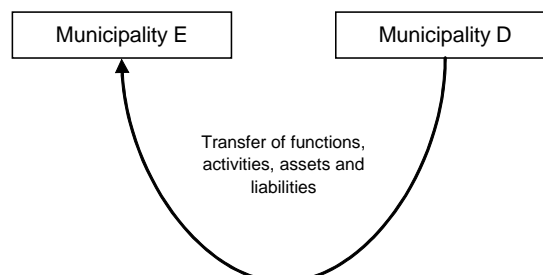
11. Reorganizations can also be voluntary, e.g., two local government entities see that a more effective service delivery can be obtained by combining together. Usually, in this situation, the proposal will have to be approved by a higher level of government.

### Forms of Reorganizations

12. Reorganizations may be described as a merger, union of districts or regions, an amalgamation or an administrative arrangement. They usually take the form of:
  - (a) An existing or newly established entity taking control of another entity or entities;
  - (b) An existing or newly established entity taking control of a part of another entity's or entities' activities; or
  - (c) Two or more entities combining to form a new entity.
13. This project was approved initially in 2007 and, at that stage, Board Members, Technical Advisors and Observers were asked to provide examples of types of entity combinations that take place in the public sector. The examples below are based on the examples provided.

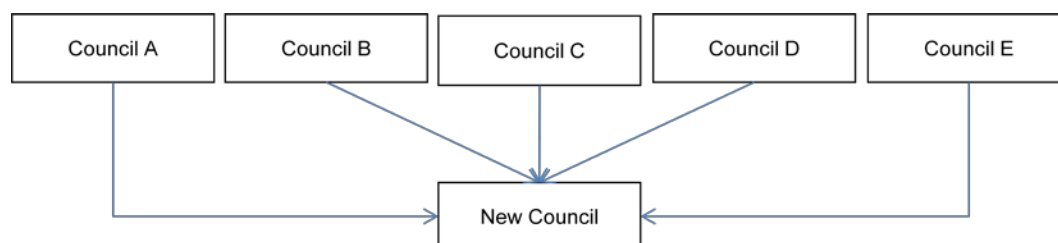
#### *Example 1: Transferring an Operation from one Entity to another Entity*

14. A Federal government creates legislation which mandates that the functions, related activities, assets and liabilities of Municipality D are annexed into the much larger Municipality E, (a neighboring municipality), without the consent of either of the municipalities or their inhabitants. The Federal government's policy reason for taking such action is to create economies of scale by ensuring that each municipality within its jurisdiction is of a certain size. Municipality D does not receive any consideration. In this jurisdiction, the local government is not controlled by the Federal government for financial reporting purposes. Thus, this combination is not under common control. It is a non-exchange transaction as there is no transfer of consideration. Municipality D is the transferee and Municipality E is the recipient.



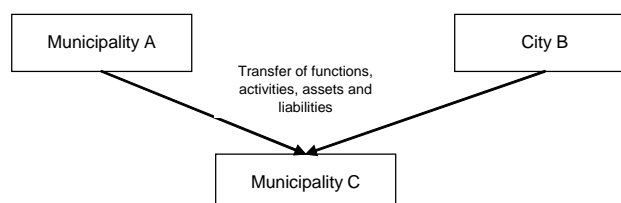
*Example 2: Creating a New Entity and Transferring Several Operations to it*

15. A Central government creates legislation which mandates that the five local government entities (Councils A, B, C, D, and E) in one geographical area (covering a city) must transfer all activities, assets and liabilities into a newly created local government entity, New Council, which is responsible for the entire geographical area. In this jurisdiction, the local government is not controlled by the Central government for financial reporting purposes. Thus, this combination is not under common control. Councils A–E are the transferees and New Council is the recipient.



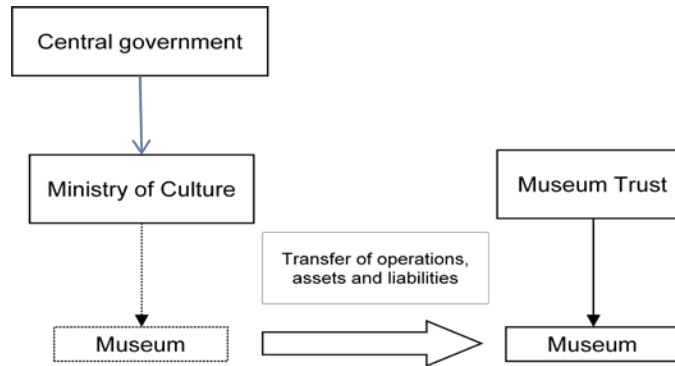
*Example 3: Creating a New Entity and Transferring Operations to it*

16. A Federal government creates legislation which mandates that two local government entities, Municipality A and City B must transfer all functions, activities, assets and liabilities into a newly created local government entity, Municipality C, for no consideration. Both entities are approximately equal in size. In this jurisdiction, the local government is not controlled by the Federal government for financial reporting purposes. Thus, this combination is not under common control. It is a non-exchange transaction as there is no transfer of consideration. Municipality A and City B are the transferees and Municipality C is the recipient.



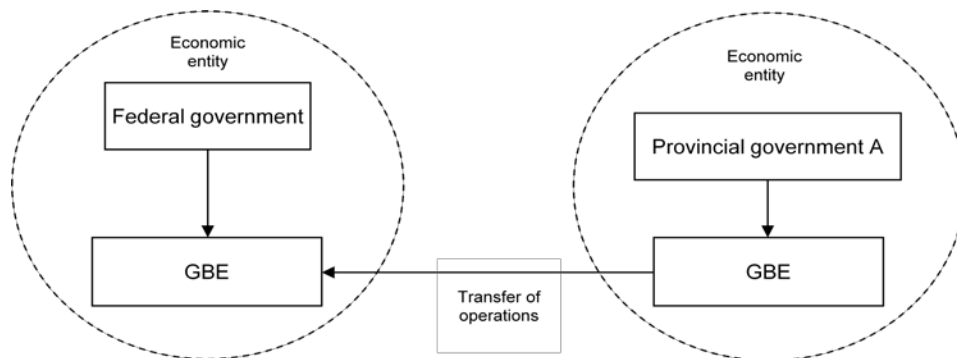
*Example 4: Creating a New Independent Entity and Transferring Operations to it*

17. A Central government transfers an operation, e.g., a Museum, from the Ministry of Culture to a newly created Museum Trust, which is independent of the Central government. The Ministry of Culture is the transferor and the Museum Trust is the recipient.



*Example 5: Acquiring another Public Sector Entity*

18. A Provincial government transfers a GBE to the Federal government.



*Analysis of the Examples*

19. One feature in common with Examples 1–5 is that the structure of the public sector within a jurisdiction has changed and responsibilities for certain operations has been transferred to another new or existing entity. However, these combinations have not changed the activities or size of the overall public sector in that jurisdiction.
20. Examples 1–5 all have a recipient entity, i.e., the entity that receives another entity, and a transferee, i.e., the entity that is transferred. This is the minimum number of entities which can meet the definition of an entity combination.
21. Examples 1–3 do not have a transferor, i.e., the entity which previously controlled the transferee as they are a type of reorganization within a level of government, in this case, local government. As each local government entity is autonomous, there is no transferor involved in the combinations. Examples 1–3 also illustrate that the entities involved in the combination can be of differing sizes.
22. Examples 4 and 5 have a transferor because the type of reorganization occurs across levels of government, Federal and Provincial, or by devolving responsibility to an independent public sector entity.

## **Alternative Accounting Treatments**

### *Objectives of Financial Reporting and User Needs*

23. The Consultation Paper, “Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities”, issued by the IPSASB in September 2008 considers that the objectives of financial reporting by public sector entities are to provide information about the reporting entity useful to users of GPFRs for:
  - (a) Accountability purposes; and
  - (b) For making resource allocation, political and social decisions.
24. Users need to be able to evaluate the nature and financial effect of an entity combination that occurs during the current reporting period. The recipient entity in a reorganization receives additional responsibilities and, operations, assets and liabilities associated with those responsibilities.
25. Items that need to be explored to determine the appropriate accounting treatment for the recipient in its consolidated financial statements are:
  - (a) The recognition of existing (i.e., only the assets and liabilities that the transferee has recognized) or all assets received and liabilities assumed.
  - (b) The measurement of the assets received and liabilities assumed, e.g., at carrying amount or at fair value.
  - (c) Where the recognition is for all assets received and liabilities assumed, does this recognition apply to the transferee only or to all the entities involved in the combination?
  - (d) Where the measurement of the assets received and liabilities assumed are at fair value, does this recognition apply to the transferee only, or to all the entities involved in the combination (fresh start accounting)?
  - (e) The treatment of the residual amount. Assuming that the recipient entity receives net assets, then the credit entry could be either a contribution from an owner or revenue (directly into the income statement or directly to net assets/equity).

### *The Transferee's Existing Assets and Liabilities at Carrying Amount*

26. At the June 2008 meeting, the Board took the preliminary view that the measurement basis for an entity combination arising from a non-exchange transaction not under common control should be carrying amount. The distinction between exchange and non-exchange combinations has been removed because a distinction between the two types of combinations could not be clearly identified. Most reorganizations will not include any consideration transferred as there is no transferor. For reorganizations with a transferor, consideration may be transferred dependent upon the terms of the transaction or other event creating the entity combination. Therefore, Staff considers that removing the exchange/non-exchange distinction does not have an effect on the Board’s preliminary view that

- the measurement basis for an entity combination not under common control should be carrying amount.
27. The structure and division of responsibilities of the public sector in a specific jurisdiction is a result of past decisions and events. This means that a responsibility, such as the delivery of state education, could be undertaken by a central government, a local government or a state government. Thus, reorganizations are in substance very similar to entity combinations under common control, i.e., transfers of operations. This reasoning is predicated on the nature and size of the public sector in the jurisdiction where a reorganization is undertaken remaining the same both before and after the reorganization takes place. Because the public sector remains the same but is organized differently, users need to have information as to the reasons for the reorganization and the entities affected, together with information about the responsibilities, assets and liabilities that the recipient has obtained. However, it does not appear necessary to identify assets and liabilities that the transferee did not recognize or to calculate the fair values of the net assets received because, overall the public sector has not changed in nature or size.
28. In Agenda Paper 4.1, Staff has called the accounting treatment in the recipient's consolidated financial statements the "reconstruction" method, i.e., recognizing the carrying amount of the transferee's existing assets and liabilities. This accounting treatment has been used in some jurisdictions for the restructuring of entities within an economic entity, i.e., entities under common control and is called merger accounting or the pooling of interests method. However, in the past, this accounting treatment has also been used for some for-profit private sector entities combinations where the combination was considered to be a uniting of interests. This method of accounting was removed from the IASB's business combinations standard in March 2004 upon the issue of IFRS 3, "Business Combinations" because finding suitable non-arbitrary and unambiguous criteria to distinguish between a "true merger" and an acquisition of another entity was not possible.

*The Transferee's Identifiable Assets and Liabilities at Fair Value*

29. An alternative accounting treatment could be for the recipient entity to recognize all identifiable assets and liabilities of the recipient at fair value. This accounting treatment is used in for-profit private sector entities to enable users to make a proper assessment of the effect of the combination. It is called the "acquisition" or "purchase" method. The use of this method allows users to determine whether or not management made the right decision to acquire the entity, and to assess the subsequent performance of that investment. The use of fair values in acquisition accounting in the for-profit private sector also helps users to make a better assessment of the cash-generating abilities of the identifiable net assets acquired<sup>1</sup>.

<sup>1</sup> IFRS 3 (January 2008), Basis for Conclusions, paragraph 203.



*All Entities Involved in the Combination's Assets and Liabilities at Fair Value*

30. Another alternative accounting treatment could be for all the entities involved in the combination to recognize assets and liabilities at fair value. This has been termed “fresh start” accounting. Some consider that where an acquirer cannot be identified with any clarity, fresh start accounting would be a superior method to use instead of the acquisition method.
31. In fresh start accounting, fair values are attributed to the assets and liabilities of all parties to the business combination. At the June 2008 meeting, the Board considered that it may be appropriate to use fresh start accounting for some types of mergers. One example of a situation where fresh start accounting could be more appropriate was cited, where approximately 2,700 entities were merged into one combined entity.
32. Staff is unaware of any jurisdiction that currently uses this accounting treatment. Therefore, it seems premature to consider this method of accounting until the concept is further developed. In particular, the development of robust criteria to determine which entity combinations would be required to use fresh start accounting, would be helpful.

*Accounting Treatment of the Difference Arising on a Reorganization*

33. At the June 2008 meeting, the Board also held the preliminary view that the difference arising on this type of entity combination is revenue/expense, as the entities to the combination are not under common control. This view is consistent with the Board’s preliminary view (in Agenda Paper 4.1) that any difference arising on a combination under common control is a contribution from owners/distribution to owners.
34. This Paper considers that a reorganization occurs where the nature and/or size of the public sector in the jurisdiction where it is undertaken remains the same both before and after the reorganization takes place. This view needs further exploration in the context of whether or not the difference arising from the reorganization, in the consolidated financial statements of the recipient, is revenue/expense.
35. If the difference is considered to be revenue, then consideration is required as to the presentation of the difference arising on a reorganization in the consolidated statement of financial performance of the recipient. Generally, this type of restructuring in the public sector is outside of the transferee’s and recipient’s control and is not expected to recur. Paragraph 99 of IPSAS 1 requires all items of revenue and expense recognized in a period to be included in surplus or deficit unless an IPSAS requires otherwise. However, IPSAS 1 does not preclude the separate presentation of items that are distinct from the ordinary activities of a public sector entity. Thus, revenue arising from a reorganization in the recipient’s consolidated financial statements could be presented as a separate category from ordinary activities. This presentation would have the advantage of not distorting the surplus or deficit from operations for the period so that the economic entity’s performance can still be assessed.



36. Another issue that may need to be considered is that the amount of the difference may vary dependent upon whether or not the entities involved in the reorganization carry their assets solely at historical cost or use a mixed measurement model and use Depreciated Replacement Cost (DRC) for the valuation of tangible fixed assets. It seems unlikely that a difference in the measurement basis should make a difference to the accounting treatment of the difference.

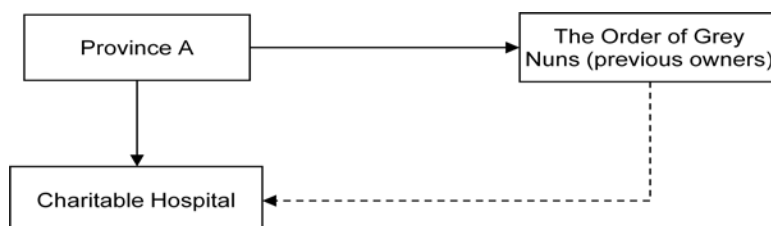
## Acquisitions

37. An acquisition is an entity combination in which the nature and/or the size of the public sector changes as a result of the entity combination. This occurs where a public sector entity acquires a private sector entity. The private sector entity can either be a non-for-profit entity or a for-profit entity.

## Forms of Acquisitions

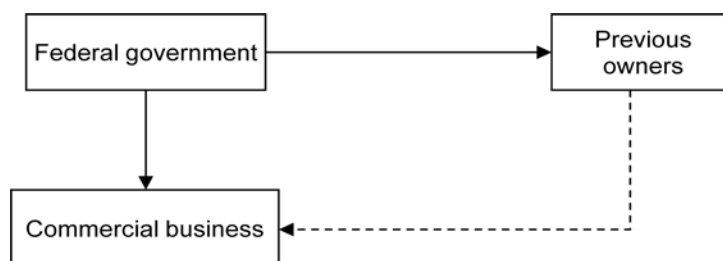
### *Example 1: Acquiring a Private Sector Not-for-Profit Entity*

38. A Provincial government acquires an operation from a private sector not-for-profit entity.



### *Example 2: Acquiring a Private Sector for-Profit Entity*

39. A Federal government acquires a retail bank which was previously owned by entities in the private sector. The current trading conditions are unfavorable and the business is in extreme financial difficulty. The government makes a policy decision to recapitalize the business rather than allowing the business to be put into statutory liquidation.



## Analysis of the Examples

40. Examples 1 and 2 illustrate that the scope or nature of activities in the public sector within a jurisdiction has changed and/or changed in size. This is because the combination occurs with a third-party that is outside of the public sector, i.e.,

- the acquiree is a part of the private sector, either a for-profit entity or a not-for-profit entity.
41. Example 1 illustrates that a public sector entity may acquire a private sector not-for-profit entity. A possible reason for undertaking this transaction is that Province A wishes to maintain the hospital's services to the public. In this example it is likely that Province A already undertakes the provision of hospital services to the public and so this acquisition only increases the size of the public sector rather than its nature.
  42. Example 2 illustrates that the activities and size of the public sector, in this particular jurisdiction, has changed. The public sector now owns a retail bank, which is a new activity. The size of the public sector has also increased. Further, the respective rights of the providers of resources, in this example, taxpayers, have changed. For example, losses made by the retail bank whilst in government ownership are effectively funded by the taxpayer.
  43. Under normal circumstances, private sector owners would not consider selling their business to a public sector entity. Therefore, the acquisition, by a public sector entity, of a business that was previously owned by the private sector occurs only in rare circumstances. Generally, it is a policy decision taken to ensure that the business continues to undertake its activities with the minimum of disruption to the rest of the economy. With the acquisition of a for-profit entity, the primary aim of any consideration transferred is to ensure that the business is adequately capitalized so that it can continue to operate. The net of the fair values of the assets acquired and the liabilities assumed, will only, by coincidence, be approximately equal to the consideration transferred.

## **Alternative Accounting Treatments**

### *Terminology*

44. Because the public sector has changed in nature and/or size Staff consider that it is appropriate to use the terminology "acquirer" instead of "recipient", "acquiree" instead of "transferee" and "former owner" instead of "transferor". This view is based upon the fact that an entity combination where the acquiree is a part of the private sector, an entity within the public sector (the acquirer) obtains control of operations or entities from another entity. Whether or not the entity combination is an exchange transaction or a non-exchange transaction does not have a bearing on the nature and size of the public sector.

### *Accounting Treatment*

45. The accounting treatment of an entity combination involving an entity from the private sector has been split into two components, the initial recognition and measurement of the acquiree and the method of accounting for the acquisition in the consolidated financial statements of the acquirer. The table below provides a summary.

<b>Initial recognition and measurement</b>		<b>Fair Value of Identifiable Net Assets Acquired</b>	<b>Carrying Amount of Existing Net Assets Acquired</b>
<b>Method of accounting</b>	Full consolidation	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Equity method	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
	Financial asset	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>

#### Initial Recognition and Measurement

46. The acquirer could recognize the acquiree in its consolidated financial statements at:
  - (a) The fair value of the identifiable net assets acquired; or
  - (b) The carrying amount of the acquiree's existing assets and liabilities.
47. Irrespective of whether fair value or carrying amount is used, the issue arises as to how the difference arising between the net assets acquired and the consideration transferred is accounted for. Note that the use of fair value may increase the amount of the difference arising.
48. This issue could be considered to be similar to the issue of how to account for the off-market portion of a concessionary loan. IPSAS 29, "Financial Instruments: Recognition and Measurement" requires that concessionary loans granted are valued at fair value as the IPSASB considers that this is the most faithfully representative determination of the concession element of the loan. The concessionary loan is separated into its component parts, i.e., the off-market portion and the on-market portion. The off-market portion of the loan is accounted for as an expense in the year the loan is issued because it results in a commitment of resources, in the form of a loan and a subsidy, on day one. The IPSASB is of the view that the initial recognition of this subsidy as an expense on recognition of the transaction provides the most useful information for accountability purposes.
49. Alternatively, the acquisition method of accounting recognizes the difference between the net assets acquired and the consideration transferred as goodwill arising on acquisition. The goodwill is considered to be an intangible asset and is assessed for impairment annually.
50. The accounting requirements for an acquisition in the for-profit private sector are set out in IFRS 3, which requires the use of the acquisition method of accounting, i.e., recognizing the fair value of the identifiable net assets acquired.

#### Method of Accounting for the Acquisition

51. The acquirer could recognize the acquiree in its consolidated financial statements by using one of the following methods:
  - (a) Using full consolidation;
  - (b) Using the equity method; or
  - (c) As a financial asset.

52. Full consolidation means that an entity combines the financial statements of the controlling entity and its controlled entities line by line by adding together like items of assets, liabilities, net assets/equity, revenue and expenses, as set out in IPSAS 6, “Consolidated and Separate Financial Statements.”<sup>2</sup>
53. For the equity method of accounting, the investment is initially recognized at cost and adjusted thereafter for the post-acquisition change in the investor’s share of net assets/equity of the investee. The surplus or deficit of the investor includes the investor’s share of the surplus or deficit of the investee. This method of accounting is set out in IPSAS 7, “Investments in Associates.”
54. The initial recognition of a financial asset is at fair value plus, in the case of a financial asset not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition of the financial asset. The basis used for subsequent measurement will depend upon the entity’s classification of the financial asset. Measurement bases include fair value, amortized cost or cost (restricted to investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured). The requirements for recognition and measurement of a financial asset are set out in IPSAS 29, “Financial Instruments: Recognition and Measurement.”

## **Other Issues**

### *Temporary Control*

55. IPSAS 6 requires that a controlled entity be excluded from the consolidated financial statements where there is evidence that (a) control is intended to be temporary because the controlled entity is acquired and held exclusively with a view to its disposal within twelve months from acquisition and (b) management is actively seeking a buyer. IPSAS 6 is based upon the December 2003 version of IAS 27. The IASB issued IFRS 5, “Non-current Assets Held for Sale and Discontinued Operations” in March 2004. IFRS 5 removed this requirement from IAS 27 to exclude from consolidation an entity which meets the above two conditions.
56. Instead, IFRS 5 specifies the required accounting treatment for any non-current asset that is held for sale. Thus its scope is wider than just controlled entities. So, a non-current asset (or disposal group) is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. Where an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal, it shall classify it as held for sale at the acquisition date only where it is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable. To meet the highly probable condition, the management must be committed to a plan to sell the asset (or disposal group) and have an active program to locate a buyer. Additionally the sale should be expected to qualify for recognition as a completed

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<sup>2</sup> See below regarding a potential issue arising regarding IPSAS 6.

sale within one year from the date of classification (as a non-current asset held for sale). This criteria is more specific and detailed compared with IPSAS 6.

57. The measurement of a non-current asset (or disposal group) that is classified as held for sale is at the lower of its carrying amount and fair value less costs to sell.

*Distinction between Acquisition of a Not-for-Profit Entity and a For-Profit Entity*

58. The nature of the entity acquired could be used to distinguish between different methods of accounting for an acquisition. A private sector not-for-profit entity has similar objectives to most public sector entities in that they provide goods and services to the public in a non-exchange transaction. Thus, where a private sector not-for-profit entity is acquired, it seems logical to account for that acquisition by the full consolidation method of accounting in the consolidated financial statements of the acquirer.
59. However, where a private sector for-profit entity is acquired, that entity has a profit objective and is similar to the public sector holding a GBE. Because GBEs have a profit objective, an alternative accounting treatment could be considered.
60. The Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA) recognizes the acquisition of a government business enterprise (GBE) as an investment, i.e., as a financial asset.
61. This method of accounting for GBEs evolved as a direct result of the focus on the net debt amount in the statement of financial position. The net debt amount is total liabilities less all financial assets. Non-financial assets are presented as a reduction of the net debt amount.
62. Thus, the structure of the statement of financial position is quite different from the structure of the statement of financial position illustrated in the Implementation Guidance of IPSAS 1, "Presentation of Financial Statements." The table below illustrates the two formats.

IPSAS 1 example		Canadian example	
<b>ASSETS</b>		<b>LIABILITIES</b>	
Current assets	91	Current liabilities	110
Non-current assets	144	Non-current liabilities	582
<b>Total assets</b>	<b>235</b>	<b>Total liabilities</b>	<b>692</b>
<b>LIABILITIES</b>		<b>FINANCIAL ASSETS</b>	
Current liabilities	110	Cash and receivables	83
Non-current liabilities	582	Loans, investments and advances	93
<b>Total liabilities</b>	<b>692</b>	<b>Total financial assets</b>	<b>176</b>
<b>Net assets</b>	<b>(457)</b>	<b>NET DEBT</b>	<b>516</b>
<b>NET ASSETS/EQUITY</b>		<b>NON-FINANCIAL ASSETS</b>	
Reserves	57	Tangible capital assets	51
Accumulated surpluses/(deficits)	(514)	Inventories	8
		<b>Total non-financial assets</b>	<b>59</b>
<b>Total net assets/equity</b>	<b>(457)</b>	<b>ACCUMULATED DEFICIT</b>	<b>457</b>

63. Therefore, on acquisition, the cost of the government's investment is the sum of the fair value of the consideration given in the acquisition plus the expenses directly incurred by the government to effect the acquisition (PS3070.11) is a part of the line item "loans, investments and advances." As a consequence, rather than acquisition accounting, where each line item of the consolidated statement of financial position has an amount related to the GBE, the acquisition of a GBE is treated as a financial asset and affects only one line item in the consolidated statement of financial position.
64. This difference in accounting treatment continues for subsequent recognition. Where acquisition accounting is used for initial recognition, subsequent recognition (assuming the acquiree continues to be controlled by the acquirer) requires the consolidation of that entity in the consolidated financial statements. In contrast, where the acquisition is accounted for on initial recognition as a financial asset, subsequent measurement requires the use of the modified equity method of accounting. This means that the amount of the financial asset is adjusted for the controlling entity's share of net income for the period.

*Change in Nature of Operation*

65. A further issue is where a public sector entity acquires a for-profit entity and intends to operate that entity as a non-cash-generating unit, i.e., as a non-for-profit entity. Irrespective of whether or not an acquisition is recognized at fair value or at carrying amount, a change in the use of an acquired asset may change its value. The issue is whether or not the intention of the acquirer should be included in the initial measurement on acquisition.
66. IFRS 3 requires that where an acquirer is intending not to use an acquired asset (as part of a business combination) or intends to use it in a way that is different from the way other market participants would use it, the acquirer shall measure the acquired asset at fair value determined in accordance with its use by other market participants.
1. Generally, most public sector entity acquisitions of a private sector entity are not market related because the acquisition has occurred by virtue of the absence of other entities being willing to acquire the entity. Thus, there are no other market participants.

*Potential Consequences of the Proposed Accounting Treatment on Other IPSASs*

67. The IPSASB currently does not have any guidance on entity combinations. The decisions made for entity combinations not under common control could have consequences for existing standards such as IPSAS 6 and IPSAS 7, "Investments in Associates." For example, if it is proposed that GBEs are included in the consolidated financial statements of a public sector entity by the equity method of accounting, there would need to be consequential amendments to both IPSAS 6 and IPSAS 7 to reflect this decision.
68. Further, the requirement in IPSAS 6 to exclude a controlled entity from consolidation where it meets certain conditions may need to be amended.

### GFS Requirements

69. GFS defines an asset as an item over which ownership rights are enforced and from which economic benefits may be derived by their owners by holding or using them<sup>3</sup>. Assets are held at current market value<sup>4</sup> which is defined as the amount that would have to be paid to acquire the asset on the valuation date. The current market value for the acquisition of a financial asset is its exchange value<sup>5</sup>. This value excludes service charges, fees, commissions, and similar payments for services provided in carrying out transactions and any taxes payable on transactions<sup>6</sup>.
70. GFS states that government units may acquire financial assets on a nonmarket basis as an element of fiscal policy, e.g., lending money at a below market interest rate or purchase shares of a corporation at an inflated price. If the market value can be determined, then the transactions should be valued at that amount and a second transaction should be recorded as an expense to account for the transfer<sup>7</sup>.

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<sup>3</sup> GFSM 2001, paragraph 7.4.

<sup>4</sup> GFSM 2001, paragraph 7.5.

<sup>5</sup> GFSM 2001, paragraph 9.6.

<sup>6</sup> GFSM 2001, paragraph 9.7.

<sup>7</sup> GFSM 2001, paragraph 9.12.



**INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS BOARD**

**PROJECT BRIEF AND OUTLINE**

**ENTITY COMBINATIONS—MARCH 2007**

**1. Subject**

How to account for entity combinations in the public sector

Business combinations are defined in IFRS 3 *Business Combinations* as:

*“The bringing together of separate entities or businesses into one reporting entity.”*

Further, it states in IFRS 3:

*“The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other businesses, the acquiree. If an entity obtains control of one or more other entities that are not businesses, the bringing together of those entities is not a business combination.”*

**2. Project Rationale and Objectives**

At present, the IPSASB Handbook does not provide guidance for public sector entities involved in entity combinations. Entity combinations is scoped out of IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*.

Entity combinations are transactions that public sector entities enter into and, as such, public sector specific guidance would assist in ensuring those transactions are appropriately reflected in the financial statements.

In addition, for combinations involving entities or businesses under common control, there is currently no international guidance available. Given the many activities and entities that governments can control, this type of combination would not be an unrealistic undertaking in the public sector.

**a) Issue identification**

As alluded to above and elaborated on further below, the key issue for this project will be the development of guidance for entity combinations involving entities or businesses under common control. All existing and proposed international guidance on business combinations currently scope out this type of combination.



b) Objectives to be achieved

Key objectives of the project will be to:

- Converge IFRS 3 *Business Combinations* as much as possible for the public sector; and
- Develop public sector specific guidance on accounting for entity combinations involving entities or businesses under common control (which may be stand-alone guidance or incorporated into a converged IFRS 3 above).

c) Link to IFAC/IPSASB Strategic Plans

*Link to IFAC Strategic Plan*

Issuing international public sector accounting standards (IPSAS) is a key role of the IPSASB. The development of accounting guidance on entity combinations (which is viewed as a ‘gap’ in the IPSASB Handbook – see below) would directly contribute to the IFAC mission by establishing and promoting adherence to high quality professional standards.

*Link to IPSASB Strategy*

The absence of public sector specific guidance of this nature is viewed as a large ‘gap’ in the IPSASB Handbook and as such needs to be addressed if the IPSASB is to support its mission. As such, a project on Entity Combinations is currently ranked as a high priority within the IPSASB draft strategic and operational plan.

Further, guidance on accounting for entity combinations involving entities or businesses under common control is an area where at present, neither the IPSASB Handbook or IASB Handbook currently provide any authoritative guidance. Given there is a need for this form of guidance in the public sector, its provisions will be in alignment with the IPSASB strategy.

### 3. Outline of the Project

a) Project Scope

The project will scope in all those entity combination arrangements which are currently scoped within IFRS 3 *Business Combinations* (and subsequent proposed revisions – referred to here as draft IFRS 3) as appropriate for the public sector. Proposed revisions to IFRS 3 scope in all but the following arrangements:

- (a) formations of joint ventures
- (b) combinations involving only entities or businesses under common control

Given the relevance of combinations involving entities or businesses under common control to the public sector, the IPSASB project will also scope in those transactions.

Final approved guidance will be applicable to public sector entities only.

Government Business Enterprises (GBEs) are profit seeking entities. As noted in the “Preface to International Public Sector Accounting Standards” GBEs apply IFRSs issued by the IASB and are therefore subject to the IASB’s “Framework for Preparation and Presentation of Financial Statements” (the IASB Framework).

However, while GBEs are required to apply IFRSs, given that they form part of the government reporting entity and, as such, are ultimately subject to consolidation into the governments financial statements, the IPSASB project may decide to consider possible reporting implications with GBEs if considered appropriate.

**b) Major Problems and Key Issues that Should be Addressed**

As a starting premise, staff believe the underlying principles of IFRS 3 are convergent for the public sector. Similarly, the proposed amendments in draft IFRS 3 stemming from phase II of the IPSASB’s review of IFRS 3 also seem convergent with the public sector on initial review. IASB deliberations on proposed revisions to IFRS 3 do not appear to have resulted in any significant deviations from many of the proposals in draft IFRS 3. The IPSASB project will make a final decision as to the applicability of the revised IFRS 3 to the public sector once the IASB project is complete (expected Q3 2007).

Regardless of the content of the revised IFRS 3, there are aspects of IFRS 3 that would require ‘public sectorization’ in order to make it more relevant to the public sector. These are discussed later in this proposal. More significant issues are considered first.

***BUSINESS COMBINATIONS INVOLVING ENTITIES OR BUSINESSES UNDER COMMON CONTROL***

IFRS 3 is scoped as follows – it does not apply to:

- (a) business combinations in which separate entities or businesses are brought together to form a joint venture.
- (b) business combinations involving entities or businesses under common control.
- (c) business combinations involving two or more mutual entities.
- (d) business combinations in which separate entities or businesses are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest (for example, combinations in which separate entities are brought together by contract alone to form a dual listed corporation).

As alluded to above, draft IFRS 3 proposes to broaden the scope effectively addressing business combinations except for situations a) and b) above.

The IPSASB currently has IPSAS 8 *Financial Reporting of Interests in Joint Ventures*. (note the IASB currently has a project on Joint Ventures - An Exposure Draft is expected to be published in the first half of 2007).

However, neither the IASB nor IPSASB has any guidance on accounting for entity combinations involving entities or businesses under common control.

The IASB defines these types of arrangements as follows:

*A business combination involving entities or businesses under common control is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory. (paragraph 10, IFRS 3)*

Governments can control a wide variety of entity types, and like any controlling entity, can choose to restructure its activities in response to any number of factors such as changes in its economic or political environment. While perhaps not a regular occurrence for governments or public sector entities, given the broad scope of government activities, governments do choose to amalgamate or consolidate activities in such a way that would meet the definition above.

While there are many ways the project could view this issue and consequently determine methodologies for the most appropriate accounting, staff believe the project could pivot on a key question – the answer to which will significantly influence to size of the project. ‘Has anything changed as a result of the combination?’

*In substance, nothing has changed by combining these commonly controlled entities*

Accounting should reflect the economic substance of transactions and events. By combining commonly controlled entities, the controlling government arguably has not changed the substance of what existed pre-combination. It has merely brought together the resources of two or more entities (businesses) into a newer entity.

Through-out the consolidation, there was never an acquirer or acquiree in the context of IFRS 3 (though the legal reality could be that one entity sub-sumes the activities of another entity), as none of the commonly controlled parties to the arrangement actually attained control, in the truest sense, of another other party to the restructuring.

The decision for a business combination and final implementation was all based on the government’s intentions and plan so as to enable it to better fulfill its own objectives – not those of the parties who were combined. In the end, the primary functions and activities of government (and possibly also the combined entities themselves) continue the same post combination as they did before.

If in substance nothing has changed, then the financial statements of the newly created entity should reflect this economic reality. As such, arguably there should be no need to consider matters or provide guidance related to matters such as:

- Determining an acquirer;
- Determining an acquiree;
- Defining control with supporting guidance;
- Asset revaluations;
- Liability revaluations;
- Guidance on valuation techniques;
- Recognition of goodwill upon combining;
- Amortization or impairment testing of goodwill; and
- Bargain purchase considerations

Instead, the financial statements for the newly created entity, at their simplest, could merely be an amalgamation (consolidation) of the existing financial information for each of the entities pre-combination.

From a user perspective, assuming that pre-combination each commonly controlled entity issued its own separate financial statements relevant to the users of those statements, users of the financial statements of the newly combined entity will continue to receive equally relevant and meaningful financial information.

*In substance, something has changed by combining these commonly controlled entities*

An alternative perspective to viewing the combination as being ‘nothing has changed’, is that by combining commonly controlled entities, the controlling government arguably has changed the substance of what existed pre-combination - ‘something has changed’. As such, the accounting should reflect this.

The creation of the new entity is much more than simply amalgamating the assets and liabilities of two or more entities (businesses). While it may be very difficult to determine an acquirer and acquiree, and the final combined entity is the result of a plan developed and implemented by a greater controlling body - the sum of the individual entities aggregate to something different than simply adding together the assets and liabilities of the individual entities.

As such, it may be necessary to develop guidance for public sector entities which address many of the matters considered within IFRS 3 – for example:

- A basis for valuing and recognizing the assets and liabilities of the combined entities;
- Given the sometimes unique nature of some fixed assets of public sector entities, determining appropriate surrogates for valuation when application of mainstream valuation approaches do not appear appropriate;

- If the combined entities are considered to create new synergies or intangible benefits which were believed not to exist pre-combination (or believed to exist in some/all of the individual entities but were unable to be recognized – eg: internally generated goodwill, previously expensed R&D) such as goodwill or other intangible assets – how these should be identified, measured and recognized in the financial statements;
- If goodwill is recognized, how to account for amortization/impairment;
- Treatment of any revaluations;
- Treatment of any benefit, akin to a perceived bargain purchase, by any of the parties to the arrangement;
- Treatment of any subsequent revenues and expenses associated with combining the entities;
- Supporting disclosures for all the above;
- How to account for all the above upon consolidation into the government reporting entity.

*In substance, something has changed for some, nothing has changed for others*

Is there a need to consider the economic substance of these arrangements on an individual basis acknowledging that entity combinations involving entities or businesses under common control can result in newly combined entities where nothing has changed in some instances, but where something has changed in some other instances.

If this is considered appropriate, criteria will need to be developed which will enable a distinction to be made.

#### *APPLICABILITY OF THE OBJECTIVES OF IFRS 3*

The underlying premise of existing and draft IFRS 3 are substantially the same – namely for the acquisition method of accounting to be used for all business combinations and for an acquirer to be identified for every business combination (extract from draft IFRS).

The IASB acknowledges that in some business combinations, domestic legal, taxation or economic factors can make it extremely difficult to identify an acquirer. Does a public sector context add an additional layer of complexity to determining an acquirer which could make application of IFRS 3 even more difficult? Staff do not consider that a public sector context does in fact add an additional layer of complexity.

However, there are a few matters within existing IFRS 3 which will need modification in order to make it applicable to the public sector environment.

*Definition of a business*

A key ingredient for a business combination is for the combination to involve businesses – a business is defined as:

*an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:*

- (1) a return to investors, or*
- (2) dividends, lower costs, or other economic benefits directly and proportionately to owners, members or participants. (extract from draft IFRS)*

Both existing and proposed revised definitions of business in IFRS 3 do not seem completely applicable to the public sector.

The profit oriented focus of the IFRSs understandably do not fully embrace the notion of a 'business' as a means of achieving an output beyond a return of economic benefit. While there may be entities within the government reporting entity which have this type of focus and for which, the above definition would be relevant (such entities would likely be GBEs who would not be required to comply with IPSASs), given that the majority of activities of the public sector are not profit oriented but more the achievement of social policy objectives, the project would need to review the definition of a business to ensure it encompasses circumstances when a public sector entity is not a profit oriented entity or becomes the acquirer of an entity which does not have a profit focus.

***RELEVANCE OF SOME DISCUSSION WITHIN IFRS 3 FOR THE PUBLIC SECTOR***

While staff consider IFRS 3 is convergent for the public sector, the project will need to consider the appropriateness of some of the content of IFRS 3 for the public sector – examples follow:

*Shares of the acquirer*

IFRS 3 discusses scenarios involving the acquirer issuing shares/equity in relation to the business combination transaction (eg: reverse acquisition). The need for such guidance for a government does not seem appropriate as a government is not made up of share capital.

Similarly, for entities within the government reporting entity who do issue share capital, they would arguably be entities to which IPSASs would not apply and as such would not require IPSASB guidance in relation to the issuance of shares as part of a business combination.

*Mutual Entities*

Draft IFRS 3 proposes to broaden its scope to include business combinations involving mutual entities. Mutual entities are defined as an entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately

to its owners, members, or participants. The project will need to consider the relevance of mutual entities to the public sector.

*Recognition of Tax Benefits*

IFRS 3 discusses the creation and recognition of tax benefits that can result from a business combination. It is arguable that there is a need for such guidance in a public sector context.

**4. Describe the Implications for any Specific Persons or Groups**

a) Relationship to IASB

The most direct implication with the IASB will be use of IASB materials as a basis for the IPSASB project. Implications may also flow from the final composition of the IPSASB task force – if considered it is appropriate to have IASB representation or some other involvement. At the very least, staff believe that close liaison with the IASB will be a reality for the IPSASB project.

b) Relationship to other projects in process and planned

Existing IFRS 3 has relationships with many other IASs (IPSASB equivalent in brackets) – examples are listed below.

IFRS 5: Non-current Assets Held for Sale and Discontinued Operations

IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors (IPSAS 3: improved version)

IAS 18: Revenue (IPSAS 9: Revenue from Exchange Transactions)

IAS 27: Consolidated and Separate Financial Statement (IPSAS 6 improved version)

IAS 28: Investment in Associates (IPSAS 7: Investment in Associates (improved))

IAS 38: Intangible Assets

IAS 39: Financial Instruments: Recognition and Measurement

Dependent upon the final form of the IPSASB work plan, the Entity Combinations project could impact on a number of proposed IPSASB projects in both the short or long term. For example, in the short term, approval for a project brief on financial instruments may be impacted. In the longer term, approval for a project on intangible assets could also be impacted by entity combinations.

As with all IPSASB projects, an IPSASB Entity Combination project will need to be cognizant of developments with the IPSASB's conceptual framework project.

c) Other

Nothing at this stage.

## **5. Development Process, Project Timetable and Project Output**

### **a) Development process**

The development of guidance will be subject to the IPSASB's formal due process. As the project progresses, regular assessment will be made to confirm the proposed path remains the most appropriate.

At a high level, for development of an IPSAS, the following steps will be taken:

- Development of a consultation paper (only the 'common control' component – see below)
- Issuance for public comment of an exposure draft (ED) of proposed requirements of an IPSAS;
- Consideration of ED responses; and
- Approval and issuance of a final IPSAS.

The issuance of documents for public comment will be subject to the usual IPSASB voting rules. Once approved for release, documents may also be released by the NSS for domestic review together with any contextual commentary considered necessary by the NSS in each jurisdiction.

Documents will be developed using a task force approach – details below.

Staff envisage the project be developed in two components.

- 1) To converge IFRS 3 for the public sector as soon as possible and will essentially follow the last three bullets of the due process outlined above.
- 2) Working in tandem with 1) but focusing on developing public sector specific guidance for combinations involving entities or businesses under common control.

Given the potential difficulty and less-evolved nature of accounting for combinations involving entities or businesses under common control, staff plan to commence that portion of the project with a consultative paper which will consider the issue from a more fundamental level and which will eventually be used as a basis to develop final guidance.

It is planned that a final IPSAS (a public-sectorized IFRS 3) would be approved first with guidance on common control to follow.

As a public-sectorized IFRS 3 is developed, the guidance on common control could either eventually be incorporated within the approved public-sectorized IFRS 3 (similar to what was done when the IPSASB approved the cash-basis components portion relating to budget reporting), or if felt more appropriate, establish entirely separate guidance.



The decision to either incorporate or issue separate guidance in relation to accounting for entity combinations involving entities or businesses under common control does not need to be finalized at this phase of the project.

b) Project timetable

<b>2007</b>	<b>Converged IFRS 3</b>	<b>Common Control</b>
March	Project proposal approved	
March/April	Task Force selected and confirmed	
April-July	Task force develop: <ul style="list-style-type: none"> <li>• IPSAS ED of IFRS 3; and</li> <li>• Consultative paper on accounting for entity combinations involving entities or businesses under common control;</li> </ul> for public comment	
22-26 July - Montreal	Update IPSASB on progress of task force	
July - October	Task force continue developing: <ul style="list-style-type: none"> <li>• IPSAS ED of IFRS 3; and</li> <li>• Consultative paper on accounting for entity combinations involving entities or businesses under common control;</li> </ul> for public comment	
<b>27-30 November Beijing</b>	<b>ED presented for IPSASB approval</b>	<b>Update IPSASB on progress of task force on consultation paper</b>
December – January 2008	ED issued for public comment	Task force continue developing consultative paper
<b>2008</b>		
January-March	Responses to ED considered IPSAS drafted	Task force continue developing consultative paper
<b>March IPSASB Meeting Wellington</b>	<b>Update IPSASB on ED responses</b>	<b>Consultative paper presented for IPSASB approval</b>
March/April		Consultative paper issued
March-July	IPSAS drafted	
<b>July IPSASB Meeting</b>	<b>IPSASB approve IPSAS on Entity Combinations</b>	<b>Update IPSASB on consultative paper responses</b>
July-November		ED on common control drafted
<b>November Meeting</b>		<b>ED on common control approved by IPSASB</b>
November/December		ED on common control issued
<b>2009</b>		
March Meeting		Update IPSASB on ED responses
<b>July Meeting</b>		<b>IPSAS on common control approved</b>

c) Project output

- November 2007: ED – Public sectorized IFRS 3 *Entity Combinations*
- March 2008: Consultative paper - accounting for entity combinations involving entities or businesses under common control
- July 2008: IPSAS - Public sectorized IFRS 3 *Entity Combinations*
- November 2008: ED - accounting for entity combinations involving entities or businesses under common control

- July 2009: IPSAS - accounting for entity combinations involving entities or businesses under common control (to be issued either as a separate document or integrated within IPSAS on entity combinations)

## **6. Resources Required**

### **a) Task Force/subcommittee required?**

A task force is proposed with a membership of six (incl Chair) – a group sizing which will make the task force more manageable. Representation should reflect a broad cross section of IPSASB constituents to enable a broad range of points of view, technical expertise and discussion to be brought to task force meetings.

Where possible, geographical representation should also be a consideration. Staff envisage that the composition would approximate the following mix:

- One surrogate for an acquirer (eg: government preparer);
- One surrogate for an acquiree (eg: government entity preparer);
- One legislative auditor (who will be required to opine on these arrangements);
- Two surrogates for users of financial statements (eg: from the IPSASB Observer group, academics, member of legislative assembly); and
- One IASB representative (preferably whose had involvement with the IASB's current project on revising IFRS 3 *Business Combinations*).

Selection of task force members will be made by the Technical Director and IPSASB Chair.

The majority of meetings are expected to be by conference call, with at least one face-to-face meeting expected.

Unless an offer of resources can be negotiated with NSS, all project materials will be written by IPSASB staff.

### **b) Staff**

It is envisaged that one Technical Manager will be required to resource the project.

## **7. Important Sources of Information that Address the Matter being Proposed**

- IFRS 3 *Business Combination*
- Exposure Draft of proposed Amendments to IFRS 3 Business Combinations – and IFRS deliberations resulting from.
- Any known guidance in member bodies which address entity combinations and accounting for common control
- Understood the IASB could have compiled a report on the status of business combination accounting amongst NSS – staff to follow up.

**8. Factors that might add to complexity or length**

The project, in particular the component relating to accounting for entity combinations involving entities or businesses under common control, could potentially become very complex – particularly if the view is taken that the entity combination has in substance resulted in more than simply two controlled entities being merged together.

Further, as evidenced by discussion under section 4(b), accounting for entity combinations involves relationships with numerous other standards. Consideration of any implications and/or consequential amendments stemming from this project could add complexity.

# 6

## ACQUISITIONS AND MERGERS

## FINANCIAL REPORTING STANDARD



ACCOUNTING  
STANDARDS  
BOARD

*Financial Reporting Standard 6  
'Acquisitions and Mergers' is issued by the  
Accounting Standards Board in respect of its  
application in the United Kingdom and by  
the Institute of Chartered Accountants in  
Ireland in respect of its application in the  
Republic of Ireland.*

# 6

## ACQUISITIONS AND MERGERS

# FINANCIAL REPORTING STANDARD

*Financial Reporting Standard 6 is set out in paragraphs 1-39.*

*The Statement of Standard Accounting Practice set out in paragraphs 4-39 should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraphs 2-3 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.*

*The Explanation set out in paragraphs 40-89 shall be regarded as part of the Statement of Standard Accounting Practice insofar as it assists in interpreting that statement.*

*Appendix III ‘The development of the FRS’ reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on FRS 6.*

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## **SUMMARY**

- a Financial Reporting Standard 6 ‘Acquisitions and Mergers’ sets out the circumstances in which the two methods of accounting for a business combination—acquisition accounting and merger accounting—are to be used.
- b Acquisition accounting regards the business combination as the acquisition of one company by another; the identifiable assets and liabilities of the company acquired are included in the consolidated balance sheet at their fair value at the date of acquisition, and its results included in the profit and loss account from the date of acquisition. The difference between the fair value of the consideration given and the fair values of the net assets of the entity acquired is accounted for as goodwill.
- c Merger accounting, on the other hand, treats two or more parties as combining on an equal footing. It is normally applied without any restatement of net assets to fair value, and includes the results of each for the whole of the accounting period. Correspondingly, it does not reflect the issue of shares as an application of resources at fair value. The difference that arises on consolidation does not represent goodwill but is deducted from, or added to, reserves.
- d The FRS requires acquisition accounting to be used for any business combination where a party can be identified as having the role of an acquirer, since this method of accounting reflects the application of resources by the acquirer and the net assets acquired.
- e Merger accounting is restricted to, and required for, those business combinations where the use of acquisition accounting would not properly reflect the true nature of the combination. A merger is a business combination in which, rather than one party

acquiring control of another, the parties come together to share in the future risks and benefits of the combined entity. It is not the augmentation of one entity by the addition of another, but the creation of what is effectively a new reporting entity from the parties to the combination.

- f A combination meets the definition of a merger only if it satisfies the five criteria set out in paragraphs 6 – 11 of the FRS. These criteria relate to:
  - 1 the way the roles of each party to the combination are portrayed;
  - 2 the involvement of each party to the combination in the selection of the management of the combined entity;
  - 3 the relative sizes of the parties to the combination;
  - 4 whether shareholders of the combining entities receive any consideration other than equity shares in the combined entity;
  - 5 whether shareholders of the combining entities retain an interest in the performance of only part of the combined entity.
- g Where a combination meets these criteria, acquisition accounting is not permitted as this method would not fairly present the effect of the combination.
- h The FRS also contains provisions for applying merger accounting to mergers effected by the creation of a new holding company, and also to certain group reconstructions where acquisition accounting may not be appropriate.

- i The FRS contains disclosure requirements applying to business combinations accounted for by using merger accounting so that the transition from separate entities to the merged entity can be understood; and further disclosure requirements, replacing those in SSAP 22 'Accounting for goodwill', for business combinations accounted for by using acquisition accounting, so that the effect of the acquisition can be understood.

## **FINANCIAL REPORTING STANDARD 6**

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### **OBJECTIVE**

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- 1 The objective of this FRS is: to ensure that merger accounting is used only for those business combinations that are not, in substance, the acquisition of one entity by another but the formation of a new reporting entity as a substantially equal partnership where no party is dominant; to ensure the use of acquisition accounting for all other business combinations; and to ensure that in either case the financial statements provide relevant information concerning the effect of the combination.

## DEFINITIONS

- 2 The following definitions shall apply in this FRS and in particular in the Statement of Standard Accounting Practice set out in paragraphs 4 – 39.

*Acquisition :-*

A business combination that is not a merger.

*Business combination :-*

The bringing together of separate entities into one economic entity as a result of one entity uniting with, or obtaining control over the net assets and operations of, another.

*Equity shares :-*

Shares other than non-equity shares.

*Group reconstruction :-*

Any of the following arrangements:

- (a) the transfer of a shareholding in a subsidiary undertaking from one group company to another;
- (b) the addition of a new parent company to a group;
- (c) the transfer of shares in one or more subsidiary undertakings of a group to a new company that is not a group company but whose shareholders are the same as those of the group's parent;
- (d) the combination into a group of two or more companies that before the combination had the same shareholders.

*Merger :-*

A business combination that results in the creation of a new reporting entity formed from the combining parties, in which the shareholders of the combining entities come together in a partnership for the mutual sharing of the risks and benefits of the combined entity, and in which no party to the combination in substance obtains control over any other, or is otherwise seen to be dominant, whether by virtue of the proportion of its shareholders' rights in the combined entity, the influence of its directors or otherwise.

*Non-equity shares :-*

Shares possessing any of the following characteristics:

- (a) any of the rights of the shares to receive payments (whether in respect of dividends, in respect of redemption or otherwise) are for a limited amount that is not calculated by reference to the company's assets or profits or the dividends on any class of equity share;
- (b) any of their rights to participate in a surplus in a winding up are limited to a specific amount that is not calculated by reference to the company's assets or profits and such limitation had a commercial effect in practice at the time the shares were issued or, if later, at the time the limitation was introduced;
- (c) the shares are redeemable, either according to their terms or because the holder, or any party other than the issuer, can require their redemption.

**3** References to companies legislation mean:

- (a) in Great Britain, the Companies Act 1985;
- (b) in Northern Ireland, the Companies (Northern Ireland) Order 1986; and
- (c) in the Republic of Ireland, the Companies Acts 1963–90 and the European Communities (Companies: Group Accounts) Regulations 1992.



## STATEMENT OF STANDARD ACCOUNTING PRACTICE

*The marginal notes give the main references to the Companies Act 1985 in Great Britain. For the equivalent references in companies legislation in Northern Ireland and the Republic of Ireland see Appendix I.*

### *Scope*

- 4 Financial Reporting Standard 6 applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period. Although the FRS is framed in terms of an entity becoming a subsidiary undertaking of a parent company that prepares consolidated financial statements, it also applies where an individual company or other reporting entity combines with a business other than a subsidiary undertaking.

### *Use of merger accounting*

- 5 A business combination should be accounted for by using merger accounting if:
  - (a) the use of merger accounting for the combination is not prohibited by companies legislation; and [4A Sch 10]
  - (b) the combination meets all the specific criteria set out in paragraphs 6–11 below and thus falls within the definition of a merger.

Acquisition accounting should be used for all other business combinations, except as provided in paragraphs 13 and 14.

*Criteria for determining whether the definition of a merger is met*

- 6 *Criterion 1* – No party to the combination is portrayed as either acquirer or acquired, either by its own board or management or by that of another party to the combination.
- 7 *Criterion 2* – All parties to the combination, as represented by the boards of directors or their appointees, participate in establishing the management structure for the combined entity and in selecting the management personnel, and such decisions are made on the basis of a consensus between the parties to the combination rather than purely by exercise of voting rights.
- 8 *Criterion 3* – The relative sizes of the combining entities are not so disparate that one party dominates the combined entity by virtue of its relative size.
- 9 *Criterion 4* – Under the terms of the combination or related arrangements, the consideration received by equity shareholders of each party to the combination, in relation to their equity shareholding, comprises primarily equity shares in the combined entity; and any non-equity consideration, or equity shares carrying substantially reduced voting or distribution rights, represents an immaterial proportion of the fair value of the consideration received by the equity shareholders of that party. Where one of the combining entities has, within the period of two years before the combination, acquired equity shares in another of the combining entities, the consideration for this acquisition should be taken into account in determining whether this criterion has been met.

- 10 For the purpose of paragraph 9, the consideration should not be taken to include the distribution to shareholders of:
- (a) an interest in a peripheral part of the business of the entity in which they were shareholders and which does not form part of the combined entity; or
  - (b) the proceeds of the sale of such a business, or loan stock representing such proceeds.

A peripheral part of the business is one that can be disposed of without having a material effect on the nature and focus of the entity's operations.

- 11 *Criterion 5* – No equity shareholders of any of the combining entities retain any material interest in the future performance of only part of the combined entity.
- 12 For the purposes of paragraphs 6–11 above any convertible share or loan stock should be regarded as equity to the extent that it is converted into equity as a result of the business combination.

*Group reconstructions*

- 13 A group reconstruction may be accounted for by using merger accounting, even though there is no business combination meeting the definition of a merger, provided:
- (a) the use of merger accounting is not prohibited [4A Sch 10] by companies legislation;
  - (b) the ultimate shareholders remain the same, and the rights of each such shareholder, relative to the others, are unchanged; and

- (c) no minority's interest in the net assets of the group is altered by the transfer.

*Combination effected by using a new parent company*

- 14 Where a combination is effected by using a newly formed parent company to hold the shares of each of the other parties to a combination, the accounting treatment depends on the substance of the business combination being effected: that is, whether a combination of the entities other than the new parent company would have been an acquisition or a merger. If the combination would have been an acquisition, one entity can be identified as having the role of an acquirer. This acquirer and the new parent company should first be combined by using merger accounting; then the other parties to the business combination should be treated as acquired by this combined company by using the acquisition method of accounting. On the other hand, where the substance of the business combination effected by a new parent company is a merger, the new parent company and the other parties should all be combined by using merger accounting.

*Applicability to various structures of business combination*

- 15 The provisions of the FRS, which are explained by reference to an acquirer or issuing entity that issues shares as consideration for the transfer to it of shares in the other parties to the combination, should also be read so as to apply to other arrangements that achieve similar results.

*Merger accounting*

- 16 With merger accounting the carrying values of the assets and liabilities of the parties to the combination are not required to be adjusted to fair value on consolidation, although appropriate adjustments [4A Sch 11]

should be made to achieve uniformity of accounting policies in the combining entities.

- 17 The results and cash flows of all the combining entities should be brought into the financial statements of the combined entity from the beginning of the financial year in which the combination occurred, adjusted so as to achieve uniformity of accounting policies. The corresponding figures should be restated by including the results for all the combining entities for the previous period and their balance sheets for the previous balance sheet date, adjusted as necessary to achieve uniformity of accounting policies.
- 18 The difference, if any, between the nominal value of the shares issued plus the fair value of any other consideration given, and the nominal value of the shares received in exchange should be shown as a movement on other reserves in the consolidated financial statements. Any existing balance on the share premium account or capital redemption reserve of the new subsidiary undertaking should be brought in by being shown as a movement on other reserves. These movements should be shown in the reconciliation of movements in shareholders' funds.
- 19 Merger expenses are not to be included as part of this adjustment, but should be charged to the profit and loss account of the combined entity at the effective date of the merger, as reorganisation or restructuring expenses, in accordance with paragraph 20 of FRS 3 'Reporting Financial Performance'.

### *Acquisition accounting*

- 20 Business combinations not accounted for by merger accounting should be accounted for by acquisition accounting. Under acquisition accounting, the identifiable assets and liabilities of the companies acquired should be included in the acquirer's [4A Sch 9]

consolidated balance sheet at their fair value at the date of acquisition. The results and cash flows of the acquired companies should be brought into the group accounts only from the date of acquisition. The figures for the previous period for the reporting entity should not be adjusted. The difference between the fair value of the net identifiable assets acquired and the fair value of the purchase consideration is goodwill, positive or negative.\*

### ***Disclosure***

#### *Acquisitions and mergers*

- 21 The following information in respect of all business combinations occurring in the financial year, whether accounted for as acquisitions or mergers, should be disclosed in the financial statements of the acquiring entity or, in the case of a merger, the entity issuing shares: [4A Sch 13(2)]
- (a) the names of the combining entities (other than the reporting entity);
  - (b) whether the combination has been accounted for as an acquisition or a merger;
  - (c) the date of the combination.

#### *Mergers*

- 22 In respect of each business combination accounted for as a merger, other than group reconstructions falling within paragraph 13, the following information should be disclosed in the financial statements of the combined entity for the period in which the merger took place:

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\* The date of acquisition and the acquisition of a subsidiary undertaking in stages are dealt with in FRS 2, paragraphs 45, 50, 84-85 and 88-89.

- (a) an analysis of the principal components of the current year's profit and loss account and statement of total recognised gains and losses into
  - (i) amounts relating to the merged entity for the period after the date of the merger, and
  - (ii) for each party to the merger, amounts relating to that party for the period up to the date of the merger.
- (b) an analysis between the parties to the merger of the principal components of the profit and loss account and statement of total recognised gains and losses for the previous financial year;
- (c) the composition and fair value of the consideration given by the issuing company and its subsidiary undertakings;
- (d) the aggregate book value of the net assets of each party to the merger at the date of the merger;
- (e) the nature and amount of significant accounting adjustments made to the net assets of any party to the merger to achieve consistency of accounting policies, and an explanation of any other significant adjustments made to the net assets of any party to the merger as a consequence of the merger; and
- (f) a statement of the adjustments to consolidated reserves resulting from the merger.

[Extension of  
4A Sch 13(4)]

[Extension of  
4A Sch 13(4)]

[4A Sch 13(3)]

[4A Sch 13(6)]

[4A Sch 13(6)]

The analysis of the profit and loss account in (a) and (b) above should show as a minimum the turnover, operating profit and exceptional items, split between continuing operations, discontinued operations and acquisitions; profit before taxation; taxation and minority interests; and extraordinary items.

*Acquisitions*

- 23** The disclosure requirements for business combinations accounted for as acquisitions apply as follows:
- (a) those in paragraphs 24–35 are required for each material acquisition; and, with the exception of those in paragraph 35, should also be given for other acquisitions in aggregate;
  - (b) the additional disclosure requirements in paragraph 36 apply to substantial acquisitions as defined in paragraph 37.
- 24** The composition and fair value of the consideration given by the acquiring company and its subsidiary undertakings should be disclosed. The nature of any deferred or contingent purchase consideration should be stated, including, for contingent consideration, the range of possible outcomes and the principal factors that affect the outcome. *[4A Sch 13(3)]*
- 25** A table should be provided showing, for each class of assets and liabilities of the acquired entity: *[4A Sch 13(5)]*
- (a) the book values, as recorded in the acquired entity's books immediately before the acquisition and before any fair value adjustments;



- (b) the fair value adjustments, analysed into
  - (i) revaluations
  - (ii) adjustments to achieve consistency of accounting policies, and
  - (iii) any other significant adjustments,giving the reasons for the adjustments; and
- (c) the fair values at the date of acquisition.

The table should include a statement of the amount of purchased goodwill or negative goodwill arising on the acquisition.

- 26 In the table required by paragraph 25, provisions for reorganisation and restructuring costs that are included in the liabilities of the acquired entity, and related asset write-downs, made in the twelve months up to the date of acquisition should be identified separately.
- 27 Where the fair values of the identifiable assets or liabilities, or the purchase consideration, can be determined only on a provisional basis at the end of the accounting period in which the acquisition took place, this should be stated and the reasons given. Any subsequent material adjustments to such provisional fair values, with corresponding adjustments to goodwill, should be disclosed and explained.
- 28 As required by FRS 3, in the period of acquisition the post-acquisition results of the acquired entity should be shown as a component of continuing operations in the profit and loss account, other than those that are also discontinued in the same period; and where an acquisition has a material impact on a major business segment this should be disclosed and explained.

- 29 Where it is not practicable to determine the post-acquisition results of an operation to the end of the period of acquisition, an indication should be given of the contribution of the acquired entity to the turnover and operating profit of the continuing operations. If an indication of the contribution of an acquired entity to the results of the period cannot be given, this fact and the reason should be explained.
- 30 Any exceptional profit or loss in periods following the acquisition that is determined using the fair values recognised on acquisition should be disclosed in accordance with the requirements of FRS 3, and identified as relating to the acquisition.
- 31 The profit and loss account or notes to the financial statements of periods following the acquisition should show the costs incurred in those periods in reorganising, restructuring and integrating the acquisition. Such costs are those that:
- (a) would not have been incurred had the acquisition not taken place; and
  - (b) relate to a project identified and controlled by management as part of a reorganisation or integration programme set up at the time of acquisition or as a direct consequence of an immediate post-acquisition review.
- 32 Movements on provisions or accruals for costs related to an acquisition should be disclosed and analysed between the amounts used for the specific purpose for which they were created and the amounts released unused.
- 33 In accordance with FRS 1, the cash flow statement should show the amounts of cash and cash equivalents paid in respect of the consideration, net of any cash and cash equivalents balances transferred as part of the

acquisition. In addition, a note to the cash flow statement should show a summary of the effects of acquisitions indicating how much of the consideration comprised cash and cash equivalents and the amounts of cash and cash equivalents transferred as a result of the acquisition.

- 34 In accordance with FRS 1, material effects on amounts reported under each of the standard headings reflecting the cash flows of the acquired entity in the period should be disclosed, as far as is practicable, as a note to the cash flow statement. This information need be given only in the financial statements for the period in which the acquisition occurs.
- 35 For a material acquisition, the profit after taxation and minority interests of the acquired entity should be given for: [4A Sch 13(4)]
- (a) the period from the beginning of the acquired entity's financial year to the date of acquisition, giving the date on which this period began; and
  - (b) its previous financial year.

*Substantial acquisitions*

- 36 For acquisitions meeting the conditions set out in the next paragraph, the following information should be disclosed in the financial statements of the combined entity for the period in which the acquisition took place: [Extension of 4A Sch 13(4)]
- (a) the summarised profit and loss account and statement of total recognised gains and losses of the acquired entity for the period from the beginning of its financial year to the effective date of acquisition, giving the date on which this period began; this summarised profit and loss account should show as a minimum the

turnover, operating profit and those exceptional items falling within paragraph 20 of FRS 3; profit before taxation; taxation and minority interests; and extraordinary items;

- (b) the profit after tax and minority interests for the acquired entity's previous financial year.

This information should be shown on the basis of the acquired entity's accounting policies prior to the acquisition.

- 37 The disclosures in paragraph 36 should be given for each business combination accounted for by using acquisition accounting where:

- (a) for listed companies, the combination is a Class I or Super Class I transaction under the Stock Exchange Listing Rules;

- (b) for other entities, either

- (i) the net assets or operating profits of the acquired entity exceed 15 per cent of those of the acquiring entity, or
- (ii) the fair value of the consideration given exceeds 15 per cent of the net assets of the acquiring entity;

and should also be made in other exceptional cases where an acquisition is of such significance that the disclosure is necessary in order to give a true and fair view. For the purposes of (b) above, net assets and profits should be those shown in the financial statements for the last financial year before the date of the acquisition; and the net assets should be augmented by any purchased goodwill eliminated against reserves as a matter of accounting policy and not charged to the profit and loss account.

*Date from which effective*

- 38** The accounting practices set out in the FRS should be regarded as standard in respect of business combinations first accounted for in financial statements relating to accounting periods commencing on or after 23 December 1994. Earlier adoption is encouraged but not required.

*Withdrawal of SSAP 23 and amendment of SSAP 22*

- 39** The FRS supersedes SSAP 23 'Accounting for acquisitions and mergers' and paragraphs 48 – 51 of SSAP 22 'Accounting for goodwill'.

## EXPLANATION

### *Introduction*

- 40 Two different methods have been used to account for business combinations: merger accounting and acquisition accounting.
- 41 In merger accounting the financial statements of the parties to the combination are aggregated, and presented as though the combining entities had always been part of the same reporting entity. Accordingly, although the merger may have taken place part of the way through the financial year, the results of the combining entities for the full financial year are reflected in the group accounts for the period and corresponding amounts are presented on the same basis. The accounting policies of the combining entities are adjusted to achieve uniformity, but the assets and liabilities need not be adjusted to reflect fair values at the date of the combination. Under merger accounting, a difference may arise on consolidation between the nominal value of the shares issued, taken together with the fair value of any other consideration, and the aggregate of the nominal values of the shares received in exchange. Such difference is not goodwill, as it does not result from the difference between the fair value of the consideration and the fair value of the identifiable net assets. It should be shown as a movement on consolidated reserves. Any share premium accounts and capital redemption reserves of the new subsidiary undertaking are not preserved as such in the consolidated accounts, since they do not relate to the share capital of the reporting entity, but are brought in by being shown as a movement on other reserves.
- 42 In acquisition accounting the results of the acquired company are brought into the group accounts only from the date of acquisition. The identifiable assets

and liabilities acquired are included at fair value in the consolidated accounts and are therefore stated at their cost to the acquiring group. The fair value of the consideration given is set against the aggregate fair value of the net identifiable assets acquired and any resulting balance is goodwill, if positive, or else a negative consolidation difference called negative goodwill.\*

- 43 The fact that a particular business combination does not meet the criteria for merger accounting, and is thus accounted for by using acquisition accounting, does not preclude the acquirer from obtaining merger relief in its individual accounts under the provisions of section 131 of the Companies Act 1985 if the requirements of that section are met. In such cases, in the consolidated accounts, acquisition accounting is applied in the normal way: goodwill is still calculated by comparing the fair value of the shares issued, rather than their nominal or recorded value, with the fair value of the net assets acquired; and any resulting excess over the nominal value of the shares issued, taken together with the fair value of any other consideration, is shown, not as share premium, but as a separate reserve.

***Definition of a merger and an acquisition***

- 44 A merger is a rare type of business combination in which two or more parties come together for the mutual sharing of benefits and risks arising from the combined businesses, in what is in substance an equal partnership, each sharing influence in the new entity. No party can be regarded as acquiring control over another, or becoming controlled by another; and the reporting entity formed by the combination must be

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\* The treatment of such balances is dealt with in SSAP 22 'Accounting for goodwill' and is the subject of a current ASB project.

regarded as a new entity rather than the continuation of one of the combining entities, enlarged by its having obtained control over the others.

- 45 An acquisition is defined as any business combination that is not a merger. In many acquisitions, the shareholders of the acquired party do not have a continuing interest in the combined entity, but instead sell their shareholdings for cash or other non-equity consideration. Even where all parties in an acquisition retain an interest in the combined entity, the parties do not come together on equal terms; one party has a greater degree of influence than the others, and is seen as acquiring the other entities in exchange for a share in the combined entity. An acquisition is therefore a transaction that is, in substance, the application of resources by the acquiring entity to obtain control of one or more other entities, by the payment of cash, transfer of other assets, the incurring of a liability or the issue of shares.
- 46 The legal form of a business combination will normally be for one company to acquire shares in one or more others. This fact does not make that company an acquirer in the sense discussed above. Similarly, the question of whether the combined entity should be regarded as a new reporting entity is not affected by whether or not a new legal entity has been formed to acquire shares in others.

***Rationale for merger accounting***

- 47 In a merger, no party to the combination can be properly regarded as obtaining control over the other; rather, the parties to the combination join together on an equal footing to form a combined enterprise for their mutual benefit.



- 48 For such mergers it is misleading to account for the combination as the application of resources by one party to obtain control over the other, since this assumes a distinction in the roles of the parties that does not reflect reality. Furthermore, it is only the legal structure of the combination that would determine which party would be treated under acquisition accounting as the acquirer, and thus determine the party whose net assets would be treated as being acquired and whose goodwill would be recognised.
- 49 A merger is a true mutual sharing of the benefits and risks of the combined entity. Therefore the joint history of the entities that have combined will be relevant to the combined group's shareholders. This record will be provided by merger accounting because it treats the separate businesses as though they were continuing as before, only now jointly owned and managed. If acquisition accounting were to be used, it would focus artificially on only one of the parties to the combination, which would lead to a discontinuity in information reported on the combined entity.
- 50 Thus the concept of a merger is of a partnership or pooling of interests, where all the parties to the combination participate in the combined businesses of the merged entity on substantially equal terms; and where the substance of the arrangement is such that the reporting entity cannot be regarded as merely being enlarged by the acquisition of the other entities, but must be considered as effectively a new reporting entity.
- 51 In a business combination that qualifies as a merger, expenses of the combination are similar in nature to expenses of a fundamental reorganisation or restructuring, and should be charged to the profit and loss account for the period in which the merger

occurred, shown as an exceptional item in accordance with paragraph 20 of FRS 3. This is not intended to prohibit the subsequent charging of issue costs to the share premium account by means of a transfer between reserves.

***Rationale for acquisition accounting***

- 52 The acquisition of another entity is a transaction by which an entity seeks to increase the assets under its control. Acquisition accounting is appropriate for most business combinations since it reflects in the financial statements the application of resources by one party to the combination in order to obtain control of the other, represented by the fair value of the net assets over which control is obtained together with goodwill.
- 53 The profits of the acquired company are brought into account only from the date of the combination and the history of the group is seen as the history of the acquirer with occasional additions when it acquires other entities.

***Deciding whether a business combination is a merger or an acquisition***

- 54 The FRS requires that to determine whether a business combination meets the definition of a merger, it should be assessed against certain specified criteria; failure to meet any of these criteria indicates that the definition was not met and thus that merger accounting is not to be used for the combination.
- 55 Individually these tests are insufficient to define the intangible quality of a true merger, and may appear arbitrary. Nevertheless, taken as a whole, they provide a reasonable basis for determining whether a particular business combination meets the definition of a merger and thus should be accounted for by using merger accounting.

- 56 In applying the criteria, it is necessary to consider the substance and not just the form of the arrangements, and to take account of all relevant information related to the combination. It is important to have regard to the transaction as a whole, including any related arrangements that are connected with the business combination either because they are entered into in contemplation of that combination or because they are part of the process by which that combination is effected. The vast majority of business combinations will be acquisitions and only in rare circumstances will a combination fulfil all the detailed conditions for it to be treated as a merger.

*Parties to the combination*

- 57 For the purposes of assessing whether a combination is a merger meeting the criteria, the parties to the combination are considered as comprising not solely the business of each entity that is combining but also the management of the entity and the body of its shareholders.
- 58 Merger accounting is not appropriate for a combination where one of the parties results from a recent divestment by a larger entity, because the divested business will not have been independent for a sufficient period to establish itself as being a party separate from its previous owner. Only once the divested business has established a track record of its own can it be considered as a party to a merger. However, a party to a combination may divest itself of a peripheral part of its business before the combination (or as part of the arrangements for the combination) and still meet the criteria for merger accounting.
- 59 Where a party to the combination is not a company with share capital, the conditions applying to equity shares should be interpreted as applying to those elements of its capital structure that allocate rights to profits and control.

*Criterion 1 – role of the parties*

- 60 An essential feature of a merger is that it represents a genuine combining of the interests of the parties; such a genuine combination of interests cannot exist if one party portrays itself, or another party, as having a dominant role as an acquirer or the subservient role of being acquired.
- 61 Where the terms of a share-for-share exchange indicate that one party has paid a premium over the market value of the shares acquired, this is evidence that that party has taken the role of an acquirer unless there is a clear explanation for this apparent premium other than its being a premium paid to acquire control.
- 62 The circumstances surrounding the transaction may provide evidence to indicate the nature of a business combination. The following, while not individually conclusive, would need to be considered: the form by which the combination was achieved, the plans for the combined entity's future operations (for example, whether any closures or disposals related more to one party than another), and the proposed corporate image (such as the name, logo and the location of the headquarters and principal operations). Where a publicly quoted company is a party to a business combination, the content of communications with its shareholders is likely also to be relevant in determining the substance of the transaction.

*Criterion 2 – dominance of management*

- 63 An essential feature of the genuine combination of interests underlying the definition of a merger is that all parties to the combination are involved in determining the management of the combined entity and reach a consensus on the appropriate structure and personnel; if decisions can be reached only by the

exercise of majority voting rights against the wishes of one of the parties to the merger, or if one party clearly dominates this process, this indicates that the combination is not a genuine pooling of interests. However, this does not preclude the possibility of all, or most, of the management team of the combined entity coming from only one of the parties, provided that this clearly reflects the wishes of the others.

- 64 In applying this test, it is necessary to consider not only the formal management structure of the combined entity, but also the identity of all persons involved in the main financial and operating decisions and the way in which the decision-making process operates in practice within the combined entity.
- 65 Normally the management of the combined entity would contain representatives of each of the combining parties. Where the senior management structure and personnel of the combined entity are essentially those of one of the combining parties, this criterion will not have been met unless it is clear that all the parties to the merger genuinely participated in the decision.
- 66 In applying this test it is necessary to consider only the decisions made in the period of initial integration and restructuring at the time of the combination; but both the short-term effects and expected long-term consequences of decisions made in this period need to be considered.

*Criterion 3 – relative size of the parties*

- 67 Where one party is substantially larger than the other parties it would be presumed that the larger party can or will dominate the combined undertaking. This will not be consistent with treating such a business combination as a merger as the combined entity will not be a substantially equal partnership.

- 68 A party would be presumed to dominate if it is more than 50 per cent larger than each of the other parties to the combination, judged by reference to the ownership interests; that is, by considering the proportion of the equity of the combined entity attributable to the shareholders of each of the combining parties. However, this presumption may be rebutted if it can be clearly shown that there is no such dominance; other factors, such as voting or share agreements, blocking powers or other arrangements, can mean that a party to the combination has more influence, or conversely less influence, than is indicated by its relative size. Circumstances that rebut the presumption of dominant influence based on relative sizes would need to be disclosed and explained.

*Criterion 4 – non-equity consideration*

- 69 Criterion 4 is concerned with the extent to which equity shareholders of the combining entities receive any consideration other than equity shares (as defined in paragraph 2 above) in the combined entity. Cash, other assets, loan stock and preference shares are all examples of non-equity consideration.
- 70 As stated in the note on legal requirements (Appendix I), companies legislation provides that one of the conditions for merger accounting is that the fair value of any consideration other than the issue of equity shares (as defined in companies legislation) did not exceed 10 per cent of the nominal value of the equity shares issued. Criterion 4 requires a further condition to be met, that all but an immaterial proportion of the fair value of the consideration received must be in the form of equity shares (as defined in paragraph 2); this definition of equity, which is that adopted in FRS 4 'Capital Instruments', is narrower than that of companies legislation, and is used to avoid the possibility of criterion 4 being met by the use of shares that, although within the statutory definition of equity, have characteristics that are closer to non-equity.

- 71 The FRS requires that all arrangements made in conjunction with the combination must be taken into account. Equity shareholders will be considered to have disposed of their shareholding for cash where any arrangement is made in connection with the combination that enabled them to exchange or redeem the shares they received in the combination for cash (or other non-equity consideration); for example, a vendor placing or similar arrangement should be treated as giving rise to non-equity consideration. However, a normal market selling transaction, or privately arranged sale, entered into by a shareholder is not made in conjunction with the combination and does not prevent the criterion being met.
- 72 A business combination may not be accounted for as a merger if a material part of the consideration that the issuing entity offers the equity shareholders in the other parties is in the form of shares with substantially reduced rights. Such an offer would be contrary to the concept that a merger is the mutual sharing in risks and rewards of the combined entity. Some adjustment to the rights attaching to the shares held by the non-issuing entities' shareholders may be compatible with the combination being a merger, as business combinations result from a negotiating process where different pre-existing rights have to be reconciled. Whether any change in the rights of one group of shareholders is sufficient to prevent that business combination being treated as a merger will depend on the facts in any individual case, taking into account such matters as what rights shareholders originally had, the total arrangement negotiated, time limits and whether any new restrictions apply equally to all sets of shareholders. In determining whether equity shares with reduced rights have been issued, both rights to vote and rights to distributions attaching to the shares would need to be taken into account. If any of these individual rights were significantly reduced or circumscribed the combination would fail to fulfil this condition.

- 73 If one entity has acquired an interest in another in exchange for non-equity consideration, or equity shares with significantly reduced rights, within the two years before those entities combined, such consideration should be regarded as part of the consideration for the combination for the purpose of determining whether this criterion is met.
- 74 Sometimes a peripheral part of the business of one of the combining parties will be excluded from the combined entity. The FRS states that shares in the peripheral business, or the proceeds of sale of the business, that are distributed to the shareholders of that party to the combination as part of the arrangements for the combination are not to be counted as part of the consideration for the purposes of this criterion.

*Criterion 5 – minorities etc*

- 75 Criterion 5 is concerned with a party retaining an interest in only part of the combined entity. The concept of a merger is that the participants enter into a mutual sharing of the risks and rewards of the whole of the new entity, including the pooled future results of the combined entity. This concept is incompatible with certain participants having a preferential interest in one part of the combined entity. This criterion would not, therefore, be met if the share of the equity in the combined entity allocated to the shareholders of one of the parties to the combination depended to any material extent on the post-combination performance of the business, or any part of it, formerly controlled by that party.
- 76 This criterion would similarly not be met where earn-outs or similar performance-related schemes are included in the arrangements to effect a merger. The test is also failed if there is any material minority (defined by companies legislation as 10 per cent) of shareholders left in one of the combining parties that have not accepted the terms of the combination offer.



- 77 However, the criterion would not necessarily be invalidated by an arrangement whereby the allocation of consideration between the shareholders of the combining parties depended on the determination of the eventual value of a specific liability or asset contributed by one of the parties—such as the eventual outcome of a claim against one of the parties, or the eventual sales value of a specific asset owned by one of the parties—as opposed to the future operating performance of that party.

***Group reconstructions***

- 78 In addition to mergers as defined above, merger accounting may also be appropriate for a group reconstruction, provided that the relative rights of the ultimate shareholders are not altered. Such reconstructions include not only the transfer of shares in a subsidiary undertaking within a group, but also arrangements such as the introduction of a new holding company, the splitting off of one or more subsidiary undertakings, as in some demergers, where a separate group is formed, and the bringing together into a new group of two or more companies that were previously under common ownership. Acquisition accounting would require the restatement at fair value of the assets and liabilities of the company transferred, and the recognising of goodwill, which is likely to be inappropriate in the case of a transaction that does not alter the relative rights of the ultimate shareholders.
- 79 Where a minority interest exists, merger accounting is permitted only for those group reconstructions that do not change the interest of the minority in the net assets of the group. Thus the transfer of a subsidiary undertaking within a subgroup that has a minority shareholder may qualify for merger accounting; but acquisition accounting must be used for the transfer of a subsidiary undertaking out of, or into, such a

subgroup. If a minority has effectively acquired, or disposed of, rights to part of the net assets of the group, the FRS requires the transfer to be accounted for by using acquisition accounting rather than merger accounting.

### ***Disclosure***

- 80 The disclosure requirements in the FRS cover and supplement those in companies legislation.

### ***Mergers***

- 81 With merger accounting the financial statements of the combined entity are drawn up by combining the results of the combining entities for the whole of the financial year in which the merger occurred. Users, particularly those who have been assessing the parties to the combination as separate businesses, may require information on the financial performance of the individual parties. The FRS therefore requires an analysis of the profit and loss account and statement of total recognised gains and losses into pre- and post-merger amounts; and a further analysis of the pre-merger amounts between each of the parties to the merger. An analysis between the parties of the preceding financial year is also required. However, it is not necessary, where revaluation gains or losses have been recognised as a result of a valuation at the year-end, to obtain further valuations at the date of the merger in order to apportion the gains or losses between pre- and post-merger periods.
- 82 Group reconstructions that are accounted for by using merger accounting are exempted from the disclosure requirements in the FRS, but must still give the information required by companies legislation.

*Acquisitions*

- 83** The disclosure requirements of the FRS provide information about the resources applied in acquisitions, the net assets acquired and the effects on the consolidated financial statements of the acquiring group. Separate presentation of the results of acquisitions assists analysis of the significance of new operations that have been acquired. In some circumstances it may also be useful to users for the results of acquisitions for the first full financial year for which they are a part of the reporting entity to be disclosed in the notes.
- 84** Paragraph 23 of the FRS requires the disclosures in paragraphs 24–35 to be given for each material acquisition, and those in paragraphs 24–34 to be given for other acquisitions in aggregate. Materiality must be judged by whether the information relating to the acquisition might reasonably be expected to influence decisions made by the users of general purpose financial statements. Paragraph 36 applies further disclosure requirements to certain substantial acquisitions.
- 85** In order to give a true and fair view of post-acquisition financial performance, paragraph 30 of the FRS requires disclosure of exceptional profits or losses determined using fair values recognised on an acquisition. Examples include profits or losses on the disposal of acquired stocks where the fair values of stocks sold lead to abnormal trading margins after the acquisition; the release of provisions in respect of an acquired loss-making long-term contract that the acquirer makes profitable; and the realisation of contingent assets or liabilities at amounts materially different from their attributed fair values. In accordance with the requirements of FRS 3, exceptional items would be included in the profit and loss account format headings to which they relate, and

would be disclosed by way of note, or on the face of the profit and loss account if necessary to give a true and fair view.

- 86** FRS 3 requires the profits or losses on the post-acquisition sale or termination of an operation, or on the disposal of fixed assets, to be shown in the profit and loss account below operating profit. Post-acquisition integration, reorganisation and restructuring costs, including provisions in respect of them, would, if material, be reported as exceptional items; but only if the restructuring is fundamental, having a material effect on the nature and focus of the enlarged group's operations, would the costs be shown below operating profit as an item falling under paragraph 20 of FRS 3. Paragraph 31 of FRS 6 requires that costs of reorganising, restructuring and integration that relate to an acquisition, whether relating to a fundamental restructuring or not, should be shown separately from other exceptional items.
- 87** The costs of reorganising, restructuring and integrating an acquired entity may extend over more than one period. For major acquisitions, therefore, management may wish to state in the notes to the financial statements the nature and amount of such costs expected to be incurred in relation to the acquisition (including asset write-downs), indicating the extent to which they have been charged to the profit and loss account. If part of these costs relate to asset write-downs (beyond any impairments recognised in adjusting to fair values on the acquisition) it may be useful to distinguish these from cash expenditure. An illustrative example of how such information might be shown is included as Appendix IV to the FRS.

*Substantial acquisitions*

- 88 Where an acquisition has been made that has a substantial effect on the consolidated results of the acquiring entity, additional disclosures are required to enable the user to assess the effect of the acquisition on the consolidated results. Although control over the acquired entity is obtained only at the date of acquisition, in most cases it is a continuing business that is acquired, and information on the results for the period up to the date of acquisition is relevant to the user. For acquisitions that meet the size tests in paragraph 37, the FRS therefore requires the disclosure of the results of the acquired entity for the part of its financial year up to the date of the acquisition, and for its previous financial year. Since neither of these periods will necessarily be twelve months, their commencing dates should also be indicated.
- 89 Several components of the pre-acquisition results are required to be shown for the part of the acquired entity's financial year up to the date of acquisition, since this period may be particularly relevant to an understanding of the post-acquisition results and may not otherwise be publicly reported. Equivalent information for the preceding financial year is likely to be of less relevance, and the disclosure requirement is limited to profit after tax and minority interests. The FRS requires this information to be given on the basis of the acquired entity's accounting policies before the acquisition; in some cases, the management of the acquiring entity may consider it helpful in explaining the impact of the acquisition to give, in addition, the same information restated onto the basis of the acquiring entity's accounting policies.

## **ADOPTION OF FRS 6 BY THE BOARD**

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*Financial Reporting Standard 6 – ‘Acquisitions and Mergers’ was approved for issue by the eight members of the Accounting Standards Board.*

Sir David Tweedie (Chairman)

Allan Cook (Technical Director)

Robert Bradfield

Ian Brindle

Michael Garner

Raymond Hinton

Donald Main

Graham Stacy

## **APPENDIX I**

### **NOTE ON LEGAL REQUIREMENTS**

#### ***Great Britain***

#### ***References are to the Companies Act 1985***

#### ***Merger accounting***

- 1 The Companies Act describes the acquisition method of accounting (Schedule 4A paragraph 9) and the merger method of accounting (Schedule 4A paragraph 11). Schedule 4A paragraph 10 lays down the conditions that must be met if a business combination is to be accounted for as a merger. The conditions are:
  - (a) that at least 90 per cent of the nominal value of the relevant shares (those with unrestricted rights to participate both in distributions and in the assets on liquidation) in the undertaking acquired is held by or on behalf of the parent company and its subsidiary undertakings;
  - (b) that the proportion referred to in (a) was attained pursuant to an arrangement providing for the issue of equity shares by the parent company or one or more of its subsidiary undertakings;
  - (c) that the fair value of any consideration other than the issue of equity shares given pursuant to the arrangement by the parent company and its subsidiary undertakings did not exceed 10 per cent of the nominal value of the equity shares issued; and
  - (d) that adoption of the merger method of accounting accords with generally accepted accounting principles or practice.

- 2 Where a group is acquired, the Companies Act requirements described in the previous paragraph also apply. References to shares of the undertaking acquired are to be construed as references to the shares of the acquired group's parent and references to the assets and liabilities, income and expenditure, and capital and reserves of the undertaking acquired are to be construed as references to the same elements of the group acquired, after making the necessary set-off and adjustments required for the consolidated accounts (Schedule 4A paragraph 12).

*Disclosures*

- 3 The following information shall be given in a note to the accounts for all business combinations taking place in the financial year:
  - (a) the names of the entities involved;
  - (b) whether the combination has been accounted for by the acquisition or merger method of accounting (Schedule 4A paragraph 13(2)).
- 4 In addition, for any business combination that significantly affects the figures shown in the group accounts, the following further information shall be given:
  - (a) the composition and fair value of the consideration for the acquisition given by the parent and its subsidiary undertakings (Schedule 4A paragraph 13(3));
  - (b) the profit or loss of the undertaking or group acquired for the period up to the date of the acquisition from the beginning of the financial year of that undertaking or group, and for the previous financial year of that undertaking or group. The date on which this financial year began should also be stated (Schedule 4A paragraph 13(4)).



- 5 Where the acquisition method of accounting has been adopted, the book values immediately prior to acquisition and fair values at the date of acquisition of each class of assets and liabilities of the acquired entity shall be stated in tabular form, including a statement of the amount of any goodwill or negative consolidation difference arising on the acquisition, together with an explanation of any significant adjustments made (Schedule 4A paragraph 13(5)).
- 6 Where the merger method of accounting has been adopted, an explanation shall be given of any significant adjustments made in relation to the amounts of the assets and liabilities of the undertaking or group acquired, together with a statement of any resulting adjustment to the consolidated reserves (including the restatement of opening consolidated reserves) (Schedule 4A paragraph 13(6)).
- 7 None of the information required by paragraph 13 of Schedule 4A to the Act need be disclosed for an undertaking which:
  - (a) is established under the law of a country outside the United Kingdom; or
  - (b) carries on business outside the United Kingdom

if, in the opinion of the directors of the parent company, the disclosure would be seriously prejudicial to the business of that undertaking or to the business of the parent company or any of its subsidiary undertakings and the Secretary of State agrees that the information should not be disclosed (Schedule 4A paragraph 16).

*Share premium and merger relief*

- 8 Section 130(1) of the Companies Act provides that if a company issues shares at a premium, whether for cash

or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares should be transferred to an account called the share premium account. The provisions of the Companies Act relating to the reduction of a company's share capital apply, with exceptions, as if the share premium account were part of its paid-up share capital.

- 9 Limited relief from the above ('merger relief') is given by sections 131–134.
- 10 Section 131 of the Companies Act provides, inter alia, that, subject to specified conditions, where an issuing company has secured at least a 90 per cent equity holding in another company, section 130 does not apply to the premium on shares issued in the transaction which takes the holding in that other company to at least 90 per cent.
- 11 Section 133(1) provides that the premium on any shares to which the relief in sections 131 and 132 of the Companies Act applies may also be disregarded in determining the amount at which any shares, or other consideration provided for the shares issued, are to be included in the offeror company's balance sheet.
- 12 The Companies Act requires the disclosure of additional information where merger relief is taken. Schedule 5 paragraphs 10 and 29 refer respectively to companies that are not obliged to prepare group accounts and those that are. They apply to arrangements attracting merger relief, that is, where a company allots shares in consideration for the issue, transfer or cancellation of shares in another body corporate ('the other company') in circumstances such that section 131(2) (merger relief) applies to the premiums on the shares.
- 13 If the company makes such an arrangement during the financial year, the following information shall be given:

- (a) the name of the other company;
  - (b) the number, nominal value and class of shares allotted;
  - (c) the number, nominal value and class of shares in the other company issued, transferred or cancelled; and
  - (d) particulars of the accounting treatment adopted in the consolidated accounts in respect of the issue, transfer or cancellation.
- 14 In addition, for companies that are required to prepare group accounts Schedule 5 paragraph 29(2) requires the disclosure of particulars of the extent to which and manner in which the profit or loss for the financial year shown in the consolidated accounts is affected by any profit or loss of the other company, or any of its subsidiary undertakings, that arose before the time of the arrangement.

*Accounts of the parent company*

- 15 The FRS deals only with the method of accounting to be used in group accounts; it does not deal with the form of accounting to be used in the acquiring or issuing company's own accounts and in particular does not restrict the reliefs available under sections 131–133 of the Companies Act.
- 16 Where a dividend is paid to the acquiring or issuing company out of pre-combination profits, it would appear that it need not necessarily be applied as a reduction in the carrying value of the investment in the subsidiary undertaking. Such a dividend received should be applied to reduce the carrying value of the investment to the extent necessary to provide for a diminution in value of the investment in the subsidiary undertaking as stated in the accounts of the parent

company. To the extent that this is not necessary, it appears that the amount received will be a realised profit in the hands of the parent company.

### ***Northern Ireland***

- 17 The legal requirements in Northern Ireland are similar to those in Great Britain. The following table shows the references to the Companies (Northern Ireland) Order 1986 that correspond to the marginal references in the FRS and the legal references in paragraphs 1–16 above.

#### ***Great Britain: the Companies Act 1985***

#### ***Northern Ireland: the 1986 Order***

#### ***Merger accounting***

Schedule 4A  
paragraphs 9–12

Schedule 4A  
paragraphs 9–12

#### ***Disclosures***

Schedule 4A  
paragraph 13

Schedule 4A  
paragraph 13

Schedule 4A  
paragraph 16

Schedule 4A  
paragraph 16

#### ***Share premium and merger relief***

Sections 130–134

Articles 140–144

Schedule 5 paragraph 10

Schedule 5 paragraph 10

Schedule 5 paragraph 29

Schedule 5 paragraph 29

***Republic of Ireland***

- 18 The following table shows the references to the European Communities (Companies: Group Accounts) Regulations 1992 and the Companies Act 1963 that correspond to the marginal references in the FRS and the legal references in paragraphs 1 – 16 above.

***Great Britain:  
the Companies Act 1985***

***Republic of Ireland:  
the 1992 Regulations***

*Merger accounting*

Schedule 4A paragraph 9	Paragraph 19
Schedule 4A paragraph 10	Paragraph 21
Schedule 4A paragraph 11	Paragraph 22
Schedule 4A paragraph 12	Paragraph 23

*Disclosures*

Schedule 4A paragraph 13(2)	The Schedule paragraph 12(2)
Schedule 4A paragraph 13(3)–13(6)	No exact equivalent; paragraph 27 of the 1992 Regulations states that if the composition of the under- takings dealt with in the group accounts has changed significantly in the course of a financial year, the group accounts must include information that makes the comparison of successive sets of group accounts meaningful.
Schedule 4A paragraph 16	No equivalent

*Share premium and merger relief*

Section 130	Companies Act 1963 section 62
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Sections 131–134	No equivalent
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Schedule 5 paragraph 10	No equivalent
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Schedule 5 paragraph 29	No equivalent
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*Merger relief in the Republic of Ireland*

- 19 As there is currently no legislation equivalent to merger relief in the Republic of Ireland, no explicit relief from the requirement of section 62(1) of the Companies Act 1963 to establish a share premium account is available.
  
- 20 However, section 149(5) of the Companies Act 1963 provides that, whilst, in general, pre-acquisition profits of acquired subsidiaries may not be treated in the holding company's accounts as revenue profit, an exemption from that provision is available in that, where the directors and auditors are satisfied and so certify that it would be fair and reasonable and would not prejudice the rights and interests of any person, the profits or losses attributable to any shares in a subsidiary may be treated in a manner otherwise than in accordance with that subsection.
  
- 21 The possible need for legal advice in relation to the application of section 149(5) to merger accounting should be considered before merger accounting is applied to Republic of Ireland companies.

## **APPENDIX II**

### **COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS**

The requirements of the FRS are consistent with International Accounting Standard 22 'Business Combinations' (revised 1993), except for the provision in paragraph 13 of that standard relating to reverse acquisitions, which is incompatible with companies legislation in the UK and the Republic of Ireland.

## APPENDIX III

### THE DEVELOPMENT OF THE FRS

#### *History*

##### *Before the Companies Act 1981*

- 1 Although some use was made of merger accounting in the UK before the Companies Act 1981, and indeed an exposure draft of an accounting standard, ED 3, was published (in 1971), there was concern that the share premium provisions of the Companies Act 1948 might be interpreted so as to prohibit the use of merger accounting. This view was confirmed by the decision in *Shearer v Bercaïn* in 1980.

##### *The Companies Act 1981 and SSAP 23*

- 2 The Companies Act 1981 introduced the concept of merger relief, removing the legal obstacle to merger accounting. Following this, the Accounting Standards Committee (ASC) issued an exposure draft, ED 31, converted into an accounting standard, SSAP 23 'Accounting for acquisitions and mergers', in 1985.
- 3 SSAP 23 based its concept of a merger on whether or not the arrangements for the combination resulted in material resources leaving the group. This concept was supported by four criteria defining the circumstances in which merger accounting was permitted:
  - (a) the business combination results from an offer to the holders of all equity shares and the holders of all voting shares that are not already held by the offeror; and



- (b) the offeror has secured, as a result of the offer, a holding of (i) at least 90 per cent of all equity shares (taking each class of equity separately) and (ii) the shares carrying at least 90 per cent of the votes of the offeree; and
  - (c) immediately prior to the offer, the offeror does not hold (i) 20 per cent or more of all equity shares of the offeree (taking each class of equity separately) or (ii) shares carrying 20 per cent or more of the votes of the offeree; and
  - (d) not less than 90 per cent of the fair value of the total consideration given for the equity share capital (including that given for shares already held) is in the form of equity share capital; not less than 90 per cent of the fair value of the total consideration given for voting non-equity share capital (including that given for shares already held) is in the form of equity and/or voting non-equity share capital.
- 4 Note, however, that merger accounting remained optional even if these criteria were met.

*The EC Seventh Directive and the Companies Act 1989*

- 5 The EC Seventh Company Law Directive introduced more stringent requirements to be met before merger accounting was permitted. The conditions of the Directive were implemented in Great Britain, with some additional provisions, by the Companies Act 1989, as amendments to the Companies Act 1985. These conditions are:
- (a) that at least 90 per cent of the nominal value of the relevant shares (those with unrestricted rights to participate both in distributions and in the assets on liquidation) in the undertaking acquired is held by or on behalf of the parent company and its subsidiary undertakings;

(b) that the proportion referred to in (a) was attained pursuant to an arrangement providing for the issue of equity shares by the parent company or one or more of its subsidiary undertakings;

(c) that the fair value of any consideration other than the issue of equity shares given pursuant to the arrangement by the parent company and its subsidiary undertakings did not exceed 10 per cent of the nominal value of the equity shares issued; and

(d) that adoption of the merger method of accounting accords with generally accepted accounting principles or practice.

6 In requiring compliance with generally accepted accounting principles, the Companies Act clearly acknowledged that merger accounting would not be appropriate for all business combinations that met the first three conditions.

7 The comparison, in condition (c), with the nominal value of shares issued is also noteworthy. The nominal value is of no economic significance. In contrast, the corresponding condition (d) of SSAP 23 refers to the fair value of the equity shares issued.

*Limiting the use of merger accounting—the ED 48 proposals*

8 ED 48 was issued by the ASC in February 1990 in response to widespread concern that the SSAP 23 conditions were too readily circumvented. It proposed to limit the use of merger accounting to a very restricted class of combinations that could be regarded as ‘true’ mergers. These were to be defined as a combination that was effectively an equal partnership between the combining parties, where no party saw itself as either an acquirer or an acquiree. In addition,

there had to be continuing involvement from the management of each of the parties in the combined entity; and the parties were to be of broadly equal size. Any minority not accepting the merger offer was not to exceed 10 per cent, and no material consideration other than equity shares was permitted.

- 9 ED 48 then proposed that merger accounting would be required, and not merely permitted, for all combinations meeting these conditions (although, as a practical matter, it has been suggested that it would be relatively easy for merging parties to ensure that one of the conditions was not met, without fundamentally altering the commercial substance of the transaction, if they did not wish to use merger accounting—and thus for practical purposes the option to use acquisition accounting might be seen to remain).
- 10 Although respondents to ED 48 were generally in agreement with its proposals, there was criticism of the conditions for merger accounting, in particular of their subjective nature, which, it was expected, would give rise to difficulties in applying them consistently.

*International Accounting Standards*

- 11 The merger concept underlying ED 48 is similar to that proposed for a ‘uniting of interests’ in the International Accounting Standard 22, revised in 1993, although that standard does not develop tests for identifying when a combination is a merger. IAS 22 defines a uniting of interests as:

“a business combination in which the shareholders of the combining enterprises combine control over the whole, or effectively the whole, of their net assets and operations to achieve a continuing mutual sharing in the risks and benefits attaching to the combined entity such that neither party can be identified as the acquirer.”

*FRED 6*

- 12 In considering the application of merger accounting, the Board was concerned by the apparent choice available in many cases between acquisition and merger accounting, and that two business combinations with very similar economic substance could be accounted for in different ways, with substantial differences in reported results and balance sheets not only for the financial year in which the combination occurred but for several years thereafter. The Board also found it difficult to identify any theoretical basis to justify the use of merger accounting for the wide range of business combinations for which it was then permissible.
- 13 In issuing FRED 6, the Board therefore adopted the intention of ED 48, of narrowing the use of merger accounting.
- 14 No major changes were proposed, but the Board sought to remove subjectivity where possible. The approach of the FRED was based on the belief that merger accounting should be applied to only a few rare instances of business combinations that were properly regarded as mergers, and that the vast majority of business combinations were more appropriately accounted for as acquisitions.
- 15 The definition of a merger was redrafted, but its intent was unchanged. The definition of an acquisition was amended to make it clear that all combinations were either mergers or acquisitions.
- 16 The six conditions under which merger accounting would have been permitted by ED 48 were redrafted as five criteria, as follows:

Criterion 1 – redrafted form of ED 48 condition (a).

Criterion 2 – amended form of ED 48 condition (b), acknowledging that to require the board of a merged entity to have equal participation from each of the parties to the merger might prevent the parties to the merger from choosing the management they considered most appropriate; and might lead to too much focus on the numerical representation of each party on the new board at the expense of considering where the real decision taking influence lay.

Criterion 3 – redrafted form of ED 48 condition (e).

Criterion 4 – redrafted form of ED 48 condition (c).

Criterion 5 – redrafted form of ED 48 conditions (d) and (f), reducing these to a more general principle.

*Disclosure*

- 17 The disclosure requirements proposed by ED 48 were extended to require analysis into pre-combination and post-combination periods of several items in the profit and loss account, and the statement of total recognised gains and losses, rather than focusing solely on profit after tax and extraordinary items.

***Matters considered in the light of responses to FRED 6***

- 18 A large majority of the respondents to FRED 6 agreed with the proposals it contained, and these are accordingly unchanged. The following paragraphs describe those points on which respondents expressed concern and explain whether or not a change was made and the Board's reasoning for its decision.

*Disclosure requirements on an acquisition*

- 19 The full disclosure requirements proposed in the FRED relating to the pre-combination results of the parties to a merger, and the acquired entity in an acquisition, were supported by a majority of respondents, and particularly by users of accounts. Concern was expressed, however, at the practical difficulties in obtaining this information relating to acquisitions, and many preparers of financial statements questioned whether such disclosures were, in practice, of value to users.
- 20 The Board has therefore reconsidered the extent of the disclosures required in respect of the acquired company, and has made three main relaxations in the requirements:
  - (a) less detailed analysis of the results of the acquired company up to the date of acquisition is now required;
  - (b) only the profit after tax and minority interests for its previous financial year is now required to be shown; and
  - (c) fuller disclosure is now required only for substantial acquisitions, defined as being 'Class I' or 'Super Class I' where the acquirer is a listed company, or in excess of 15 per cent of net assets or profits for others.

The FRS now states that this information is to be given using the accounting policies of the acquired company, instead of being restated using the acquirer's accounting policies.

- 21 Some respondents suggested that it would be more helpful for all disclosure requirements relating to acquisitions to be consolidated into one standard. The Board has accordingly included in this FRS the proposed disclosure requirements set out in FRED 7 (which were based on those in SSAP 22), amended to take account of responses made to that FRED. It has also incorporated references to the disclosure requirements relating to acquisitions in FRS 1 and FRS 3, unchanged other than to make it clear that the disclosures should be made separately for each material acquisition, and for other acquisitions in aggregate.

*Disclosure requirements on a merger*

- 22 The Board concluded that, in the case of a merger, no relaxation of the proposed disclosures was appropriate. Because of the continuing involvement of management of both parties to the merger, the practical difficulties would be less, and the likely significance of the merger to the shareholders would make it desirable to provide fuller information. Although it was argued that analysing pre-merger results among the parties was in some sense contrary to the concept of merger accounting, in that the financial statements were drawn up on the basis that the parties had always been merged, the Board took the view that full information on the combining parties separately was important to an understanding of the combined entity.

*Definitions and criteria for merger accounting*

- 23 The definitions of mergers and acquisitions, and the criteria for merger accounting, were generally agreed as appropriate by respondents, and only minor drafting changes have been made. Criterion 4 has been amended to make clear the effect of an entity disposing of part of its business prior to the combination.

*Group reconstructions*

- 24 There was general agreement with the proposed use of merger accounting in group reconstructions, but some respondents requested that this should be more widely available. The Board has therefore agreed to widen the definition of group reconstructions, provided minority rights are unaffected, to include situations where a new holding company is created; where a 'horizontal group' of companies under common ownership become a group under the companies legislation definition; and where a part of a group is transferred to a new company, not part of the group but owned by the same shareholders as the group.

*Merger expenses*

- 25 The FRED proposed that merger expenses should be charged to the profit and loss account. Although a majority of respondents supported this proposal, there was significant support for deducting such costs from reserves, in a way similar to the costs of issuing an equity instrument under FRS 4. The Board believes, however, that there is a fundamental difference between the costs of issue of an equity instrument, which raises new capital, from which the costs may sensibly be deducted, and the costs of a merger, which does not raise new capital, but which requires an expenditure of resources that should therefore be charged to the profit and loss account. The Board has clarified that these costs should be shown as an exceptional item in accordance with paragraph 20 of FRS 3.



*Demergers*

- 26 Several respondents suggested that the FRS should deal with the accounting issues arising on demergers as well. However, the Board took the view that such issues as arise on a demerger are unrelated to those of business combinations, and should not be dealt with in the same FRS (although the restructuring that takes place on a demerger may fall within the group restructuring provisions of this FRS).

*Alternative view – prohibiting the use of merger accounting*

- 27 The Preface to the FRED set out an alternative view, that the use of merger accounting should be prohibited (other than for certain group reconstructions). This alternative view attracted little support; most commentators thought that mergers, although rare, were a separate class of business combination for which merger accounting should be available. The Board has, accordingly, not proceeded with that proposal.

## **APPENDIX IV**

### **ILLUSTRATIVE EXAMPLE OF DISCLOSURE OF REORGANISATION AND INTEGRATION COSTS**

*This example is provided as an aid to understanding and does not form part of the Financial Reporting Standard.*

Paragraph 87 of the Explanation suggests that, for major acquisitions, management may wish to include in the notes to the financial statements the amount of reorganisation and other costs to be incurred in relation to the acquisition. The following example indicates one way in which this optional information might be presented. The best form of the disclosure will depend on individual circumstances.

## COSTS OF REORGANISING AND INTEGRATING ACQUISITIONS

	Acquisition of European business (note (a))	Other acquisitions	TOTAL
	£ million	£ million	£ million
Announced but not charged as at the previous year-end	—	25	25
Announced in relation to acquisitions during the year	170	—	170
Adjustments to previous years' estimates	—	(5)	(5)
	170	20	190
Charged in the year			
— operating profit	55	12	67
— elsewhere	65	—	65
	120	12	132
Announced but still to be charged at 31 December 1995	50	8	58

Note (a): Acquisition of European business

	£ million
Cost of acquisition	400
Reorganisation and integration expenditure announced	
Fundamental restructuring:	
– withdrawal from existing US business and related redundancies	65
Other items (to be charged to operating profit):	
– other redundancy costs	75
– re-branding and redesign costs	<u>30</u>
Announced reorganisation and integration costs as shown in above table	<u>170</u>
Total investment	<u>570</u>

In addition to the £120 million expenditure shown in the above table, reorganisation and integration costs charged during the year include £30 million in respect of write-downs to fixed assets consequent on the closure of the XYZ plant.



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## **MINUTES FROM PREVIOUS MEETINGS—ENTITY COMBINATIONS**

- April 2010
- December 2009
- September 2009
- February 2009
- June 2008
- March 2007

### **April 2010**

### **3. Entity combinations**

#### **Approve IPSAS (Agenda Item 3)**

The IPSASB considered a draft IPSAS 32, “Entity Combinations: Acquisitions.”

#### ***Key Issue: Scope***

The IPSASB discussed whether or not the scope section of proposed IPSAS 32 clearly identified which entity combinations would be within its scope. At its December 2009 meeting, the IPSASB agreed that the exchange/non-exchange split should be removed and the scope revised to exclude all non-exchange entity combinations.

A Member pointed out that the revised wording had removed the exchange/non-exchange split, but that some non-exchange entity combinations would still be within the scope of the draft Standard because it addresses bargain purchases.

The IPSASB discussed whether or not to continue with this draft Standard or to instead focus on the main issues for the public sector relating to entity combinations (i.e., mergers and reorganizations).

It was noted that the decision in June 2008 to split the project between exchange and non-exchange entity combinations so that a limited convergence project with IFRS 3, “Business Combinations” could be undertaken has been problematic—this is the third time that the Board has discussed the scope of the draft Standard and Members are still not clear which entity combinations are within its scope.

After a lengthy deliberation on the scope of the proposed IPSAS, the IPSASB agreed not to progress with the finalization of the draft Standard, but instead to focus on public sector specific entity combinations issues. The work undertaken on the draft Standard could be used at a later stage of the project.

*Issues to be addressed in wider entity combinations project*

The IPSASB suggested topics which should be addressed in an issues paper on entity combinations, as follows.

- How should reorganizations or mergers be accounted for?
  - Merger accounting – If merger accounting is used, should the comparative amounts be restated as if the entities had always been one entity?
  - Fresh start accounting – Explanation is needed as to the effect that different measurement bases will have on the amounts reported. For example, if the measurement basis is historical cost, the change in amounts reported when assets are revalued when the reorganization or merger occurs is likely to be material, whereas if the measurement basis is replacement cost, the change in amounts reported is likely to be immaterial.
- How should combinations of entities under common control (e.g., a transfer of functions between government departments) be accounted for?
  - Should there be, or is there, an assumption, that the controlling entity is the owner?
- Is the acquisition of a private sector entity in distress in substance different from other acquisitions?
  - If so, should there be a different accounting treatment? For example, the use of equity accounting for entities in distress and the use of consolidation accounting for acquisitions.
  - Should bailouts of private sector entities be considered as a separate issue from other entity combinations?
- Accounting for goodwill – To which types of entity combinations should it apply?
- How should combinations of entities be accounted for where a cash-generating operation is acquired and the acquirer operates it as a non-cash-generating operation?
- Valuation of items in an entity combination – What is the benefit of revaluing items in an entity combination? Does the benefit outweigh the cost? Do different types of entity combinations change the answer?

The IPSASB agreed that the staff should prepare an Issues Paper on entity combinations in the public sector, to be discussed at the June 2010 meeting.



December 2009

## **7. Entity combinations**

### **Approve Final Standard (Agenda Item 5)**

The IPSASB considered a draft IPSAS 32, “Entity Combinations from Exchange Transactions.” Members were in agreement that the requirements of IFRS 3 were appropriate for a limited number of entity combinations in the public sector but continued to have concerns about how best to limit the scope of the proposed Standard. There were concerns that an exchange/non-exchange approach might not be appropriate because of arguments that some public sector entity combinations do result in an exchange of value.

#### **Key Issue: Scope**

The IPSASB discussed whether the scope section of proposed IPSAS 32 clearly identified which entity combinations would be within its scope. Concerns were raised regarding the following:

- The fact that the scope focuses and lists the types of entity combinations that are excluded from the Standard, rather than explaining clearly what type of entity combinations are included in the scope. The scope should be revised to make a positive statement about the types of entity combination that are included in the Standard.
- The need to highlight a characteristic for entity combinations that are excluded from the scope of the Standard that an “owner” of the acquiree cannot be identified, rather than focusing on the identity of the acquirer.
- Bargain purchases – a bargain purchase is not synonymous with a distress sale. The intent of a bargain purchase is different from a distress sale. A distress sale where a government steps in is usually due to that government’s responsibility to be the lender of last resort. A bargain purchase occurs where some sort of price is ascertained, whereas where there is no price, it is a non-exchange entity combination.
- Reference should be to “accounting for acquisitions” or something similar, rather than distinguishing between exchange and non-exchange transactions.
- Editorial suggestions were given to improve the clarity of revised paragraph 5 regarding reorganizations.

The following comments were made regarding the revised paragraph 3:

- The notion of “willing” parties is not necessary in the explanation of what an “entity combination from an exchange transaction” means.
- It does not address situations where there is a wide share ownership and this aspect should be included.

- The example of the acquisition of an airline should be changed to the acquisition of a hospital, as this example is more common.
- Split this paragraph into two paragraphs to deal with the two aspects discussed, that an entity combination within the scope of this standard arises from an arm's length transaction and that the transaction requires the owner or controlling entity of the acquiree to be identified. If the owner or controlling entity cannot be identified then the entity combination is outside the scope of the standard.

The IPSASB directed the staff to revise the wording of the scope section of draft IPSAS 32 to include further explanation so as to make it clear which entity combinations would be within its scope. IPSAS 32 will be considered for approval at the IPSASB meeting in April 2010.

September 2009

## **4. Entity Combinations**

### **Review Responses to ED 41 (Agenda Item 8)**

The IPSASB considered the Staff analysis of the key issues raised from the responses to ED 41, "Entity Combinations from Exchange Transactions."

#### **Key Issue 1: ED 41 not relevant to the public sector**

Some respondents to ED 41 questioned whether entity combinations from exchange transactions actually occur in the public sector or occur frequently enough for the proposed guidance to be relevant to public sector entities. The IPSASB discussed this issue and generally agreed that entity combinations from exchange transactions, while rare, do occur in some jurisdictions and therefore this project should continue. Several Members highlighted that it is important to communicate this point and that the IPSASB has a separate project to issue guidance on public sector specific entity combinations.

#### **Key Issue 2: Scope limitation**

Several respondents considered that the proposed scope of ED 41 is inappropriately limited and identified several reasons as to why. The IPSASB discussed whether the distinction between exchange and non-exchange entity combinations is the most appropriate distinction. Concerns were raised regarding the lack of clarity of the scope as it is currently worded in ED 41. For example, could a local government merger, where no consideration is transferred, actually be an exchange transaction, because the acquirer receives net assets and assumes responsibilities? The assumption of responsibilities could be seen as an exchange for the net assets. ED 41 does not make it clear that an exchange transaction relates to consideration being transferred and not the exchange of net assets for the assumption of responsibilities, even though the definition of a non-exchange transaction is clear that consideration transferred is financial. Thus, local government mergers would not meet the definition of an entity combination from an exchange transaction. The IPSASB generally agreed that ED 41 should be explicit that

local government mergers or amalgamations are excluded from the scope of ED 41 and that the guidance should explain that local government mergers are a public sector specific issue.

Another example was discussed regarding the lack of clarity of scope in ED 41. This situation arises where there is an acquisition of an entity which is insolvent, such as where payment is made of CU1 in exchange for the assumption of net liabilities. This type of combination could be seen to be a non-exchange transaction and thus excluded from the scope of ED 41.

The IPSASB discussed several alternatives regarding how the scope of ED 41 could be clarified by excluding from the scope of ED 41 the following:

- Acquisitions that are directed or forced;
- Acquisitions that are a result of a loss of subsidies; and
- Acquisitions where there is no determined purchase price—although it was acknowledged that a lack of consideration is addressed in ED 41 as it includes in its scope mergers by contract alone.

Alternatively, the IPSASB also discussed whether or not it would be easier to add guidance in ED 41 regarding which combinations are included in the scope (i.e., what is an entity combination from an exchange transaction?). It was noted that as ED 41 is a convergence project with a private sector standard and by its very nature ED 41 will not address most entity combinations occurring in the public sector. Therefore, ED 41 should be explicit that entity combinations from exchange transactions are rare. Further, ED 41 should also be explicit that its underlying assumptions relate to:

- Entity combinations where there is a willing buyer and a willing seller;
- An acquirer can always be identified; and
- There are “owners” of the acquired entity.

The IPSASB also discussed whether or not the phrase “from an exchange transaction” at the end of “entity combination” was a useful phrase to include and whether or not the notion of an exchange transaction was already implicitly embedded in ED 41, as it is based on a private sector standard. Additionally, a suggestion was made that the scope of ED 41 could be made clearer by returning to the original term “business combination” instead of using “entity combination.”

The IPSASB directed the Staff to revise the wording of the scope section of ED 41 to include further explanation to make it clear which entity combinations would be within its scope.

Additionally, a respondent raised a concern that paragraph 5 of ED 41 refers to IPSAS 3 and the hierarchy for guidance on non-exchange entity combinations, but this reference is not helpful because there is currently no international or national guidance on how to

account for entity combinations from non-exchange transactions. The IPSASB agreed that the reference to IPSAS 3 and the hierarchy should be removed from ED 41.

### **Key Issue 3: Need for a project on goodwill**

Several respondents considered that the paragraphs relating to the treatment of goodwill arising from the acquisition of a non-cash-generating operation should be in the text of the Standard itself and not in the Application Guidance. The IPSASB agreed with this suggestion.

A respondent also suggested that a separate project be initiated to review the accounting treatment for goodwill in public sector entities. The IPSASB agreed that this issue should be added to the list of potential projects to be considered as the IPSASB's 2010-2012 Strategic Plan is developed. Project priorities will be assessed at the next IPSASB meeting in December 2009.

### **Key Issue 4: Changes to IAS 27 not reflected in IPSAS 6**

A respondent raised a concern regarding the fact that amendments made to IAS 27, "Consolidated and Separate Financial Statements" at the same time as the revision to IFRS 3, "Business Combinations" in January 2008, have not been reflected in IPSAS 6, "Consolidated and Separate Financial Statements," either as a consequential amendment to ED 41 or as a separate update of IPSAS 6. The amendments to IAS 27 provide additional guidance which is not currently reflected in IPSASs. The IPSASB generally agreed that the amendments to IAS 27 need to be considered, and that this should be a separate project to ED 41. The IPSASB agreed that this issue should also be added to the list of potential projects to be considered as the IPSASB's 2010-2012 Strategic Plan is developed.

**February 2009**

## **4. ENTITY COMBINATIONS (IFRS 3 CONVERGENCE and NON-EXCHANGE ENTITY COMBINATIONS)**

### **Approve ED 41 (Agenda Item 4)**

The IPSASB considered draft ED 41, "Entity Combinations from Exchange Transactions." The proposed adaptations from IFRS 3, "Business Combinations" are based on the directions the IPSASB gave the Staff at its June 2008 meeting.

The IPSASB discussed the proposed distinction between an acquisition of a business and an acquisition of a function which was introduced to enable any residual arising on an acquisition of an integrated set of activities and assets which predominantly encompass service potential to be identified and immediately expensed. Some Members commented that it would be difficult to distinguish between a business and a function. Other Members thought that the accounting treatment of any residual arising from an entity combination is a separate issue from the acquisition itself. Therefore, the distinction between business and function is not necessary. Furthermore, it was noted that the

distinction is artificial and unnecessary. Any definition needs to cover a range of entity combinations rather than being characterized as either an acquisition of a business or an acquisition of a function. The IPSASB agreed that the proposed split between an acquisition of a business or function is unnecessary and should be removed.

It was suggested that the term "operation" should be used instead of the terms "business" and "function" as the word operation encompasses the range of activities that are acquired. The IPSASB agreed that the terms business and function should be replaced with one definition, based on the definition of a business, using the word "operation."

Initially, there was support for the distinction between a function and a business on the basis that it is necessary to ensure that any residual arising on an acquisition of a non-cash-generating unit is immediately expensed. Some commented that there are two impairment standards within the IPSASB suite of standards which could be amended to cover the issue of impairment testing of any residual. It was also noted that goodwill only occurs in a cash-generating environment and therefore any residual arising on the acquisition of a non-cash-generating unit should be immediately expensed. The Staff noted that IPSAS 21, "Impairment of Non-Cash-Generating Assets" deals with testing of impairment of non-cash-generating assets. IPSAS 21 does not consider that unallocated service potential, including goodwill, will arise at a non-cash-generating unit level. Hence, non-cash-generating assets are tested for impairment at the individual asset level. The IPSASB agreed that ED 41 should include proposed consequential amendments to IPSAS 26 so that guidance on how to test any goodwill arising on cash-generating units will be included. The IPSASB also agreed that Application Guidance will be included in ED 41 regarding the application of IPSAS 21 to the acquisition of non-cash generating units. The Introduction to ED 41 will also explain the application of IPSAS 21 and IPSAS 26.

It was questioned whether the split in ED 41 between exchange and non-exchange entity combinations was the best distinction to use. Specifically, can entity combinations be clearly divided between exchange and non-exchange transactions? A suggested approach could be to distinguish between entity combinations occurring between a willing buyer/seller, i.e., where there is no compulsion and then use accounting requirements based upon IFRS 3. It was also acknowledged that the line between exchange and non-exchange transactions is sometimes unclear; however, the IPSASB discussed this split when debating the project on revenue from non-exchange transactions, which resulted in IPSAS 23. A Member commented that the suggestion regarding "no compulsion" could be used instead as an indicator, to help in distinguishing between an exchange or non-exchange transaction, but ultimately, it is not a clear distinction.

It was suggested that, instead of the split between exchange and non-exchange entity combinations, "restructures within the public sector that are imposed by, or subject to approval of, the relevant government" be scoped out of any standard based upon IFRS 3. The effect of this proposal would be to limit the scope of ED 41 to combinations where a government expands the boundaries of the government.

The IPSASB agreed that ED 41 should be consistent with existing IPSASB standards and retain the exchange/non-exchange split. However, wording in the Introduction should reflect that ED 41 is limited to convergence with IFRS 3 and that other types of entity combinations which occur in the public sector will be addressed separately in order to determine the appropriate accounting treatment.

A Member commented that it was not clear whether mergers between public sector entities are within the scope of ED 41. Another Member commented that IFRS 3 asserts that an acquirer can always be identified but, the context of IFRS 3 is that entity combinations take place by using an exchange transaction. The fact that non-exchange transactions are prevalent in the public sector is a key difference between the public sector and the private sector. Another Member supported this approach because ED 41 addresses entity combinations from exchange transactions only and thus mergers which do not meet this definition are outside the scope of ED 41. It was agreed that this point needs to be made in the Basis for Conclusions of ED 41 and draft wording was proposed. The IPSASB also agreed that the second sentence of IN6 should be removed as it asserts that the acquirer can always be identified.

Other changes to ED 41 were agreed as follows:

- Amendment of the heading above paragraph 43 (IFRS 3 ref) to refer to "indirect acquisitions" rather than "acquisitions where no consideration is transferred."
- Amendment of paragraph 43 (IFRS 3 ref) to delete sub-paragraphs (b) and (c) as these situations do not arise in the public sector.
- Deletion of paragraph 44 (IFRS 3 ref) as it is not relevant due to the amendment of paragraph 43.
- Amend definition of "ownership interests" to be consistent with IPSAS 6.

The IPSASB directed Staff to redraft ED 41 in light of these comments and to circulate it for comment and ultimate approval out of session, jointly with ED 40 (see item 3 above).

### **Entity Combinations from Non-Exchange Transactions**

The IPSASB considered an issues paper on entity combinations from non-exchange transactions. The paper is based on the directions the IPSASB gave the Staff at its June 2008 meeting. The IPSASB considered the following key issues.

#### ***KI 1: Amendments to the definitions of an acquiree, acquirer and entity combination***

The Staff proposed that for entity combinations arising from non-exchange transactions the parties to the combination are more appropriately described as "recipient" instead of "acquirer" and "transferee" instead of "acquiree," with a consequential amendment to the definition of an entity combination. These terms are consistent with the terms used in IPSAS 23. The IPSASB agreed with this proposal.

***KI 2: Identifying whether entities are under common control is dependent upon the structure and legislation in a particular jurisdiction***

The Preface to IPSASs sets out the types of public sector entities to which IPSASs are designed to apply, including national governments, regional governments and local governments. The Staff consider that whether lower levels of government are controlled by higher levels of government is dependent upon the structure and legislation in place in a particular jurisdiction. The IPSASB discussed this assertion. A Member commented that applying this assertion will not lead to comparability between jurisdictions. Another Member agreed with this assertion, but noted that this should not pre-empt decisions regarding the accounting treatment of these types of entity combinations.

Another Member pointed out that whether or not an entity combination takes place between entities under common control is a matter of substance over form. There needs to be differentiation between the ability of a legislature (i.e., parliament) to mandate an entity combination from the ability of the executive (i.e., ministries or departments) to mandate an entity combination. Another Member commented that whether or not a lower level of government is under the control of a higher level of government is fact based. It was also noted that control for the purposes of financial reporting is based upon power and benefits of ownership rather than regulatory control and any subsequent Consultation Paper on this issue should cover this point.

The IPSASB generally agreed that whether or not an entity combination takes place between entities under common control is dependent upon the jurisdiction. However, the accounting treatment of this type of entity combination (from a non-exchange transaction under common control), is a separate issue. The IPSASB also agreed that the issues raised need to be addressed in the next stage of this project.

***KI 3: Internal restructuring within an economic entity of existing entities***

The Staff set out an example where a provincial government restructures a program by transferring it from one department to another department. The Staff proposed that in the recipient entity, recognition should be of existing assets and liabilities; measurement should be at carrying amount and any difference arising should be a contribution from owners. A Member commented that, for some situations, fresh start accounting could be appropriate.

Another Member commented that carrying amount is a sensible approach since there are no resulting consolidation adjustments in the economic entity's consolidated financial statements. From a performance measurement perspective, the recipient entity could change its measurement basis and revalue the assets it received from the entity combination transaction. It was noted that, in practice, whether to revalue assets before or after an entity combination is a much-debated issue. It was also pointed out that the onus is on the parties to an entity combination to agree on the approach taken to the valuation of assets, before the entity combination is undertaken. The IPSASB generally agreed that the accounting proposed for the recipient entity appears to be consistent with their view.

***KI 4: Internal restructuring within an economic entity by creating a new entity***

The Staff set out an example where a national government transfers the operations of two boards or commissions into a new entity. The Staff proposed that in the recipient entity, i.e., the new entity, recognition should be of existing assets and liabilities; measurement should be at carrying amount and any difference arising should be a contribution from owners. The IPSASB generally agreed that the issues that arise in this example are similar to the ones highlighted in Key Issue 3.

***KI 5: External restructuring to transfer one entity into another entity***

The Staff set out an example where a federal government creates legislation which mandates that the operations of one municipality are annexed into another municipality, in a jurisdiction where municipalities are not under the control of the federal government. At its June 2008 meeting, the IPSASB held a preliminary view that this type of entity combination should be accounted for at carrying amount. At that meeting, it was acknowledged that this treatment may be inconsistent with some of its other Standards, such as IPSAS 23, where initial measurement of an asset, received in a non-exchange transaction, is fair value.

A Member commented that the conclusion reached in IPSAS 23 was a practical solution rather than a conceptual decision as there was no other practical method to measure the asset. A difference between a non-exchange transaction and a non-exchange entity combination is that, in an entity combination, the carrying amounts are known (because there is access to the accounting records). Therefore, the IPSASB could justify a departure from the treatment in IPSAS 23. Additionally, in jurisdictions where financial statements are also used for the assessment of taxes or rates payable, recognizing assets at fair value increases the depreciation charge and thus the cost of services is seen to rise. Another Member commented that, for practical purposes, where a jurisdiction undertakes regular restructuring of its entities, that carrying amount is the simplistic solution.

Another Member commented that where a new entity is created it may be better to recognize assets and liabilities at fair value so that the entity's performance can be properly assessed. Another Member commented that, at present, it was difficult to find a good rationale to differentiate between acquiring an asset in a non-exchange transaction from the acquisition of an operation.

Another Member pointed out that the first priority is to have consistency of accounting treatment within a particular area, in this case, entity combinations and therefore, the accounting treatment in IPSAS 23 is not relevant to the discussion of the appropriate accounting treatment of entity combinations from non-exchange transactions.

Another aspect that was highlighted is where an entity combination from an exchange transaction is under common control as this is not addressed in IFRS 3.

Overall, the IPSASB considered that a key point from this discussion is that it was a practical decision in IPSAS 23 to require assets acquired from non-exchange transactions to be measured at fair value on initial recognition. This practical decision should not



limit the development of an accounting treatment for entity combinations from non-exchange transactions. The IPSASB agreed that the issues raised, as noted above, need to be examined in further detail.

June 2008

## **5. ENTITY COMBINATIONS**

Staff provided a brief background noting that in Accra the Board had agreed the need for this project to commence in 2008 with the general view that IFRS 3 could be convergent for the public sector.

Staff gratefully acknowledged the support provided by the staff of the South African member in the preparation of the papers as well as those Board members who were able to provide, since the Accra meeting, examples of entity combinations in their jurisdictions.

Members began by discussing the view that, overall, for those restructurings which fall outside of IFRS 3 (particularly where under common control), public sector restructurings should occur with no re-measurement of the underlying assets and liabilities impacted i.e., carrying values should be used.

Even if the restructuring occurred between entities where the existence of common control was transitory in nature (eg: forced amalgamation of municipalities by a higher level of government), it was noted that such restructurings should also apply carrying values. In such circumstances there was arguably a common control which existed beyond that of a transitory nature – notably the collective common control of the general citizenry by the higher level of government.

To use a value other than carrying value would have the potential to compromise comparability between the current and future periods, consistency, accountability and impose a cost to perform the re-measurement which would not at least equal the benefits.

The broad application of carrying values to public sector restructurings outside of IFRS 3 was generally supported by numerous members. An additional comment was made that from, for example, the perspective of amalgamating/annexing of municipalities, to re-measure assets and liabilities would subsequently impact costs of services to citizens despite the substance of the restructured entities remaining the same.

Members considered that despite general agreement with the opening discussion, it was still necessary to have a fulsome discussion on the underlying issues.

### Grouping of Restructurings

Staff noted that in keeping with the scope of IFRS 3, it was being proposed to have the project consider four categories of restructurings divided into two groups:

Group 1 – Entity Combinations – public sector version of IFRS 3 covering restructurings:

- not under common control – exchange transactions; and

Group 2 – Transfer of Functions – separate IPSAS project covering restructurings:

- not under common control – non-exchange transaction;
- under common control – exchange transaction; and
- under common control – non-exchange transaction.

Comment was made as to the need for a project for any of the group 2 restructurings as the resulting accounting should all be at carrying value. The lack of complexity did not warrant a specific project.

Others considered that the absence of international guidance for at least common control restructurings, which were very prevalent in the public sector, necessitated the need for a public sector project. The IPSASB generally shared this view though there was discussion as to how the four categories should be grouped. Some considered that the groupings could be more user-friendly.

A suggestion was made to organize according to whether or not the restructuring was an exchange or non-exchange arrangement i.e.,

Group 1 – within a public sector version of IFRS 3:

- Exchange - not under common control; and
- Exchange - under common control; and

Group 2 – separate IPSAS project;

- Non-exchange - not under common control; and
- Non-exchange - under common control.

Some support was expressed for this approach though it was noted that IFRS 3 currently scopes out business combinations under common control. An alternative suggestion to improve user friendliness was to re-consider the proposed headings for the groups, in particular, ‘transfer of functions’. Some considered that transfer of functions was not broad enough to encompass the various restructurings which could occur in that grouping.

Overall, the Board:

- agreed progressing the project using the groupings provided by staff (this position was subsequently reconsidered by the Board); and
- directed staff to reconsider the labels for group 1 and particularly group 2 to ensure they better encompass the broad suite of restructurings that could occur within each.

Staff then moved discussion to consider public sector specific issues associated with each of group 1 and group 2 restructurings.

Issues - Group 1 • not under common control - exchange

*Non-GBE-Type Acquisitions*

Staff noted the issue related to the acquisition of an entity whose under-lying assets predominately encompass service potential (eg: non-GBEs) vs economic potential (eg: GBEs). The recognition of goodwill/purchase premium for non-GBE-type entities was inconsistent with the existing definition of goodwill in IFRS 3 (which focuses on economic potential). Staff noted that the different treatment of goodwill based on the under-lying assets of the acquired entity formed the basis of existing guidance of the Canadian public sector accounting standards board.

In response to a question, staff clarified that any potential goodwill calculated would be based upon acquired assets which had been re-measured to fair value as at the acquisition date and therefore that re-measurement should encompass future service potential.

Given the clarification, members expressed concern at the inappropriateness of allocating costs to future periods for service potential. It was noted that some time in the future, there was the option for the recipient entity to re-measure its assets if it was felt that their full service potential was not correctly reflected in the existing carrying value.

As such, the Board expressed the preliminary view:

- supporting the Canadian approach that where the acquisition involved an entity where the under-lying assets predominately encompass service potential, any purchase premium/goodwill calculated after fair valuing the acquired identifiable assets and liabilities, should be immediately expensed;
- supporting staff's intention to review the definitions within IFRS 3 (eg: business, business combination) to take into consideration the service provision aspects of public sector entities.

Issues - Group 2 • not under common control – non-exchange  
• under common control – exchange  
• under common control – non-exchange

In relation to group 2 restructurings, staff noted that the focus of the issues discussion would be on recognition, measurement and disclosures with brief discussion about terminology/definitions and presentation of the guidance within the IPSASB Handbook.

*Recognition*

Staff focused discussion on contribution by and distributions to owners and revenue and expense.

Staff led the IPSASB through existing guidance in IPSASs 1, *Presentation of Financial Statements* and 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* as

well as the work of some national standard setters to assist in determining the most appropriate approach for recognition.

- Restructurings under common control – exchange and non-exchange: staff discussion focused on the key tenet that ultimately the controlling body is restructuring within itself. Supported by further rationale, staff advised that their preliminary view was that for such restructurings, recognition should be treated as a contribution/distribution by/to owner
- Restructurings not under common control - non-exchange: staff focused on the key tenet that the control of the body requiring or imposing the restructuring is often transitory in nature. As such, ultimately the controlling body is not restructuring within itself. Given this, the staff preliminary view was that such restructurings should more likely be recognized as revenue and expense.

The Board re-considered an earlier expressed view that even when control is transitory, often in those situations, it could be considered that common control in substance actually exists over the entities being re-restructured. However, in one jurisdiction a constitutional challenge was raised in the courts over the ability of an upper-level of government to combine two municipalities - and the municipalities won. The outcome of the case provided evidence that the nature of the relationship between the parties perhaps was not as simple as what might have been thought.

In considering these views, the Board overall was comfortable with staff's preliminary views on recognition:

- under common control – exchange – contribution by and distributions to owners;
- under common control – non-exchange – contribution by and distributions to owners; and
- not under common control – non-exchange – more likely revenue and expense.

### *Measurement*

Staff noted that there was much existing guidance on measurement developed by standard setters which focuses essentially on the acquisition approach ie: measuring acquired assets and liabilities at fair value with guidance on the treatment of goodwill.

- Restructurings under common control – exchange and non-exchange: as with recognition, staff discussion focused on the key tenet that no acquisition has occurred of an entity external to the government reporting entity - ultimately the controlling body is restructuring within itself. As such, the application of re-measurement principles did not appear appropriate. Re-measurement could result in the creation of artificial gains/losses and impose costs for both the revaluation and subsequent consolidation adjustment for the group reporting entity.

As such, staff provided the preliminary view that for restructurings under common control, carrying value for the assets and liabilities impacted by the restructuring provides a better reflection of the substance of the transaction.

Board members were comfortable with staff's preliminary view to progress the project using carrying value as the measurement basis for restructurings under common control – exchange and non-exchange.

- Restructurings not under common control – non-exchange: staff noted that much existing guidance indicated fair value as the appropriate measurement basis, most notably IPSAS 23 which requires an asset acquired through a non-exchange transaction to initially be measured at fair value.

Staff noted that the application of a fair value measurement (an arms-length valuation basis) to a non-acquisition restructuring which will often not be an arms-length arrangement (eg: forced restructuring of municipalities), appeared inconsistent.

As such, staff revised its preliminary view so that for restructurings not under common control - non-exchange, that carrying value provides a better reflection of the substance of the transaction.

A member noted that in guidance they are developing, fair value was the measurement basis being proposed in these circumstances for the recipient with cost being the basis for the transferor. A key reason supporting this proposal was the existing guidance of standard setters where the combination occurs not under common control – further, the requirements on IPSAS 23 were relevant.

In response it was raised that re-measurement in these circumstances seemed questionable – and further that it could be that carrying value and fair value would often be very similar. An additional comment was made that carrying values were most appropriate noting that the recipient entity does have the choice to perform a complete revaluation after the restructuring has concluded. A suggestion was made if there was a possibility to allow, only when a restructuring occurs, a one-off revaluation to be applied by the recipient which does not place them on a revaluation model.

While the Board was finding a preference for the use of carrying values, there was the question of how to reconcile with the fair value basis in IPSAS 23. Staff noted the inconsistency agreeing the need to reconcile the two. Further, staff highlighted that in reconciling with IPSAS 23, reconciling with IPSASs 12, *Inventories*, 16 *Investment Property* and 17, *Property, Plant and Equipment* would also need to be addressed.

A suggestion put forward was to possibly distinguish between IPSAS 23 and the restructuring by viewing one as a combination and the other as an acquisition. A further suggestion was to somehow amend or further refine the application of IPSAS

23 to a very particular unique circumstance. Staff agreed to further consider all these suggestions.

Therefore, subject to staff reconciling with IPSAS 23 (and other IPSASs), Board members were comfortable progressing the project using carrying value as the measurement basis for restructurings not under common control – non-exchange.

- Mergers: staff briefly discussed possible issues where there is a merger – notably considering the merits of fresh start accounting.

Staff considered that why there may be merits to fresh start accounting, the reality was arguably that for mergers in the public sector, the substance of the combining entities would continue to exist though within a new legal structure. Further, from a pragmatic perspective, pooling of interest was considered a very well established and understood approach. However with fresh start, the broad concepts tended to well understood with agreement on its detailed application appearing to be less commonly understood.

As such, staff provided the preliminary view that in merger situations, carrying values (pooling of interest) should be the measurement basis.

The Board was informed of a jurisdiction where there was the potential for fresh start accounting possibly being a more appropriate basis for the some 2700 entities which were merging into one combined entity. The Board acknowledged the uniqueness of this situation and requested staff to take such combinations into consideration – with the possibility of seeking out the experience of members to see if there were any other instances where fresh start accounting could be more appropriate.

It was suggested if fresh start accounting should be provided in the IPSAS guidance as an allowable alternative. The general view of the Board was to minimize alternatives within standards. Further it was considered that generally, the substance of the merged entity has not changed and therefore made it questionable as to the appropriateness of applying fresh start accounting. Further a comment was made that existing literature does not appear to have any detailed guidance on the application of the fresh start approach, and as such, to allow it as an allowable alternative within an IPSAS could further broaden the dimensions of any IPSASB project.

A question was posed about the practicalities of preparing financial statements for the merged entity, in particular, the reporting period applied. It was brought to the Board's attention that in one jurisdiction, such mergers are legislated to only occur at the commencement of the financial year. As such, there was no need to prepare financial statements for a partial period for the merged entity. Given this legislative requirement, 'cut-off' between the old and combining entities was relatively clean. Another noted that in their experience the most usual circumstance was that a set of financial statements are prepared for the newly merged entity from the date of merger until the reporting date – even is this constitutes reporting for part of a period.

Given the discussion the Board was comfortable progressing the project with staff's preliminary view of applying the pooling of interest (carrying value) approach.

#### *Disclosures*

Staff gave the Board a brief overview of possible themes for disclosures. Overall the Board considered the disclosures reasonable. There was discussion that those relating to matters such as rationale or planned objectives from the restructuring or explanations as to why the chosen method of restructuring (eg: merger) was used, were better reflected in, for example, management commentary.

As such the Board was comfortable progressing the project with staff's suggestions for disclosures except those relating to planned objectives or explanations as to why the chosen method of restructuring was used.

#### *Presentation within the IPSASB Handbook*

While cosmetic in nature staff presented (if only for the Board's re-affirmation) the preliminary view that final guidance on the project should be broken into two separate IPSASs. The Board was comfortable with this preliminary view.

Finally, staff gave a broad outline of planned timeframes of next steps for the project:

- November 2008: a preliminary draft of a public sectorized version of IFRS 3;
- February 2009: draft exposure draft of IFRS 3 and a draft discussion paper for the group 2 restructurings (non-exchange only).

#### *Grouping of Restructurings - Reconsidered*

In providing a staff summary of preliminary views agreed by the Board, there was a reconsideration of the need for the project to consider those restructurings under common control – exchange. There was concern as to the reality of occurrence of such restructurings. Instead, some believed that out of the group 2 restructurings, the project should only focus on non-exchange restructurings. In doing so, the Board could aim for a quick completion of an ED based on IFRS 3 for exchange transactions not under common control and focus energies into a project which deals with the more problematic non-exchange restructurings which are more commonplace in the public sector.

Opposition to the suggested scope out of restructurings under common control – exchange was not noted, and as such staff agreed to scope the group 2 restructurings to non-exchange restructurings only.

Staff were cautioned against characterizing numerous types of restructurings as being public sector specific. While the reality might be, for example, that common control restructurings are more frequent in the public sector, that did not make them a public

sector specific occurrence. Such restructurings and related issues could occur in the private sector. Staff agreed and noted the point for future reference.

### Summary of Board Decisions

- *Grouping of Restructurings -*
  - Group 1:
    - not under common control – exchange; and
  - Group 2:
    - under common control – non-exchange; and
    - not under common control – non-exchange; and
  - staff to reconsider the labels for group 1 and particularly group 2 to ensure they better encompass the broad suite of restructurings that could occur within each; and
  - staff to be cautious against characterizing numerous types of restructurings as being public sector specific; and
- *Issues - Group 1*
  - Non-GBE-Type Acquisitions:
    - where the acquisition involves an entity whose under-lying assets predominately encompass service potential, any purchase premium/goodwill calculated after fair valuing the acquired identifiable assets and liabilities, should be immediately expensed; and
    - review the definitions within IFRS 3 (eg: business, business combination) to take into consideration the service provision aspects of public sector entities; and
- *Issues – Group 2*
  - Recognition:
    - under common control – non-exchange – contribution by and distributions to owners; and
    - not under common control – non-exchange – more likely revenue and expense; and
  - Measurement:
    - All group 2 restructurings to be at carrying value; and
    - seek examples where fresh start accounting may be appropriate; and
  - Disclosures - progress with staff's suggestions except those relating to planned objectives or explanations for the chosen method of restructuring; and
- *Presentation within the IPSASB Handbook* – the Board re-affirmed that final guidance from the project should be broken into two separate IPSASs.

**March 2007**

## **9. ENTITY COMBINATIONS**

Staff presented a project brief acknowledging that earlier Board discussions about the IPSASB strategic plan, in particular, future projects both selected by the Board and timeframes for their commencement, would influence proposed timeframes in the brief.



In reviewing the brief, the Board considered that overall, IFRS 3 *Business Combinations* is convergent for the public sector – in particular application of the purchase/acquisition method. However, the Board believed there to be numerous entity combinations occurring in the public sector for which application of the purchase/acquisition method would not be the most appropriate method of accounting.

Entity combinations could often result in there not necessarily being an acquirer or control. As such, the Board wanted a fuller understanding of a broader range of entity combinations occurring in the public sector – which would help in scoping what could be a very significant portion of an overall entity combinations project.

Examples of entity combinations for which the application of the principles of IFRS 3 could be problematic included (but not necessarily limited to);

- entities under common control;
- amalgamations of cities/municipalities; and
- transfer of activities from central government to local government or vice versa.

To help discussion on next steps for a project, the Board requested an issues paper be developed which considered accounting issues associated with these combinations and others. To assist in making the issues paper as comprehensive as possible, the Board asked for the opportunity to provide examples of combinations which they would like to see reflected in the paper. Further, requests were made for the paper take into account fair value considerations and also issues related to combining entities with different accounting policies. The paper will be provided later in 2007.