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Agenda Item
10

Date: August 29, 2011
Memo to: Members of the IPSASB
From: Annette Davis
Subject: Entity Combinations and Amalgamations

Objective of this Session

- To **discuss** and **provide directions** on issues relating to entity combinations.
- To **discuss** and **provide directions** on the draft Consultation Paper, *Entity Combinations and Amalgamations*.

Agenda Material

10.1 Issues Paper: Distinguishing between different types of entity combinations and potential methods to account for them

10.2 Draft Consultation Paper, *Entity Combinations and Amalgamations*

Introduction

1. Agenda Paper 10.1 deals with issues related to:
   (a) Proposed revisions to the definitions related to entity combinations;
   (b) Distinguishing between types of entity combinations and the related accounting treatment;
   (c) The relationship between entity combinations and the entering into of a joint venture; and
   (d) The existence of minority interests.
2. Agenda Paper 10.2 is the draft Consultation Paper. Because there are outstanding issues, it covers only (1) the introduction, (2) definitions, (3) the scope, (4) measurement bases, and (5) amalgamations. It will be updated to include sections on entity combinations under common control and not under common control for the December 2011 meeting.
3. Appendix A includes an extract of the draft minutes from the June 2011 meeting relating to entity combinations.

Appendix A: Extract from Draft Minutes of June 2011 Meeting

7. ENTITY COMBINATIONS

Discuss issues and approved project briefs for joint arrangements and consolidations

(Agenda Item 6)

The staff presented issues papers relating to the term 'operation', other working definitions, distinguishing among different types of entity combination and potential methods to account for them. The staff noted that these issues papers will form the basis of the draft Consultation Paper, updated for the IPSASB's comments and directions at this meeting.

Working Definition of the term 'Operation'

It was noted that the working definition of an entity combination is 'the bringing together of separate entities and/or operations into one entity'. At the March 2011meeting, the IPSASB agreed that there should be a definition for the term 'operation'. It was also agreed that staff should explore whether a more appropriate term could be found. The three terms to be considered were 'component of an entity', 'separable part of an entity', or operation. The IPSASB agreed that 'operation' is the most appropriate term to use. It also agreed the working definition of 'operation', as follows:

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

Terminology

The staff proposed revisions to the working definitions of the parties to an entity combination. Members made the following comments:

- That further work on the wording of the proposed definition for a combining entity as an entity meeting that definition could also meet the definition of a recipient. In addition, the proposed definitions were unclear as to which definition is met where two entities combine that are controlled by the same ultimate controlling entity.
- That the proposed definition of a resulting entity could be clarified by adding the following words at the end 'where no single entity gains control.'
- The proposed definitions do not deal with entity combinations under joint control and as this type of entity combination is in the scope of the project, this aspect needs to be clear in the proposed definitions.
- It was suggested that instead of having one definition for an entity combination dealing with two types of entity combination perhaps the different types of entity combination should have separate definitions.

Staff agreed to consider how to improve the working definitions.

One Entity Gains Control of another Entity or Operation

The staff proposed that in the consolidated financial statements of the recipient, modified carrying amount or fair value is the appropriate measurement approach or basis to use for the measurement of the individual assets received and liabilities assumed in the newly controlled entity or operation. The IPSASB discussed the modified carrying amount measurement approach and agreed that it was not an appropriate approach to use because it assumes that the carrying amounts of the entity that is gained control of are incorrect. The IPSASB agreed that carrying amount and fair value are appropriate measurement bases to consider. A Member suggested that the discussion of fair value needs to include an explanation that it is an exit value.

The staff proposed an approach to determining which measurement basis or approach to use based on distinguishing the type of entity that is gained control of, i.e., a public sector entity or operation, a GBE, a private sector for-profit entity or operation or a private sector not-for-profit entity or operation. The IPSASB discussed this approach and considered that the initial or first distinction among different types of entity combinations where one entity gains control of another entity or operation, should be based upon whether the parties to an entity combination are under common control or not under common control. This is because an entity combination occurring under common control can be considered to be an entity transacting with itself and so is not a transaction that can occur at arm's length. It was noted that this is a conceptual difference between this type of entity combination and one where an entity gains control of an entity or operation from a third-party (not under common control).

The IPSASB considered that the type of newly-controlled entity or operation could be used as a secondary distinction to help determine the measurement basis. Other criteria suggested as possible ways to distinguish between the types of entity combination to help determine the measurement basis were:

- whether there was negotiation;
- whether consideration was transferred; and
- whether the nature of the operation (or activity) has changed.

The staff asked the IPSASB whether it had examples of an entity combination which is a contribution from an owner. Two Members indicated they knew of such examples and will make them available to staff.

The IPSASB considered the appropriate accounting treatment of the difference arising from the net assets received or net liabilities assumed and the consideration transferred (if any) in the recipient's consolidated financial statements. The IPSASB discussed the situation where net assets are received and the difference arising is a debit. There were differing views as to whether this difference meets the definition of an asset and therefore should be recognized as goodwill, or does not meet the definition of an asset and therefore should be expensed in surplus or deficit. A Member suggested that bail-outs made during the global financial crisis should be specifically considered. A TA considered that where a recipient assumes net liabilities and the transferor transfers

consideration in excess of this amount, the recipient should reflect a gain as it is an overpayment by the transferor.

The IPSASB briefly considered the accounting treatment of an entity combination in the consolidated financial statements of a transferor (i.e., the entity that loses control of an entity or operation). A Member suggested that the accounting treatment for a transferor could be limited to entity combinations under common control to avoid the issues that arise when a transferor loses control of an entity or operation to a third-party not under common control.

Two or More Entities Combine Where None of the Combining Entities Gain Control of the Other Entity or Entities

The staff commented that the title of type of entity combination was used because the term merger has negative connotations, particularly for private sector for-profit accounting. The IPSASB generally agreed that it would be much clearer if the title was 'mergers', although if a better title could be found it would be considered.

The IPSASB generally agreed with the description of fresh start accounting. The IPSASB agreed that carrying amount is the appropriate measurement basis to use for the resulting entity. A Member suggested that there should be additional commentary that carrying amount is an appropriate measurement basis to use because there is no relative change in the use of or control of assets and so there is no need to change their valuation. Another Member suggested an additional disadvantage with fair value for this type of entity combination is that it is not market-tested.

The IPSASB agreed that the accounting treatment of the net assets/equity of the combining entities should be combined into the resulting entity's financial statements.

A Member suggested that the Consultation Paper needs to acknowledge that, for either type of entity combination, an entity or operation could be applying cash accounting. Where this is the situation, the entity applying cash accounting would need to apply accrual IPSASs before applying the accounting treatment for an entity combination.

The IPSASB agreed that the Consultation Paper should cover the accounting treatment of the combining entities (i.e., the entities that combine to form the resulting entity where no single entity gains control). The IPSASB also agreed that combining entities should continue to prepare their financial statements on a going concern basis until the date of the entity combination.

The IPSASB agreed that the decision flow chart for an entity combination was useful and should be updated to reflect the comments made at the meeting. The IPSASB agreed that for entity combinations where one entity gains control of another entity or operation that the first distinction should be whether or not the entity combination is undertaken within an economic entity, i.e., under common control. The second distinction could be the type of newly-controlled entity or operation or one of the other suggestions made above. These two distinctions would help determine the measurement basis to use. Then a third layer is necessary for the decision relating to how to account for the difference arising between the net assets received or the net liabilities assumed and the consideration transferred (if any).

ENTITY COMBINATIONS AND AMALGAMATIONS

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Objective of this Issues Paper

- To **discuss and provide directions** on:
  - Proposed revisions to the definitions related to entity combinations;
  - Distinguishing between types of entity combinations and the related accounting treatment;
  - The relationship between entity combinations and the entering into of a joint venture; and
  - The existence of minority interests.

Proposed Revisions to Working Definitions

Proposal to Amend the Working Definition of Entity Combination

1. The working definition of an entity combination is:

   "The bringing together of separate entities and/or operations into one entity."

2. The term "operation" is necessary in the working definition of an entity combination so that parts of an entity being brought together into one entity meet the definition of an entity combination. The working definition of operation was agreed at the June 2011 meeting, and is as follows:

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

3. This means that for a part of an entity to meet the working definition of an entity combination, that part must have (1) an integrated set of activities (hereafter "activities"), assets and liabilities, (2) activities and assets, or (3) activities and liabilities. In other words, to meet the working definition, one of the necessary characteristics that a part of an entity must have is activities.

4. However, the phrase used in the working definition is "entities and/or operations." The inclusion of the term "entity" has not been explored. As IPSASs do not define "entity"[1] it needs to be clear as to what this term means in the working definition of an entity combination.

5. The scope of this project is to develop requirements for entity combinations, i.e., the bringing together, by gaining control or combining, where those entities have more than assets and liabilities, i.e., there must be an integrated set of activities. However, an entity can exist without activities. This situation could arise, for example, where an entity controlled by the Department of Health has unused land and buildings, i.e., it has assets but no activities. This entity is transferred to another Department. The way the working definition of an entity combination is currently worded this example would be encompassed in its scope. In other

[1] However, it does define "controlled entity," "controlling entity," and "economic entity." See Appendix A for these definitions.

words, an entity can exist and have assets and/or liabilities but not have an "integrated set of activities."

6. The IASB also does not define entity. IFRS 3, *Business Combinations*, deals with this issue by not including "entity" in the definition of a business combination which is "a transaction or other event in which an acquirer obtains control of one or more businesses…."

7. Staff considers that this is an issue because IPSASs already specify the accounting requirements where an entity gains control of an asset or a group of assets or assumes responsibility for a liability or a group of liabilities. It is not the intention of this project to amend or override these requirements. Therefore the working definition needs to be clarified.

8. One method to clarify the working definition is to refer solely to the bringing together of separate operations, as follows:

   "The bringing together of separate ~~entities and/or~~ operations into one ~~entity~~operation."

9. In conjunction with this amendment, the working definition of operation would be amended to:

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

10. Another method to clarify the working definition of an entity combination is to define entity. However, entity is used extensively in IPSASs and developing a definition of it would be a substantial project in itself. The Phase 1 Conceptual Framework ED explains only "reporting entity" and "group reporting entity."

11. Therefore, Staff consider that amending the working definition of an entity combination to refer solely to the bringing together of separate operations and the consequential amendment to operation is the preferred option.

> *Question 1 for the IPSASB:*
>
> Do you agree with the revised working definitions of entity combination (set out in paragraph 8) and operation (set out in paragraph 9)?
>
> Note that the working definition of an entity combination is further revised below.

Proposal to Separately Define Different Types of Entity Combination

12. The working definition of an entity combination uses the wider notion of "bringing together separate operations[2] into one entity" to address the wide scope of this project and includes, but is not limited to, the gaining of control. This

[2] The rest of this Issues Paper adopts the revised working definition of operation proposed in paragraph 9.

means that it encompasses two types of entity combination, (1) where one entity gains control of one or more operations, and (2) where two or more operations combine and none of the combining operations gain control of the other operations.

13. At its June 2011 meeting, the IPSASB agreed that the type of entity combination where two or more operations combine and none of the combining operations gain control of the other operations should be called "merger" for clarity. Staff proposes that the description becomes the basis of a working definition for mergers, as follows:

"A **merger** is a transaction or other event where two or more operations combine and none of the combining operations gain control of the other operations."[3]

14. In addition, at the IPSASB's June 2011 meeting, it was suggested that instead of having one definition for an entity combination dealing with two types of entity combinations, each type of entity combination could have a separate definition. If the IPSASB agrees that having a working definition for one type of entity combination, i.e., mergers, is an appropriate way forward, the working definition of an entity combination could be narrowed to include only transactions or other events where one entity gains control of one or more operations, consistent with the suggestion at the June 2011 meeting.

15. Having a separate definition for each type of entity combination also has the advantage that the definitions of the parties can be clarified to ensure that an operation involved in either an entity combination or merger can only meet the conditions of one definition. The proposed revised working definition would be as follows:

An **entity combination** is a transaction or other event where a recipient gains control of one or more ~~the bringing together of separate entities and/or~~ operations ~~into one entity~~.

Question 2 for the IPSASB:

Do you agree with the proposed working definition of a merger (set out in paragraph 13)?

Note that a proposal to use different term is set out below.

Question 3 for the IPSASB:

Do you agree with the revised working definition of an entity combination[4] (set out in paragraph 15)?

[3] A merger can occur within an economic entity, i.e., under common control and not under common control. This point will be made in the scope section of the draft Consultation Paper.

Proposal to use the Term "Amalgamation" instead of the term "Merger"

16. At its June 2011 meeting, it was acknowledged that the term "merger" has negative connotations and if a better term could be found it would be considered. A suggestion was made that the term "amalgamation" could be used. Staff received an offline comment also recommending use of the term "amalgamation."

17. Staff considers that the term "amalgamation" is a better term to use and should replace the term "merger."

> *Question 4 for the IPSASB:*
>
> Do you agree that the term "amalgamation"[5] should be used rather than the term "merger"?

Proposed Revisions to Definitions of the Parties to an Entity Combination

18. At its June 2011 meeting, the IPSASB made suggestions to improve the working definitions. This section of the Issues Paper assumes that the proposals to revise the working definitions above are agreed upon (although these changes are also shown in mark-up).

Proposals to Revise Definitions Related to Entity Combinations

19. The revised working definition of an entity combination is: "a transaction or other event where a recipient gains control of one or more operations." Related definitions are "recipient" and "transferor."

20. To be consistent with the revised working definition of an entity combination, the working definition of recipient should refer to "gaining" control rather than "obtaining" control. Staff considers that the phrase at the end of the definition "that is transferred" is unnecessary and has the potential to cause confusion because "transferred" is additional to the gaining of control. The focus should be solely on the gaining of control and so Staff considers that this phrase should be deleted.

21. Similarly with transferor, the wording should relate to "loss of" control rather than transferring an entity or operation. Because a transferor can lose control of an operation without an entity combination occurring, e.g., where an operation is closed, Staff considers that the definition of transferor needs to be limited to transactions or other events that meet the definition of an entity combination. A further issue is that the term "transferor" is described in IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*. To overcome these issues the wording "for the purposes of this [Standard]" has been added to limit the definition to this project.

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4 The rest of this Issues Paper adopts the revised working definition of entity combination proposed in paragraph 15.

5 The rest of this Issues Paper uses the term amalgamation.

22. In addition, Staff proposes a further definition to describe the operation that is gained control of in an entity combination, i.e., the newly controlled operation.

23. The proposed changes are set out in Table 1 below.

Table 1: Proposed Revised Definitions Relating to Entity Combinations

A **newly controlled operation** is the operation that a recipient gains control of in an entity combination.
A **recipient** is the entity that ~~obtains~~ gains control of ~~the~~ one or more ~~entity or~~ operations ~~that is transferred~~.
A **transferor**, for the purposes of this [Standard] is the entity that ~~transfers~~ loses control of one or more of its ~~entities or~~ operations to another entity (the recipient) in an entity combination.

Question 5 for the IPSASB:

Do you agree with the working definitions for newly controlled operation, recipient and transferor (set out in Table 1)?

Proposals to Revise Definitions Related to Amalgamations

24. The proposed working definition of an amalgamation is: "a transaction or other event where two or more operations combine and none of the combining operations gain control of the other operations." Related definitions are "combining entity" and "resulting entity." Staff considers that both definitions should refer to "operation" rather than "entity" because an amalgamation can occur between operations or entities and the proposal above makes it explicit that an operation can either be an entity or part of an entity.

25. At its June 2011 meeting, the IPSASB also agreed to clarify the definition of a resulting entity to add the following words at the end of the definition: "where no single entity gains control." Staff has incorporated this suggestion in the definition, but has used slightly different wording.

26. The proposed changes are set out in Table 2 below.

Table 2: Proposed Revised Definitions Relating to Amalgamations

A **resulting ~~entity~~operation** is the ~~entity~~ operation that is the result of ~~the entity combination where~~ two or more ~~entities~~ operations combininge where none of the combining operations gain control of the other operations.
A **combining ~~entity~~operation** is an ~~entity~~ operation that combines with another ~~entity~~ operation to form the resulting ~~entity~~operation.

Question 6 for the IPSASB:

Do you agree with the working definitions for combining operation and resulting operation (set out in Table 2)?

Consequential Revision to the Definition of Entity Combination under Common Control

27. If accepted, the proposed revisions above require consequential amendments to the working definition of an entity combination under common control. The proposed changes are set out in Table 3 below.

Table 3: Proposed Revised Definitions Relating to Entity Combinations or Amalgamations under Common Control

An **entity combination or amalgamation involving ~~entities or~~ operations under common control** is an entity combination or amalgamation in which all of the combining ~~entities and/or~~ operations are ultimately controlled by the same entity or entities both before and after the entity combination or amalgamation.

Question 7 for the IPSASB:

Do you agree with the revised working definition for entity combination or amalgamation involving operations under common control (set out in Table 3)?

What Criteria or Other Basis should be used to determine the Measurement Basis?

28. At the June 2011 meeting, Staff proposed an approach to determining which measurement basis or approach to be applied in the recipient's consolidated financial statements based on distinguishing between the type of newly controlled operation, i.e., (1) a public sector operation, (2) a GBE, (3) a private sector for-profit operation or (4) a private sector not-for-profit operation. The IPSASB considered that this distinction could be used, but as a secondary distinction, after first determining whether the entity combination occurred within an economic entity, i.e., under common control.

29. Because of this change in approach, there was no discussion of the section of the June 2011 Issues Paper on entity combinations under common control. The following section is based upon that paper.

Entity Combinations under Common Control: Recipient Accounting

30. An entity combination is a transaction or other event where one entity gains control of one or more operations. Where the recipient and transferor are part of the same economic entity, the entity combination takes place under common control. Therefore, to determine whether an entity combination takes place under common control, you need to look at the ultimate controlling entities of the recipient and transferor to see whether it is the same party. If it is, then the entity combination takes place under common control.

What is the Appropriate Measurement Basis or Approach?

31. An entity combination taking place under common control can be considered to be an economic entity transacting with itself and so is not a transaction that is at arm's length. The question is what is the appropriate measurement basis or approach to use? The IPSASB agreed at its June 2011 meeting that carrying amount and fair value are appropriate measurement bases to consider.

32. Using carrying amount has the advantage of being a practical and low cost measurement approach that is easily understandable.

33. Using fair value as a measurement basis is also possible because the recipient in an entity combination needs to measure the individual assets and liabilities of the newly controlled operation. Fair values can be ascertained for individual assets and liabilities irrespective of the fact that the entities that are party to the entity combination are under common control. Using fair value would be consistent with the existing requirements in IPSASs where fair value is used on the acquisition of an asset in a non-exchange transaction because IPSASs do not distinguish between entities under common control and entities not under common control.

34. However, the entity combination takes place within an economic entity, so there is a question of why remeasurement to fair value would be relevant? Fair value is used as a measurement basis for assets acquired in a non-exchange transaction as an estimate of cost as at the date of acquisition, because non-exchange transactions do not have a cost (or have a nominal cost).

35. Using carrying amount for an entity combination under common control means that users have a measure of the value of the resources recognized prior to the entity combination. The benefits of requiring remeasurement of those resources to fair value (and so obtaining a current value of the resources) would not exceed the costs of obtaining the fair values because the entity combination takes place at the direction of the ultimate controlling entity.

36. Staff considers that carrying amount is the appropriate measurement approach for recognition of the assets acquired and the liabilities assumed in a newly controlled operation in the consolidated financial statements of the recipient.

> *Question 8 for the IPSASB:*
>
> Do you agree that carrying amount is the appropriate measurement approach for the newly controlled operation in the recipient's consolidated financial statements where the entity combination takes place under common control?

What is the Appropriate Accounting Treatment of the Difference Arising from the Net Assets Received or Net Liabilities Assumed and the Consideration Transferred (if any) in the Recipient's Consolidated Financial Statements?

37. In a situation where the recipient acquires net assets and no consideration is transferred, the difference arising is a credit. Where the recipient acquires net

assets and an amount up to the value of the net assets acquired is transferred to the transferor, the consideration transferred reduces the amount of the credit. Where the consideration transferred equals the net assets acquired, then there is no difference arising. Where the consideration transferred is in excess of the net assets acquired, the difference arising is a debit.

38. For entity combinations under common control, it is unlikely that consideration is transferred.

Possible Accounting Treatment of Difference Arising Where the Recipient Receives Net Assets

39. Where the recipient acquires net assets and no consideration is transferred, or an amount up to the value of the net assets acquired is transferred to the transferor, the difference arising will result in an increase in net assets in the consolidated financial statements of the recipient. In other words, the recipient has received an economic gain or an increase in service potential by the receipt of an operation from the transferor. This increase in net assets could be recognized as:

(a) A gain[6] in surplus or deficit; or

(b) A contribution from owners.

Gain

40. Because the entity combination takes place within an economic entity, the difference arising should not be recognized as a gain in surplus or deficit. This is because no transaction has occurred outside of the economic entity. This is consistent with the treatment in IPSAS 8, *Interests in Joint Ventures* where a venturer contributes assets to a joint venture. The venturer recognizes a gain or loss on disposal of the assets only to the extent that it is attributable to the interests of the other venturers[7].

Contribution from Owners

41. A transaction or other event that gives rise to an entity combination could be a transaction with owners acting in their capacity as owners. The *Glossary of Defined Terms* defines "contributions from owners," as follows:

"**Contributions from owners** means future economic benefits or service potential that has been contributed to the entity by parties external to the entity, other than those that result in liabilities of the entity, that establish a financial interest in the net assets/equity of the entity, which:

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6 Staff considered whether the term "revenue" should be used. However, the definition of revenue refers to a "gross inflow" whereas the difference arising as the result of an entity combination is a net amount and therefore the term "gain" is used. This parallels the treatment of the disposal of property, plant, and equipment in IPSAS 17, *Property, Plant, and Equipment* where the gain or loss arising from the derecognition of an item of property, plant, and equipment shall be included in surplus or deficit when the item is derecognized (IPSAS 17.83).

7 IPSAS 8, paragraph 54.

(a) Conveys entitlement both to distributions of future economic benefits or service potential by the entity during its life, such distributions being at the discretion of the owners or their representatives, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or

(b) Can be sold, exchanged, transferred or redeemed."

42. IPSAS 1, *Presentation of Financial Statements* requires contributions from owners, where they explicitly give rise to residual interests in the entity in the form of rights to net assets/equity, to be recognized as a direct adjustment to net assets/equity[8]. To meet the definition of a contribution from owners, a transaction or other event which gives rise to an entity combination must be a contribution by a party external to the recipient and establish or increase the financial interest in the net assets/equity of the recipient.

43. It is likely that an entity combination under common control is a contribution from owners because a party external to the recipient has contributed net assets (in the form of a newly controlled operation) and it increases the financial interest in the net assets/equity of the recipient.

Question 9 for the IPSASB:

Do you agree that the recipient in an entity combination under common control should recognize the difference arising from the net assets received or net liabilities assumed and the consideration transferred (if any) as a contribution from owners?

Entity Combinations under Common Control: Transferor Accounting

Existing Requirements

44. IPSAS 6,[9] *Consolidated and Separate Financial Statements* includes requirements where a controlling entity loses control of a controlled entity, irrespective of how control is lost. It requires the inclusion of the revenue and expenses of that controlled entity in the consolidated financial statements until the date on which the controlling entity loses control of the controlled entity. IPSAS 6 also requires that the difference between the proceeds from disposal (if any) and the controlled entity's carrying amount at the date of disposal is recognized in the consolidated statement of financial performance as a gain or loss on disposal of a controlled entity.

45. IPSAS 6 also includes accounting requirements where a controlling entity retains an interest in the formerly controlled entity. IPSAS 6 requires that, from the date the controlled entity ceases to be a controlled entity, it is accounted for according

[8] IPSAS 1, paragraph 122.

[9] The requirements of IPSAS 6 relating to a controlling entity's loss of control of a controlled entity are set out in Appendix C. [Yet to be attached.]

to the relevant accounting standard dependent upon the type of interest retained. For example, where formerly controlled entity becomes an investment, IPSAS 29 applies.

46. The question is whether the existing requirements of IPSAS 6 are appropriate where a transferor loses control of a controlled entity in an entity combination. If it is agreed that these requirements are not appropriate, then IPSAS 6 may need to be amended.

What is the Appropriate Measurement Basis or Approach?

47. Staff considers that the appropriate measurement basis for a transferor in an entity combination is carrying amount because this is consistent with the requirements of IPSAS 6. This parallels the measurement approach adopted by the recipient which seems consistent in this situation because the entity combination takes place under common control.

> *Question 10 for the IPSASB:*
>
> Do you agree that a transferor should derecognize the assets and liabilities that are a part of an entity combination at carrying amount where the entity combination takes place under common control?

What is the Appropriate Accounting Treatment of the Difference arising in the Transferor?

48. IPSAS 6 requires that the difference between the proceeds from disposal (if any) and the controlled entity's carrying amount at the date of disposal is recognized in the consolidated statement of financial performance as a gain or loss on disposal of a controlled entity. [10, 11]

49. Staff considers that the requirements in IPSAS 6 for the accounting treatment of the loss of control of a controlled entity are not appropriate for the transferor in an entity combination under common control. The treatment of the difference arising should parallel the treatment in the recipient because the entity combination takes place within an economic entity. The proposal above for the treatment of the difference arising for a recipient in an entity combination under common control is that it meets the definition of a contribution from owners. A transferor would then recognize a distribution to owners. The *Glossary of Defined Terms* defines "distributions to owners," as follows:

"Future economic benefits or service potential distributed by the entity to all or some of its owners, either as a return on investment or as a return of investment."

50. The transferor has lost control of an operation comprising net assets to a recipient within the same economic entity. These net assets represent future economic

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10 IPSAS 6, paragraph 51.

11 IFRS 5 does not include requirements for the gain or loss arising from sale. Instead they are included in IAS 27, paragraph 34(f) and are consistent with the requirements of IPSAS 6.

benefits or service potential and are either a return on investment or a return of investment to the ultimate controlling entity.

Question 11 for the IPSASB:

Do you agree that the transferor should recognize the difference arising from the derecognition of the assets and liabilities that are a part of an entity combination and the consideration transferred (if any) as a distribution to owners?

Entity Combinations Not under Common Control: Recipient Accounting

What is the Appropriate Measurement Basis or Approach?

51. This section of the Issues Paper explores possible criteria to determine the measurement basis in the recipient's consolidated financial statements where the recipient gains control of another operation and this transaction or other event does not occur within an economic entity, i.e., it is not under common control.

52. At the June 2011 meeting, Staff proposed that the type of newly controlled entity, i.e., (1) a public sector entity or operation, (2) a GBE, (3) a private sector for-profit entity or operation or (4) a private sector not-for-profit entity or operation, could be used to determine the appropriate measurement basis to be applied in the recipient's consolidated financial statements. The IPSASB considered that other criteria should be explored to help determine the measurement basis or approach to use. Suggestions included:

    (a) Whether there was negotiation;

    (b) Whether consideration was transferred; and

    (c) Whether the nature of the operation (or activity) has changed.

53. In addition, it was suggested that an initial method of determining the measurement basis could be to distinguish between entity combinations occurring solely between public sector entities and those entity combinations that occur between public sector entities and private sector entities. In other words, (1) both the recipient and transferor are public sector entities before the entity combination takes place, and (2) the recipient is a public sector entity and the transferor is a private sector entity (which could be for-profit or not-for-profit entity).

54. These suggestions are discussed below.

Negotiation

55. Negotiation usually takes place before an entity combination occurs so that the recipient and transferor can agree on the terms of the combination. Where the recipient and transferor are public sector entities, this negotiation is usually limited to determining the operations, assets and liabilities to be included in the entity combination, the date of the entity combination and other items, such as the conditions of transfer of employees. The negotiation does not usually include a price, or consideration transferred, because no or nominal consideration is

transferred. This is a difference between the public sector and the for-profit private sector where a key factor in agreeing a business combination is agreement on the consideration to be transferred.

56. An entity combination may be undertaken at the direction of a higher level of government and, in this situation, there may be very little negotiation. As a result the recipient and transferor may not be willing parties to the entity combination.

57. Where the recipient is a public sector entity and the transferor is a private sector entity, the negotiation will usually include agreement on the consideration to be transferred.

58. Where an entity combination is undertaken by willing parties, the level of negotiation is determined by the parties to the entity combination. Where it is directed or forced, there may be no negotiation. Negotiation may or may not include discussion on the amount of consideration to be transferred. Trying to determine how to apply the level of negotiation to an entity combination to choose a measurement basis or approach to apply to an entity combination appears to be too subjective.

Consideration

59. Where consideration is transferred, it is the cost to the recipient of the entity combination. The consideration transferred for the acquirer in a business combination in a for-profit private sector entity is the amount it must pay to gain control of the acquiree, i.e., the newly controlled operation. For many entity combinations where the recipient and transferor are public sector entities no consideration is transferred. However, there are situations where consideration is transferred. When this is the situation, the amount of consideration could be similar to the fair value of the net assets received, or their carrying amount, or a nominal amount.

60. If the measurement basis was determined based on whether consideration is transferred, then a recipient could negotiate for consideration to be transferred and so use the form of the transaction rather than its substance to determine the measurement basis. Staff considers that the transfer of consideration is not a distinguishing feature of an entity combination and should not be used to determine the measurement basis or approach to adopt for an entity combination.

Nature of Operation or Activity Changes

61. The measurement basis or approach could be based on whether the nature of the newly controlled operation or its activities changes because of the entity combination. A drawback with this approach is that the change in nature occurs subsequent to the entity combination and is at the discretion of the recipient. Management intentions subsequent to a transaction or other event do not generally determine the measurement basis or approach for other types of transactions. For example, the receipt of an asset from a non-exchange transaction is measured at fair value as at the date of acquisition. Its intended future use is not taken into account on initial recognition. A recipient's intention

or subsequent use of an asset, e.g., a change in use, may affect the asset's useful life (for depreciation purposes) and/or its value in use (for impairment purposes), but this occurs after the date of acquisition.

62. Staff considers that the determination of the measurement basis or approach to use in the recipient's consolidated financial statements should not be based on a change in nature of the newly controlled operation or changes in its activities because it occurs after the entity combination has taken place.

Type of Transferor

63. Another method of determining the measurement basis could be to distinguish between entity combinations where (1) both the recipient and transferor are public sector entities before the entity combination takes place, and (2) the recipient is a public sector entity and the transferor is a private sector entity (which could be for-profit or not-for-profit entity) before the entity combination takes place.

64. The recipient will always be a public sector entity because only public sector entities apply accrual IPSASs and so it is the sector that the transferor belongs to that is of relevance.

65. Staff considers that the determination of the measurement basis or approach to adopt in the recipient's consolidated financial statements should be based on whether the transferor is a public sector entity or a private sector entity. The reason for this is that it is the most objective assessment that can be made compared with the other suggestions above.

> *Question 12 for the IPSASB:*
>
> Do you agree that the determination of the measurement basis or approach (i.e., carrying amount or fair value) to be used in the recipient's consolidated financial statements should be based on whether the transferor is a public sector entity or a private sector entity?

Type of Transferor: Public Sector Entity

66. In the consolidated financial statements of the recipient, Staff considers the appropriate measurement basis or approach to use is carrying amount. This is because the objective of the public sector is to provide public goods and services and to redistribute wealth for a variety of social and economic purposes. An entity combination is generally undertaken to achieve a more effective distribution of responsibilities and associated activities within a jurisdiction. The allocation of responsibilities changes over time and is usually achieved by way of entity combinations.

67. Users need to be able to evaluate the nature and financial effect on an entity combination and so need to have information as to the reasons for the entity combination, the nature of the newly controlled operation and the responsibilities, assets and liabilities that the recipient has gained control of as a result of the entity combination. Using carrying amount as the measurement approach is a practical

and low cost approach that is easily understandable for users. Furthermore, it avoids the drawbacks in the use of fair value for assets and liabilities where there is no deep and liquid market, which results in an estimate of fair value as there is no market-based value to use.

Question 13 for the IPSASB:

Do you agree that carrying amount is the appropriate measurement approach to use for a newly controlled operation where the transferor is a public sector entity?

Type of Transferor: Private Sector Entity

68. Where a recipient gains control of an operation from a private sector transferor, Staff considers the appropriate measurement basis or approach to use is fair value.

69. In jurisdictions that require their private sector for-profit entities to adopt IFRSs, the acquisition of a business is measured at the fair value of the identifiable assets received and liabilities assumed and any non-controlling interest in the acquiree plus goodwill. Staff has not identified any public sector specific reason/s for not adopting the same measurement basis. The use of fair value is also consistent with the measurement basis used for the acquisition of an asset in a non-exchange transaction. In addition, the use of fair value as a measurement basis requires recognition of all identifiable assets and liabilities in a newly controlled operation.

70. Fair value provides users with a measure of the current value of the resources the recipient gained control of as a result of the entity combination. A current value measure is important because the newly controlled entity is from the private sector and there is an impact on the size and nature of the public sector because of the entity combination. In other words, where net assets are received, the entity combination increases the resources the public sector controls. Therefore, fair value information will be relevant to users for decision-making and accountability purposes. It will provide information such as the current value of the net assets received compared with the amount of consideration transferred (if any).

71. An example of this type of entity combination is where a local government acquires a profit-making entity with the intention of using the future profits to keep the level of local taxes at the same level rather than having to increase them. The use of fair value in this example appears to be appropriate.

72. Other entity combinations take place because, e.g., in the global financial crisis, governments bailed out a number of private sector banks and other types of entities. As a result, some of these formerly private sector entities are now controlled by a government. In many instances the public sector entity holding these newly controlled operations intends to sell them once they have recovered, however, this intention may or may not occur sometime after the entity combination. It should not affect the measurement basis for recognizing that entity combination.

Question 14 for the IPSASB:

Do you agree that fair value is the appropriate measurement basis for a newly controlled operation where the transferor is a private sector entity?

What is the Appropriate Accounting Treatment of the Difference arising from the Net Assets Received or Net Liabilities Assumed and the Consideration Transferred (if any) in the Recipient's Consolidated Financial Statements?

73. In the recipient's consolidated financial statements, the individual assets received and liabilities assumed in an entity combination are recognized. This section of the Issues Paper explores possible accounting treatments of the difference arising from the net assets received or net liabilities assumed and the consideration transferred (if any). The amount of the difference arising will be dependent on the measurement basis or approach that has been adopted and it may have the effect of increasing or decreasing the amount of net assets or liabilities recognized by the recipient. Another factor which may affect the difference arising is whether the recipient transfers consideration to the transferor.

74. This section of the Issues Paper assumes that the difference arising is calculated as the difference between:

    (a) The net assets received or the net liabilities assumed using the measurement basis or approach determined in a previous section of this Issues Paper; and

    (b) The consideration transferred (if any).

Consideration Transferred (if any)

75. Consideration transferred refers to the situation where a recipient transfers cash or other assets to the transferor. Consideration transferred can also be the sum of cash or other assets transferred by the recipient and liabilities incurred by the recipient, to the transferor. In rare circumstances, consideration transferred may also include equity interests issued by the recipient.

76. Any costs incurred by the recipient in effecting an entity combination are not included in the calculation of consideration transferred. The accounting treatment of these costs is not dealt with in this Issues Paper and will be considered at the December 2011 meeting.

77. In a situation where the recipient acquires net assets and no consideration is transferred, the difference arising is a credit. Where the recipient receives net assets and an amount up to the value of the net assets acquired is transferred to the transferor, the consideration transferred reduces the amount of the credit. Where the consideration transferred equals the net assets acquired, then there is no difference arising. Where the consideration transferred is in excess of the net assets received, the difference arising is a debit.

Possible Accounting Treatment of Difference Arising Where the Recipient Receives Net Assets

78. Where the recipient receives net assets and no consideration is transferred, or an amount up to the value of the net assets received is transferred to the transferor, the difference arising will result in an increase in net assets in the consolidated financial statements of the recipient. This increase in net assets could be recognized as:

    (a) A gain[12] in surplus or deficit; or

    (b) A contribution from owners.

79. As ownership interests occur only rarely in public sector entities, it is unlikely that a transaction or other event that gives rise to an entity combination not under common control will be a transaction with owners acting in their capacity as owners. Therefore, this section of the Issues Paper does not deal with differences that arise that meet the definition of a contribution from owners.

Gain

80. Where a recipient receives net assets in a transaction or other event that gives rise to an entity combination not under common control there is an inflow of economic benefits or service potential which results in an increase in net assets/equity during that reporting period. In other words, the recipient has received an economic gain or an increase in service potential by the receipt of an operation from the transferor. So it makes sense that the difference arising is a gain recognized in surplus or deficit irrespective of the type of newly controlled operation.

81. Furthermore, the treatment of the difference arising as a gain is consistent with the requirement in IPSAS 23, *Revenue from Non-exchange Transactions (Taxes and Transfers)* that an inflow of resources from a non-exchange transaction recognized as an asset shall be recognized as revenue, except to the extent that a liability is also recognized in respect of the same inflow[13].

82. The recognition of a gain is also consistent with the treatment of a gain arising from a bargain purchase in IFRS 3, *Business Combinations*.

Where the Difference Arising is a Debit and Net Assets are Received

83. Where the consideration transferred is in excess of the net assets received, the difference arising is a debit. The debit could be recognized as:

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12 Staff considered whether the term "revenue" should be used. However, the definition of revenue refers to a "gross inflow" whereas the difference arising as the result of an entity combination is a net amount and therefore the term "gain" is used. This parallels the treatment of the disposal of property, plant, and equipment in IPSAS 17, *Property, Plant, and Equipment* where the gain or loss arising from the derecognition of an item of property, plant, and equipment shall be included in surplus or deficit when the item is derecognized (IPSAS 17.83).

13 IPSAS 23, paragraph 44.

(a) A loss[14] in surplus or deficit; or

(b) Goodwill.

84. Existing IPSASs do not include a definition of goodwill or any requirements for its recognition and measurement.

85. International guidance on the requirements for the initial recognition and measurement of goodwill for the for-profit private sector are included in IFRS 3. The requirements for its subsequent measurement are included in IAS 36, *Impairment of Assets*. IFRS 3 requires:

"The acquirer shall recognize goodwill as of the acquisition date measured as the excess of (a) over (b) below:

(a) The aggregate of:

(i) The consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see paragraph 37);

(ii) The amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and

(iii) In a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS."[15]

86. In other words, goodwill is the residual cost of a business combination. IFRS 3 defines goodwill as:

"An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized."

87. IAS 36 requires that goodwill is tested for impairment annually[16].

88. The IPSASB's current definition of an asset is[17]:

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14 Similar to the reasoning for the use of the term "gain" instead of the term "revenue" above, the term "loss" is used rather than the term "expense."

15 IFRS 3, *Business Combinations*, paragraph 32.

16 IAS 36, paragraph 10(b).

17 In December 2010, the IPSASB issued a Consultation Paper, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements*. The result of this project may change the definition of an asset.

"**Assets** are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity."

89. Where a debit does arise, does it meet the definition of an asset? The recipient has gained control of another operation as a result of a past event, i.e., the transaction or other event giving rise to the entity combination. The recipient recognizes an increase in net assets and the consideration transferred to the transferor is in excess of this amount, so there may be unidentified assets that have not been separately recognized.

90. Where the newly controlled operation is a public sector operation, its assets will be held primarily to provide service potential rather than economic benefits. It seems unlikely that unallocated service potential, i.e., service potential not directly related to a recognized asset, can occur. So, a debit could simply be an overpayment. If so, it should be expensed in the reporting period in which it occurs. This is consistent with the IPSASB's conclusions in IPSAS 21, *Impairment of Non-Cash-Generating Assets* that it is possible to identify the service potential of individual assets so the creation of a service-generating unit (by analogy from IAS 36's cash-generating unit) is unnecessary. IPSAS 21 requires impairment testing on individual non-cash-generating assets.

91. Where the newly controlled operation was formerly in the private sector, it is likely that consideration is transferred to the former owners of that operation because the former owners are in the for-profit private sector. The conclusion in IFRS 3 is that a debit arising meets the definition of an asset and is therefore recognized as goodwill.

92. If the debit arising does not meet the definition of goodwill, it should be recognized as a loss in surplus or deficit. A possible reason for this subsidy arising from an entity combination not under common control would be because the recipient paid the former owners on the basis of what the newly controlled operation was formerly worth rather than its current market value.

Accounting Treatment of Difference Arising Where the Recipient Assumes Net Liabilities

93. Where the recipient assumes net liabilities, this Issues Paper assumes that no consideration is transferred by the recipient as it is assuming net liabilities.

94. Where the recipient assumes net liabilities, the difference arising will result in a decrease in net assets in the consolidated financial statements of the recipient. In other words, the recipient has assumed an economic loss by the receipt of an operation from the transferor. This decrease in net assets should be recognized as a loss in surplus or deficit irrespective of the type of newly controlled operation.

Summary and Staff View

95. Where the recipient gains control of another operation, the difference arising is calculated as the difference between the net assets received or the net liabilities assumed and the consideration transferred (if any). Table 4 below sets out where

the difference arising could be recognized broken down by the amount of consideration transferred.

Table 4: Treatment of Difference Arising

	Treatment of Difference Arising[18]	
Consideration Transferred	**Recipient Receives Net Assets**	**Recipient Assumes Net Liabilities**
No/nominal	Gain	Loss
Some	Gain	–
Amount equaling NA	–	–
Amount in excess of NA	Loss or Goodwill	–

96. Staff considers that where the recipient gains control of another operation and the difference arising is less than or equal to the amount of net assets received or the net liabilities assumed, the difference arising is a gain or loss irrespective of the type of newly controlled operation.

97. Staff does not have a view on where the difference arising should be recognized, i.e., as a loss or as goodwill, when the difference arising is greater than the amount of net assets received. Staff considers that each view has valid reasons and considers that this should be a question asked of constituents in the Consultation Paper.

Question 15 for the IPSASB:

Do you agree that where a recipient receives net assets and transfers no or nominal consideration, the difference arising is a gain in surplus or deficit?

Question 16 for the IPSASB:

Do you agree that where a recipient assumes net liabilities, the difference arising is a loss in surplus or deficit?

Question 17 for the IPSASB:

Do you agree that where a recipient receives net assets and transfers consideration in excess of the net assets received, the difference arising could be recognized as a

[18] The treatment of the difference arising in two jurisdictions is set out in Appendix C.

loss in surplus or deficit or goodwill capitalized in the statement of financial position?

Formation of a Joint Venture

98. At its March 2011 meeting, the IPSASB agreed that the formation of a jointly controlled entity (as described in IPSAS 8, *Interests in Joint Ventures*) is within the scope of this project when the formation meets the definition of an entity combination. This section of the Issues Paper considers:

(a) Whether other types of joint ventures identified in IPSAS 8, i.e., jointly controlled operations and jointly controlled assets are in also in the scope of this project when their formation meets the definition of an entity combination;

(b) Whether, as a result of the formation of joint ventures being in the scope of the project, the working definitions need amendment; and

(c) How the recognition and measurement of an entity combination may be affected by the fact it is also a formation of a joint venture.

Types of Joint Ventures Included in the Scope of this Project

99. IPSAS 8 identifies and describes three broad types of joint ventures: jointly controlled operations, jointly controlled assets, and jointly controlled entities[19].

100. As explained above, the IPSASB agreed that jointly controlled entities, where they also meet the definition of an entity combination are in the scope of this project. Further consideration of the other types of joint ventures described in IPSAS 8 is required to determine whether they also could meet the definition of an entity combination.

101. A jointly controlled operation is described as a joint venture which involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership, or other entity, or a financial structure that is separate from the venturers themselves[20]. A venturer's interest in a jointly controlled operation is in the assets it controls and the liabilities it incurs related to that joint venture. On formation, there are no accounting adjustments to be made because the assets, liabilities, revenue (if any) and expenses are already recognized in the financial statements of the venturer[21].

102. However, if an existing jointly controlled operation is acquired e.g., by purchase or exchange, the venturer gains assets and/or liabilities related to the joint venture activity. In this situation, it would meet the definition of an entity combination where the joint venture activity meets the definition of an operation. If the acquisition of a jointly controlled operation does not meet the definition of an entity combination, it would be accounted for as an acquisition of a group of

19 See Appendix D for extracts from IPSAS 8.
20 IPSAS 8, paragraph 17.
21 IPSAS 8, paragraph 20.

assets and/or liabilities which are dealt with in existing IPSASs and therefore is outside the scope of this project.

103. Staff considers that where a jointly controlled operation is acquired, e.g., by purchase or exchange, it would meet the definition of an entity combination where it meets the definition of an operation.

104. Jointly controlled assets are described as assets that are jointly controlled, and often jointly owned, for the purpose of the joint venture. A venturer's interest in jointly controlled assets is in its share of the assets it jointly controls and the liabilities it incurs related to that joint venture. On formation, there are no accounting adjustments to be made because the assets, liabilities, revenue (if any) and expenses are already recognized in the financial statements of the venturer[22].

105. Where a jointly controlled asset is acquired, a venturer recognizes its share classified according to the nature of the asset. If that jointly controlled asset is also jointly operated it is debatable whether it could meet the definition of an operation. If it does meet the definition of an operation then it could also meet the definition of an entity combination.

106. In its revised standard IFRS 11, *Joint Arrangements*, one of the reasons the IASB merged these two types of joint venture (jointly controlled operations and jointly controlled assets) into one, now called joint arrangements, was because elements from both types were usually present[23]. The IPSASB has a project to revise IPSAS 8 and so it is likely that the requirements in IFRS 11 will be replicated in IPSAS 8.

107. In summary, Staff considers that:

(a) A jointly controlled entity could meet the definition of an entity combination either on formation or acquisition; and

(b) A jointly controlled operation or (possibly) jointly controlled assets could meet the definition of an entity combination on acquisition.

108. Because the different types of joint venture described in IPSAS 8 could meet the definition of an entity combination, this Issues Paper will refer to the "formation or acquisition of a joint venture."

Question 18 for the IPSASB:

Do you agree that the acquisition of a joint venture could meet the definition of an entity combination and therefore is within the scope of this project?

[22] IPSAS 8, paragraph 27.

[23] IFRS 11, Basis for Conclusions, paragraph BC25.

How the Formation or Acquisition of a Joint Venture Meets the Definition of an Entity Combination and Whether the Definitions need Amendment as a Result

109. Subsequent to the March meeting, the definition of an entity combination has undergone further revision. Earlier in this Issues Paper, the definition is amended so that it only defines entity combinations as transactions or other events where a recipient gains control of one or more operations. A separate definition has been formed, amalgamations, to cover a transaction or other event where two or more operations combine and none of the combining operations gain control of the other operations. In relation to the formation of a joint venture, it is the definition of an entity combination that is relevant because it deals with the gaining of control, which can be seen as being similar to the gaining of joint control over a joint venture.

110. Where a transaction or other event that gives rise to the formation of a joint venture also meets the definition of an entity combination, i.e., a recipient gains control of one or more operations, then the formation of that joint venture is within the scope of this project. This will be the situation when a venturer forms a joint venture and that joint venture meets the definition of an operation. A venturer "is a party to a joint venture and has joint control over that joint venture." The venturer is also the recipient, but rather than gaining control over one or more operations, instead gains joint control over one or more operations, with one or more other venturers.

111. The definition of a joint venture is: "a binding arrangement whereby two or more parties are committed to undertake an activity that is subject to joint control." In most cases the formation of a joint venture will meet the definition of an operation because a joint venture, by definition, includes an activity, so will usually meet the "integrated set of activities" part of the definition of an operation. Where the joint venture also has assets and/or liabilities it will meet the second part of the definition of an operation.

112. The same reasoning applies where a venturer acquires a joint venture rather than forming it.

113. Staff does not consider that the working definitions related to entity combinations need to be amended for the formation of joint ventures to be within the scope of this project. Rather, a separate section is needed in the Consultation Paper to deal with how the formation or acquisition of a joint venture may also meet the definition of an entity combination and when it does, how the accounting treatment for an entity combination applies.

Question 19 for the IPSASB:

Do you agree that the working definitions related to entity combinations do not need to be amended for the formation or acquisition of joint ventures?

Recognition and Measurement of an Entity Combination where it also is a Formation or Acquisition of a Joint Venture

Entity Combinations under Common Control

114. For entity combinations under common control, Staff has proposed that, in the consolidated financial statements of the recipient, the measurement approach for the newly controlled operation should be carrying amount and the difference arising will be a contribution from owners where the net assets received exceed the consideration transferred (if any). This accounting treatment could be applied where the formation or acquisition of a joint venture takes place within an economic entity, i.e., under common control. In this situation, the recipient is also the venturer.

115. IPSAS 8 includes requirements on the formation of a jointly controlled entity. In the individual financial statements of the venturer, the contribution of cash or other resources by the venturer is recognized as an investment in the jointly controlled entity[24]. In the consolidated financial statements of the venturer, the venturer recognizes its interest in the jointly controlled entity by using either proportionate consolidation or the equity method[25]. Assets contributed to the jointly controlled entity by the venturer are derecognized and a gain or loss on disposal of the assets is recognized only to the extent that it is attributable to the interests of the other venturers[26].

116. Where the formation of a jointly controlled entity meets the definition of an entity combination and is also under common control, the requirements in IPSAS 8 are different from the proposed accounting treatment of an entity combination under common control because the assets contributed on formation of the jointly controlled entity are contributed by the venturer and not by the owner of the venturer, which is the case for an entity combination under common control. IPSAS 8 does not include specific guidance on the formation of a joint venture which takes place within an economic entity.

117. Staff considers the requirements of IPSAS 8 relating to the formation of a jointly controlled entity should remain the same because they reflect the substance of the formation of a jointly controlled entity.

118. IPSAS 8 does not explicitly include requirements on the acquisition of a joint venture. An acquisition of a joint venture may be by purchase, exchange or through a non-exchange transaction. Where the acquisition of a joint venture meets the definition of an entity combination and is also under common control, the venturer/recipient should apply the proposed accounting treatment for entity combinations under common control. In other words, in the consolidated financial statements of the venturer/recipient, the assets and liabilities of the joint venture are recognized at carrying amount. The presentation of assets and

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24 IPSAS 8, paragraph 34.
25 IPSAS 8, paragraph 35.
26 IPSAS 8, paragraph 54.

liabilities will differ according to the type of joint venture, e.g., where it is the acquisition of a jointly controlled entity, the venturer/recipient will recognize its share of the net assets. Where it is a jointly controlled operation, venturer/recipient will recognize the assets it controls and the liabilities it has assumed. The difference arising is the difference in the net assets received and the consideration transferred (if any) and is recognized as a contribution from owners.

119. Staff considers that the proposed accounting requirements for entity combinations under common control should be applied to the acquisition of a joint venture. The future Standard/s on entity combinations should include specific requirements so that the interaction between the entity combination aspects of the transaction or other event and the acquisition of a joint venture are clear.

Question 20 for the IPSASB:

Do you agree that:

(a) The requirements in IPSAS 8 related to the formation of a jointly controlled entity are appropriate when it takes place under common control; and

(b) This project should propose requirements for the acquisition of a joint venture where it meets the definition of an entity combination and is under common control?

Entity Combinations not under Common Control

120. For entity combinations not under common control, Staff has proposed that, in the consolidated financial statements of the recipient, the measurement basis or approach for the newly controlled operation should be carrying amount where the transferor is a public sector entity and fair value where the transferor is a private sector entity. Where the recipient receives net assets and transfers no or nominal consideration, Staff proposes that the difference arising is a gain in surplus or deficit. Where the recipient receives net assets and transfers consideration in excess of the net assets received, Staff proposes that the difference arising could either be recognized as a loss in surplus or deficit or goodwill capitalized in the statement of financial position, with a related question to constituents in the Consultation Paper.

121. As set out in paragraph 115 above, IPSAS 8 includes requirements on the formation of a jointly controlled entity. Where the formation of a jointly controlled entity meets the definition of an entity combination and is not under common control, the requirements in IPSAS 8 are similar to the proposed accounting treatment of an entity combination not under common control because the gain or loss recognized on the disposal of assets the venturer has contributed to the formation of the jointly controlled entity is recognized in surplus or deficit only to the extent that it is attributable to the interests of the other venturers. This difference in treatment of the gain or loss is appropriate because it relates to the

fact that a venturer has joint control of a jointly controlled entity rather than control of a controlled entity.

122. Staff considers the requirements of IPSAS 8 relating to the formation of a jointly controlled entity should remain the same because they reflect the substance of the formation of a jointly controlled entity.

123. Where the acquisition of a joint venture meets the definition of an entity combination and is also not under common control, the venturer/recipient should apply the proposed accounting treatment for entity combinations not under common control. In other words, the measurement basis or approach in the consolidated financial statements of the venturer/recipient will be carrying amount where the other venturer or venturers are public sector entities and fair value where the other venturer or venturers are private sector entities. The presentation of assets and liabilities will differ according to the type of joint venture, e.g., where it is the acquisition of a jointly controlled entity, the venturer/recipient will recognize its share of the net assets. Where it is a jointly controlled operation, venturer/recipient will recognize the assets it controls and the liabilities it has assumed.

124. Applying the proposed accounting treatment where the venturer/recipient receives net assets and transfers no or nominal consideration means that the difference arising is recognized as a gain in surplus or deficit. Where the recipient receives net assets and transfers no or nominal consideration, Staff proposes that the difference arising is a gain in surplus or deficit. Where the venturer/recipient receives net assets and transfers consideration in excess of the net assets received, the difference arising would either be recognized as a loss in surplus or deficit or goodwill capitalized in the statement of financial position.

125. Staff considers that the proposed accounting requirements for entity combinations not under common control should be applied to the acquisition of a joint venture. The future Standard/s on entity combinations should include specific requirements so that the interaction between the entity combination aspects of the transaction or other event and the acquisition of a joint venture are clear.

Question 21 for the IPSASB:

Do you agree that:

(a) The requirements in IPSAS 8 related to the formation of a jointly controlled entity are appropriate (i.e., not under common control); and

(b) This project should propose requirements for the acquisition of a joint venture where it meets the definition of an entity combination and is not under common control?

Minority Interests

126. The discussion above does not consider an entity combination where less than 100% of the ownership interest is obtained by the recipient. This section of the

Issues Paper considers situations where a recipient gains control of less than 100% of the newly controlled operation. The portion that does not relate to the controlling entity is termed a "minority interest." The *Glossary of Defined Terms* defines minority interest as:

"That portion of the surplus or deficit and net assets/equity of a controlled entity attributable to net assets/equity interests that are not owned, directly or indirectly, through controlled entities, by the controlling entity."

Measurement of a Minority Interest

127. A minority interest can be measured at either:

(a) Fair value; or

(b) The minority interest's proportionate share of the newly controlled operation's net assets.

128. Where a newly controlled operation is listed on a stock exchange, fair value will be based on active market prices for the equity shares not held by the recipient. Where it is not listed, fair value will need to be estimated using a valuation technique.

129. Staff has proposed that carrying amount be used as the measurement approach for entity combinations under common control and entity combinations not under common control where the transferor is a public sector entity. For these types of entity combinations it makes sense that any minority interest is measured as a proportionate share of the newly controlled operation's net assets because fair value has not been used as a measurement basis for the assets received and liabilities assumed in the newly controlled operation.

130. For an entity combination not under common control and where the transferor is a private sector entity, Staff has proposed that fair value be used as the measurement basis for the assets received and liabilities assumed in the newly controlled operation. In this situation there is a choice between measuring a minority interest at fair value (because fair value has been used as the measurement basis) or as a proportionate share of the newly controlled operation's net assets.

131. The IASB, in IFRS 3, has given acquirers' the option to choose whether to value non-controlling interests (formerly minority interests) at fair value or as a proportionate share of the acquiree's net assets. IFRS 3 requires the identifiable assets and liabilities of the acquiree to be measured at fair value (with some limited exceptions). The reason the IASB permits a choice is because it was not able to agree on a single measurement basis because the Board was split[27].

132. Given that (1) the majority of entity combinations in the public sector do not involve the transfer of consideration, and (2) the majority of newly controlled

[27] IFRS 3, 2008, Basis for Conclusions paragraph BC210.

entities will not be listed entities, Staff considers that a minority interest should be measured as a proportionate share of the newly controlled operation's net assets.

Question 22 for the IPSASB:

Do you agree that a minority interest should be measured as a proportionate share of the newly controlled operation's net assets?

Effect of a Minority Interest

133. The presence of a minority interest affects the amount of difference arising on the entity combination, so that it is calculated as the difference between:

(a) The net assets received or the net liabilities assumed using the measurement basis or approach determined in a previous section of this Issues Paper; plus

(b) The amount of any minority interest in the newly controlled operation; and

(c) The consideration transferred (if any).

134. The presence of a minority interest in an entity combination has the effect of decreasing the amount of the gain recognized where no consideration or consideration up to the amount of the net assets of the newly controlled operation is transferred. Where the consideration transferred is in excess of the net assets of the newly controlled operation, a minority interest increases the amount of loss recognized in surplus or deficit, or goodwill recognized in the statement of financial position. Table 5 below sets out the effect of a minority interest.

Table 5: Change in Amount of Difference Arising due to the Existence of a Minority Interest

Consideration Transferred	**Recipient Receives Net Assets**	**Affect of Minority Interest**
No/nominal	Gain	Smaller gain recognized
Some	Gain	Smaller gain recognized
Amount equaling NA	–	–
Amount in excess of NA	Loss or Goodwill	Larger loss or goodwill recognized

Question 23 for the IPSASB:

Do you agree that the effect that a minority interest has on the difference arising is correct?

Draft Flowchart for an Entity Combination and Amalgamation

135. Appendix E sets out the revised flowchart that illustrates entity combinations and amalgamations. It will be updated and changed dependent upon the IPSASB's view as to its usefulness and decisions relating to the accounting treatment.

Question 24 for the IPSASB:

Do you have any comments regarding the flowchart?

Appendix A: Extract of Existing Definitions in IPSASs

Term	Definition	Location
carrying amount (of an intangible asset)	The amount at which an asset is recognized after deducting any accumulated amortization and accumulated impairment losses.	31.16
carrying amount (of investment property)	The amount at which an asset is recognized in the statement of financial position.	16.7
carrying amount (of property, plant, and equipment)	The amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses.	17.13
carrying amount of a liability	The amount at which a liability is recognized in the statement of financial position.	10.7
carrying amount of an asset	The amount at which an asset is recognized in the statement of financial position, after deducting any accumulated depreciation and accumulated impairment losses thereon.	10.7
control	The power to govern the financial and operating policies of another entity so as to benefit from its activities.	2.8
control of an asset	Arises when the entity can use or otherwise benefit from the asset in pursuit of its objectives, and can exclude or otherwise regulate the access of others to that benefit.	23.7
controlled entity	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
controlling entity	An entity that has one or more controlled entities.	6.7
cost	The amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.	16.7
costs of disposal	Incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.	21.14
costs to sell	The incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes. Disposal may occur through sale or through distribution at no charge or for a nominal charge.	27.9
current replacement cost	The cost the entity would incur to acquire the asset on the reporting date.	12.9
distributions to owners	Future economic benefits or service potential distributed by the entity to all or some of its owners, either as a return on investment or as	1.7

	a return of investment.	
economic entity	A group of entities comprising a controlling entity and one or more controlled entities.	1.7
exchange transactions	Transactions in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange.	9.11
fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.	9.11
fair value less costs to sell	The amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.	21.14
Government Business Enterprise	An entity that has all the following characteristics: (a) Is an entity with the power to contract in its own name; (b) Has been assigned the financial and operational authority to carry on a business; (c) Sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery; (d) Is not reliant on continuing government funding to be a going concern (other than purchases of outputs at arm's length); and (e) Is controlled by a public sector entity.	1.7
net realizable value	The estimated selling price in the ordinary course of operations, less the estimated costs of completion and the estimated costs necessary to make the sale, exchange or distribution.	12.9
recoverable amount (of an asset or a cash-generating unit)	The higher of an asset's or a cash-generating unit's fair value less costs to sell and its value in use.	26.13
recoverable amount (of property, plant, and equipment)	The higher of a cash-generating asset's fair value less costs to sell and its value in use.	17.13
recoverable service amount	The higher of a non-cash-generating asset's fair value less costs to sell and its value in use.	21.14
value in use of a cash-generating asset	The present value of the estimated future cash flows expected to be derived from the continuing use of an asset and from its	26.13

	disposal at the end of its useful life	
value in use of a non-cash-generating asset	The present value of the asset's remaining service potential.	21.14

Appendix B: Extract from IPSAS 6, *Consolidated and Separate Financial Statements*

51. The revenue and expenses of a controlled entity are included in the consolidated financial statements from the acquisition date (the relevant international or national accounting standard dealing with business combinations provides guidance on the meaning of the acquisition date). The revenue and expenses of a controlled entity are included in the consolidated financial statements until the date on which the controlling entity ceases to control the controlled entity. The difference between the proceeds from the disposal of the controlled entity and its carrying amount as of the date of disposal, including the cumulative amount of any exchange differences that relate to the controlled entity recognized in net assets/equity in accordance with IPSAS 4, The Effects of Changes in Foreign Exchange Rates, is recognized in the consolidated statement of financial performance as the gain or loss on the disposal of the controlled entity.

52. From the date an entity ceases to be a controlled entity, provided that it does not become (a) an associate as defined in IPSAS 7, or (b) a jointly controlled entity as defined in IPSAS 8, it shall be accounted for as a financial instrument. IPSAS 29 provides guidance on the recognition and measurement of financial instruments.

53. The carrying amount of the investment at the date that the entity ceases to be a controlled entity shall be regarded as the cost on initial measurement of a financial instrument.

Appendix C: Existing Guidance on the Treatment of the Difference Arising by National Standard Setters

Public Sector Accounting Board (PSAB) (Canada)

1. The Public Sector Accounting Board (PSAB) in Canada requires that where a government acquires a governmental unit, the excess of the purchase cost over the government's share of the fair value of the net assets acquired, termed a "purchase premium," is recognized as an expense in the period of acquisition (PS 2510.13). The fact that consideration is transferred indicates that the acquiree was not a public sector entity before the acquisition takes place. PSAB has commenced a project to address the accounting treatment for the acquisition of a public sector entity or operation not under common control.

2. Additionally, PSAB requires that a purchase premium arising on an acquisition of a GBE is recognized as an asset (PS 3070.7). The PSAB's definition of a GBE is narrower than the IPSASB's as it includes only those entities that can self-sustain by primarily selling goods and services to outside the government reporting entity.

Accounting Standards Board (ASB) (South Africa)

3. The Accounting Standards Board (ASB) in South Africa requires that an acquirer in a transfer of functions not under common control recognizes the difference between the assets acquired and liabilities assumed and the consideration transferred (if any) in surplus or deficit (GRAP 106.65). The definition of a function is similar to the proposed definition of an operation.

4. An acquirer in a transfer of functions under common control recognizes the difference between the carrying amounts of the assets acquired, the liabilities assumed and the consideration paid (if any) in accumulated surplus or deficit (GRAP 105.39).

Appendix D: Extracts from IPSAS 8, *Interests in Joint Ventures*

Jointly Controlled Operations

17. The operation of some joint ventures involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership, or other entity, or a financial structure that is separate from the venturers themselves. Each venturer uses its own property, plant, and equipment and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finances, which represent its own obligations. The joint venture activities may be carried out by the venturer's employees alongside the venturer's similar activities. The joint venture agreement usually provides a means by which the revenue from the sale or provision of the joint product or service and any expenses incurred in common are shared among the venturers.

18. An example of a jointly controlled operation is when two or more venturers combine their operations, resources, and expertise to manufacture, market, and distribute jointly a particular product, such as an aircraft. Different parts of the manufacturing process are carried out by each of the venturers. Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the binding arrangement. A further example is when two entities combine their operations, resources, and expertise to jointly deliver a service, such as aged care where, in accordance with an agreement, a local government offers domestic services and a local hospital offers medical care. Each venturer bears its own costs and takes a share of revenue, such as user charges and government grants, such share being determined in accordance with the binding agreement.

19. **In respect of its interests in jointly controlled operations, a venturer shall recognize in its financial statements:**

    (a) **The assets that it controls and the liabilities that it incurs; and**

    (b) **The expenses that it incurs and its share of the revenue that it earns from the sale or provision of goods or services by the joint venture.**

20. Because the assets, liabilities, revenue (if any) and expenses are already recognized in the financial statements of the venturer, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

21. Separate accounting records may not be required for the joint venture itself, and financial statements may not be prepared for the joint venture. However, the venturers may prepare management accounts so that they may assess the performance of the joint venture.

Jointly Controlled Assets

22. Some joint ventures involve the joint control of, and often the joint ownership by, the venturers of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture. The assets are used to obtain benefits for the venturers. Each venturer may take a share of the output from the assets, and each bears an agreed share of the expenses incurred.

23. These joint ventures do not involve the establishment of a corporation, partnership, or other entity, or a financial structure that is separate from the venturers themselves. Each venturer has control over its share of future economic benefits or service potential through its share of the jointly controlled asset.

24. Some activities in the public sector involve jointly controlled assets. For example, a local government may enter into an arrangement with a private sector corporation to construct a toll road. The road provides the citizens with improved access between the local government's industrial estate and its port facilities. The road also provides the private sector corporation with direct access between its manufacturing plant and the port. The agreement between the local

authority and the private sector corporation specifies each party's share of revenues and expenses associated with the toll road. Accordingly, each venturer derives economic benefits or service potential from the jointly controlled asset, and bears an agreed proportion of the costs of operating the road. Similarly, many activities in the oil, gas, and mineral extraction industries involve jointly controlled assets. For example, a number of oil production companies may jointly control and operate an oil pipeline. Each venturer uses the pipeline to transport its own product, in return for which it bears an agreed proportion of the expenses of operating the pipeline. Another example of a jointly controlled asset is when two entities jointly control a property, each taking a share of the rents received and bearing a share of the expenses.

25. **In respect of its interest in jointly controlled assets, a venturer shall recognize in its financial statements:**

    (a) **Its share of the jointly controlled assets, classified according to the nature of the assets;**

    (b) **Any liabilities that it has incurred;**

    (c) **Its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;**

    (d) **Any revenue from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and**

    (e) **Any expenses that it has incurred in respect of its interest in the joint venture.**

26. In respect of its interest in jointly controlled assets, each venturer includes in its accounting records and recognizes in its financial statements:

    (a) Its share of the jointly controlled assets, classified according to the nature of the assets rather than as an investment. For example, a share of a jointly controlled road is classified as property, plant, and equipment;

    (b) Any liabilities that it has incurred, for example those incurred in financing its share of the assets;

    (c) Its share of any liabilities incurred jointly with other venturers in relation to the joint venture;

    (d) Any revenue from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

    (e) Any expenses that it has incurred in respect of its interest in the joint venture, for example those related to financing the venturer's interest in the assets and selling its share of the output.

27. Because the assets, liabilities, revenue, and expenses are recognized in the financial statements of the venturer, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

28. The treatment of jointly controlled assets reflects the substance and economic reality and, usually, the legal form of the joint venture. Separate accounting records for the joint venture itself may be limited to those expenses incurred in common by the venturers and ultimately borne by the venturers according to their agreed shares. Financial statements may not be prepared for the joint venture, although the venturers may prepare management accounts so that they may assess the performance of the joint venture.

Jointly Controlled Entities

29. A jointly controlled entity is a joint venture that involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other entities, except that a binding arrangement between the venturers establishes joint

control over the activity of the entity.

30. A jointly controlled entity controls the assets of the joint venture, incurs liabilities and expenses and earns revenue. It may enter into contracts in its own name and raise finance for the purposes of the joint venture activity. Each venturer is entitled to a share of the surpluses of the jointly controlled entity, although some jointly controlled entities also involve a sharing of the output of the joint venture.

31. A common example of a jointly controlled entity is when two entities combine their activities in a particular line of service delivery by transferring the relevant assets and liabilities into a jointly controlled entity. Another example arises when an entity commences a business in a foreign country in conjunction with a government or other agency in that country, by establishing a separate entity that is jointly controlled by the entity and the government or agency in the foreign country.

32. Many jointly controlled entities are similar in substance to those joint ventures referred to as jointly controlled operations or jointly controlled assets. For example, the venturers may transfer a jointly controlled asset, such as a road, into a jointly controlled entity, for tax or other reasons. Similarly, the venturers may contribute to a jointly controlled entity assets that will be operated jointly. Some jointly controlled operations also involve the establishment of a jointly controlled entity to deal with particular aspects of the activity, for example, the design, marketing, distribution, or after-sales service of the product.

33. A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other entities in conformity with IPSASs, or other accounting standards if appropriate.

34. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in the accounting records of the venturer and recognized in its financial statements as an investment in the jointly controlled entity.

Financial Statements of a Venturer

Proportionate Consolidation

35. **A venturer shall recognize its interest in a jointly controlled entity using proportionate consolidation or the alternative method described in paragraph 43. When proportionate consolidation is used, one of the two reporting formats identified below shall be used.**

…

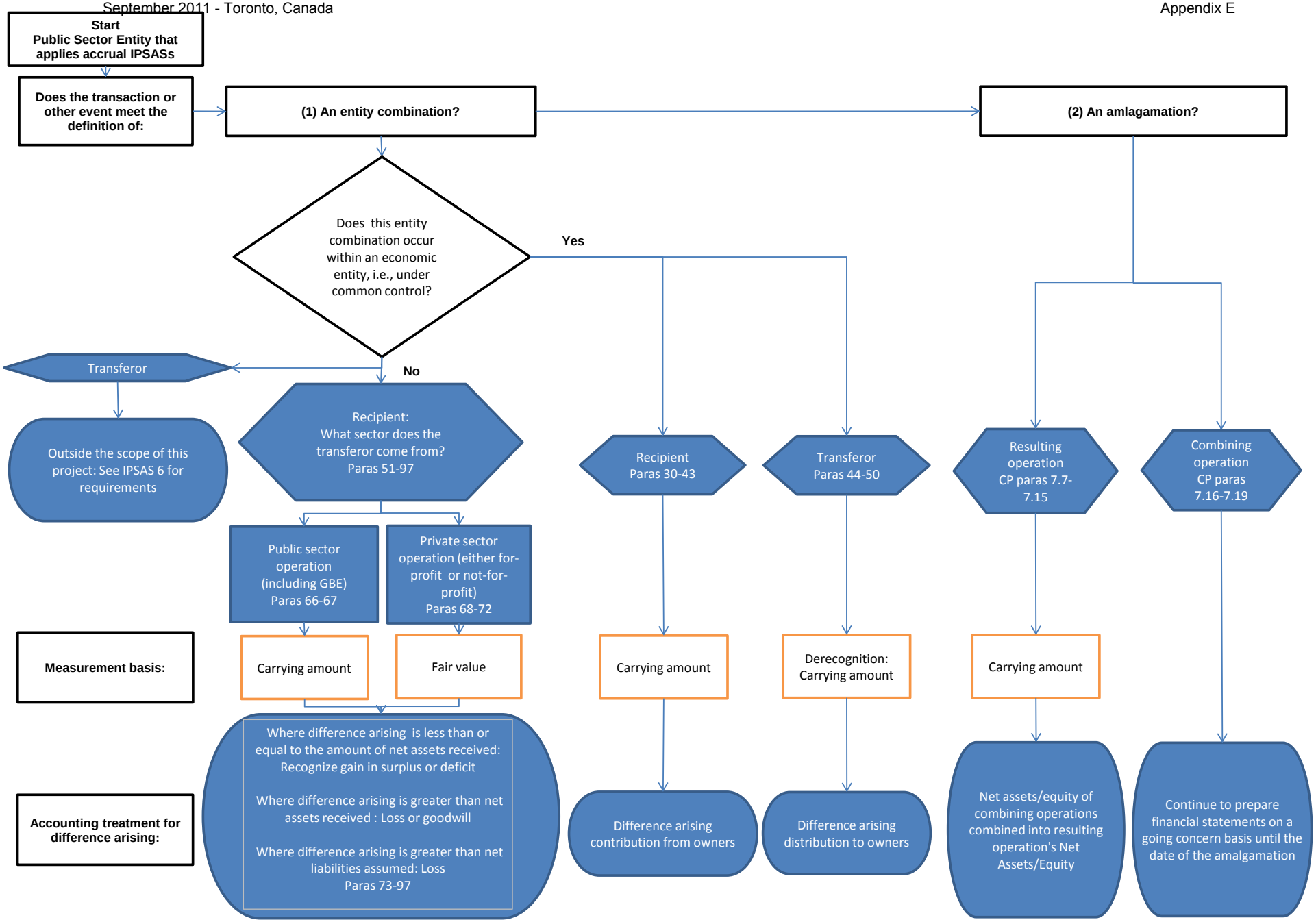
Transactions between a Venturer and a Joint Venture

54. **When a venturer contributes or sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction shall reflect the substance of the transaction. While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the venturer shall recognize only that portion of the gain or loss that is attributable to the interests of the other venturers. The venturer shall recognize the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realizable value of current assets or an impairment loss.**

55. **When a venturer purchases assets from a joint venture, the venturer shall not recognize its share of the gains of the joint venture from the transaction until it resells the assets to an independent party. A venturer shall recognize its share of the losses resulting from these transactions in the same way as gains, except that losses shall be recognized immediately when they represent a reduction in the net realizable value of current assets or an impairment loss.**

56. To assess whether a transaction between a venturer and a joint venture provides evidence of

impairment of an asset, the venturer determines the recoverable amount or recoverable service amount of the assets in accordance with IPSAS 21, Impairment of Non-Cash-Generating Assets, or IPSAS 26, Impairment of Cash-Generating Assets, as appropriate. In determining value in use of a cash-generating asset, the venturer estimates future cash flows from the asset on the basis of continuing use of the asset and its ultimate disposal by the joint venture. In determining value in use of a non-cash-generating asset, the venturer estimates the present value of the remaining service potential of the asset using the approaches specified in IPSAS 21.


Start
Public Sector Entity that applies accrual IPSASs
Does the transaction or other event meet the definition of:
(1) An entity combination?
(2) An amlagamation?
Does this entity combination occur within an economic entity, i.e., under common control?
Yes
No
Transferor
Outside the scope of this project: See IPSAS 6 for requirements
Recipient: What sector does the transferor come from? Paras 51-97
Public sector operation (including GBE) Paras 66-67
Private sector operation (either for-profit or not-for-profit) Paras 68-72
Recipient Paras 30-43
Transferor Paras 44-50
Resulting operation CP paras 7.7-7.15
Combining operation CP paras 7.16-7.19
Measurement basis:
Carrying amount
Fair value
Carrying amount
Derecognition: Carrying amount
Carrying amount
Accounting treatment for difference arising:
Where difference arising is less than or equal to the amount of net assets received: Recognize gain in surplus or deficit
Where difference arising is greater than net assets received : Loss or goodwill
Where difference arising is greater than net liabilities assumed: Loss
Paras 73-97
Difference arising contribution from owners
Difference arising distribution to owners
Net assets/equity of combining operations combined into resulting operation's Net Assets/Equity
Continue to prepare financial statements on a going concern basis until the date of the amalgamation

DRAFT CONSULTATION PAPER

ENTITY COMBINATIONS AND AMALGAMATIONS

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1 Introduction

1.1 The objective of this Consultation Paper is to explore the recognition and measurement bases that may validly be adopted for a transaction or other event that gives rise to an entity combination or an amalgamation in the general purpose financial statements (GPFSs, hereafter financial statements) of an entity that uses accrual based IPSASs.

1.2 Entity combinations and amalgamations are prevalent in the public sector as governments and public sector entities restructure for a variety of reasons, such as to achieve a more effective distribution of responsibilities and associated activities or to deliver higher and/or better public services or goods. An entity combination or amalgamation may be undertaken voluntarily or can be at the direction of legislation or other authority, e.g., legislation is enacted by a Central government to reduce the number of local government entities in order to improve services and reduce costs.

1.3 IPSASs do not provide guidance on how to account for an entity combination or amalgamation. This Consultation Paper is the first step in determining the requirements and guidance appropriate for entity combinations and amalgamations in public sector entities.

1.4 Conceptual Framework Exposure Draft 1, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Role, Authority and Scope; Objectives and Users; Qualitative Characteristics; and Reporting Entity* (CF–ED 1 Conceptual Framework Phase 1), issued by the IPSASB in December 2010, explains that "the objectives of financial reporting by public sector entities are to provide information about the entity that is useful to users of GPFRs for accountability purposes and for decision-making purposes."[1]

1.5 An entity that gains control of one or more operations in an entity combination acquires operations, assets and/or liabilities together with additional responsibilities associated with those operations. The resulting operation of an amalgamation receives the operations, assets, liabilities and net assets/equity of all of the combining operations. For accountability and decision-making purposes, users need to be able to evaluate the nature and financial effect of an entity combination or an amalgamation that takes place during a reporting period.

1.6 This Consultation Paper deals with the following situations:

(a) Where one entity gains control of one or more operations. This is termed an "entity combination";

(b) Where one entity gains joint control of one or more operations (with one or more other venturers), i.e., has entered into a joint venture, that also meets the definition of an entity combination. This is a type of entity combination; and

(c) Where two or more operations combine and no one operation gains control of the other operations. This is termed an "amalgamation".

[1] CF–ED 1, paragraph 2.1.

1.7 This Consultation Paper includes in its scope entity combinations under common control and entity combinations not under common control, undertaken with or without the transfer of consideration. It considers the accounting treatment in the consolidated financial statements of the parties to an entity combination, i.e., in the entity that gains control, and the entity that loses control (for entity combinations under common control only), of one or more operations.

1.8 Where an entity combination also meets the definition of a joint venture, the Consultation Paper considers the accounting treatment in the entities that are the venturers.

1.9 For amalgamations, the Consultation Paper considers the accounting treatment in the consolidated financial statements of the entity that is a result of the amalgamation and in the operations that combine.

2 Definitions

2.1 Across different jurisdictions, the terms used to describe an entity combination or amalgamation can vary. The paragraphs below explain the definitions used in this Consultation Paper to ensure that an entity combination or amalgamation is referred to consistently and to easily and consistently identify the entities and operations.

Entity Combination

2.2 The definition of an entity combination used in this Consultation Paper is:

> *"A transaction or other event where a recipient gains control of one or more operations."*

Explanation of the Term "Operation"

2.3 An "operation" is defined as:

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

2.4 The definition of operation means that an entity can comprise one operation or comprise of several operations. The definition also means that the gaining of control of an asset or a group of assets, or the assumption of a liability or a group of liabilities that do not constitute an operation, do not meet the definition of an entity combination. Guidance on the accounting treatment of the gaining of control of an asset or a group of assets, or the assumption of a liability or a group of liabilities is within the scope of other IPSASs.

Parties to an Entity Combination

2.5 Where one entity gains control of one or more operations during the reporting period, the entity that loses control of the operation is the transferor and the entity that gains control of the operation is the recipient. The operation being transferred is the newly controlled operation. The wording of the definitions is set out in Table 1 below.

Table 1: Definitions of the Parties to an Entity Combination

A **newly controlled operation** is the operation that a recipient gains control of in an entity combination.
A **recipient**, for the purposes of this Consultation Paper, is the entity that gains control of the operation.
A **transferor**, for the purposes of this Consultation Paper, is the entity that loses control of one or more of its operations to another entity (the recipient) in an entity combination.

2.6 The terms "recipient" and "transferor" are used in IPSAS 23, *Revenue from Non-exchange Transactions (Taxes and Transfers)*. IPSAS 23 sets out the requirements for the financial reporting of revenue arising from non-exchange transactions, other than non-exchange transactions that give rise to an entity combination. The revenue of many public sector entities is derived from non-exchange transactions such as transfers. Transfers are inflows of future economic benefits or service potential from non-exchange transactions, other than taxes. The entity that transfers assets to another entity is the transferor and the entity that obtains the transfer is the recipient. The IPSASB considers that the use of these terms for entity combinations is consistent with the way the terms are used in IPSAS 23.

2.7 Whilst IPSAS 23 does not define recipient or transferor, the IPSASB considers it appropriate to define these terms in this Consultation Paper because, unlike IPSAS 23[2] it deals with both exchange and non-exchange transactions. Furthermore, this Consultation Paper deals with the accounting treatment for both the recipient and transferor, whereas IPSAS 23 deals only with the accounting treatment for the recipient.

Amalgamation

2.8 The definition of an amalgamation used in this Consultation Paper is:

> *"A transaction or other event where two or more operations combine and none of the combining operations gain control of the other operations."*

2.9 The use of the term "operation" has the same meaning as defined above relating to entity combinations.

[2] The System of National Accounts (SNA) 2008 also uses the term "transfer" to mean a non-exchange transaction. SNA 2008 defines "transfer" as "a transaction in which one institutional unit provides a good, service or asset to another unit without receiving from the latter any good, service or asset in return as a direct counterpart.

Parties to an Amalgamation

2.10 Where two or more operations combine during the reporting period and none of the combining operations gain control of the other operations, the operation that is the result of the amalgamation is termed the resulting operation. The operations that combine are termed the combining operations. An amalgamation may or may not involve the formation of a new entity as the resulting operation. The wording of the definitions is set out in Table 2 below.

Table 2: Definitions of the Parties to an Amalgamation

A **combining operation** is an operation that combines with another operation to form the resulting operation.
A **resulting operation** is the operation that is the result of two or more operations combining where none of the combining operations gain control of the other operations.

Common Control

2.11 This Consultation Paper includes within its scope combinations or amalgamations of operations under common control. IPSASs do not have a definition or description of the term "common control." This Consultation Paper deals with entity combinations and amalgamations under common control and so a definition has been developed.

2.12 The definition of an entity combination or amalgamation involving operations under common control used in this Consultation Paper is:

> *"An entity combination or amalgamation in which all of the combining operations are ultimately controlled by the same entity or entities both before and after the entity combination or amalgamation."*

3 Scope

3.1 The purpose of this section is to set out the scope of the transactions and other events that give rise to an entity combination or an amalgamation which are included in this Consultation Paper.

Entity Combination

Under Common Control

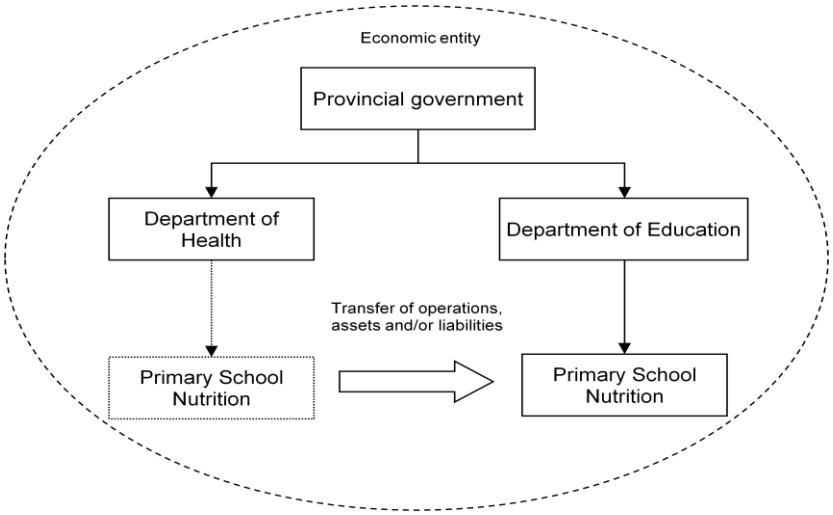
3.2 An entity combination is a transaction or other event where one entity gains control of one or more operations. Where the recipient and transferor are part of the same economic entity, the entity combination takes place under common control. This Consultation Paper includes in its scope the accounting treatment in the consolidated financial statements of:

(a) The recipient, i.e., the entity that gains control of one or more operations; and

(b) The transferor, i.e., the entity that loses control of one or more operations.

3.3 This can be illustrated as follows.

Diagram 1: Entity Combination under Common Control



3.4 Diagram 1 illustrates an entity combination between entities that are under common control. The Department of Education gains control of the Primary School Nutrition operation from the Department of Health. The Department of Education is the recipient and the Department of Health is the transferor.

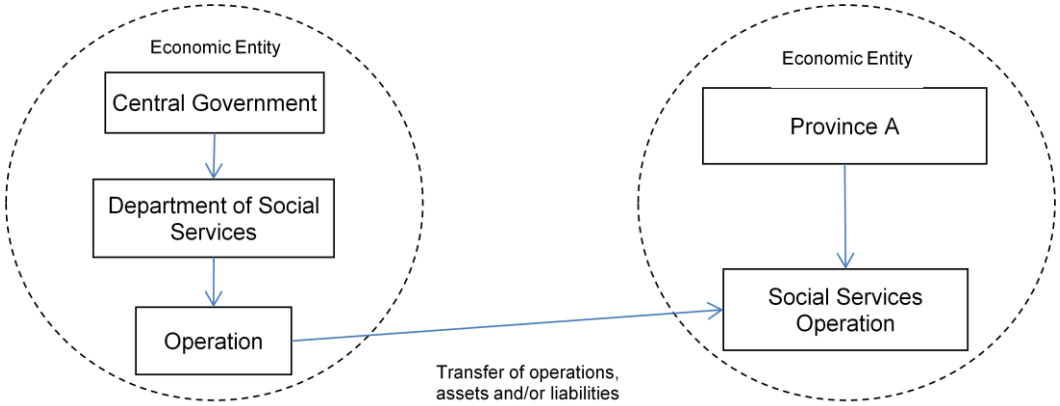
Not Under Common Control

3.5 Where the recipient and transferor are not part of the same economic entity, the entity combination does not take place under common control. This Consultation Paper includes in its scope the accounting treatment in the consolidated financial statements of the recipient, i.e., the entity that gains control of one or more operations.

3.6 The Consultation Paper does not deal with the accounting treatment in the consolidated financial statements of the transferor where an entity combination does not take place under common control because a controlling entity can lose control of a controlled entity without an entity combination occurring, e.g., by the closure of an operation. An exception is made for transferors where an entity combination takes place under common control because the nature of an entity combination under common control can be dictated by the ultimate controlling entity. In this situation, a transferor will apply the existing requirements in IPSAS 6, *Consolidated and Separate Financial Statements*.

3.7 An entity combination not under common control can be illustrated as follows.

Diagram 2: Gaining Control of an Operation not under Common Control



3.8 Diagram 2 illustrates an entity combination between entities that are not under common control. In this example, local government is not under the control of the central government. The Department of Social Services within the Central government transfers an operation to Council A. Council A is the recipient and the Department of Social Services is the transferor.

Entity Combination that also meets the Definition of a Joint Venture

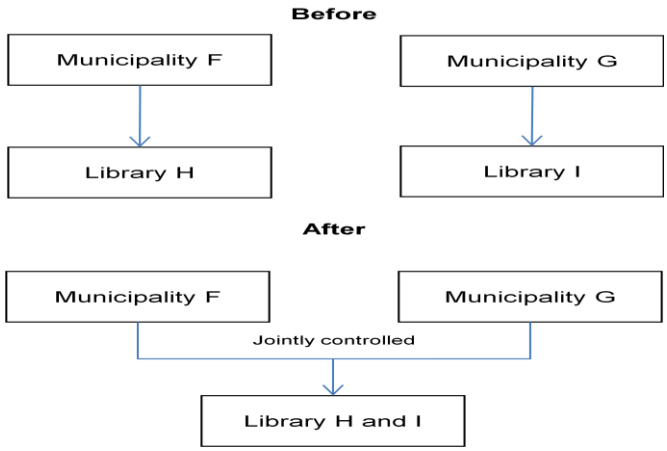
3.9 Where a transaction or other event meets the definition of an entity combination it may also meet the definition of a joint venture. The definition of a joint venture is: "a binding arrangement whereby two or more parties are committed to undertake an activity that is subject to joint control." An entity combination will also meet the definition of a joint venture when a venturer enters (by formation or acquisition) into a joint venture and that joint venture meets the definition of an operation. A venturer "is a party to a joint venture and has joint control over that joint venture."

3.10 In terms of the definitions used for an entity combination, the venturer is also the recipient, but rather than gaining control over one or more operations, instead, it gains joint control over one or more operations, with one or more other venturers.

3.11 In most cases entering into a joint venture will meet the definition of an operation because a joint venture, by definition, includes an activity, so will usually meet the "integrated set of activities" part of the definition of an operation. Where the joint venture also has assets and/or liabilities it will meet the second part of the definition of an operation.

3.12 An entity combination not under common control that also meets the definition of a joint venture can be illustrated as follows.

Diagram 3: Entity Combination that also meets the Definition of a Joint Venture



3.13 Diagram 3 above illustrates an entity combination where two municipalities (Municipality F and Municipality G) have separate library services (Library H and Library I). In this example, the local government is not under the control of central government. They agree to join the libraries together into one operation (Library H and I) and share joint control of the resulting operation. Municipality F and Municipality G are the recipients/venturers and Library H and I is the new jointly-controlled operation and joint venture.

Amalgamation

3.14 An amalgamation is a transaction or other event where two or more operations combine and no one operation gains control of the other operations. It can take place either within an economic entity, i.e., under common control, or between separate economic entities, i.e., not under common control. This Consultation Paper includes in its scope the accounting treatment in the consolidated financial statements of:

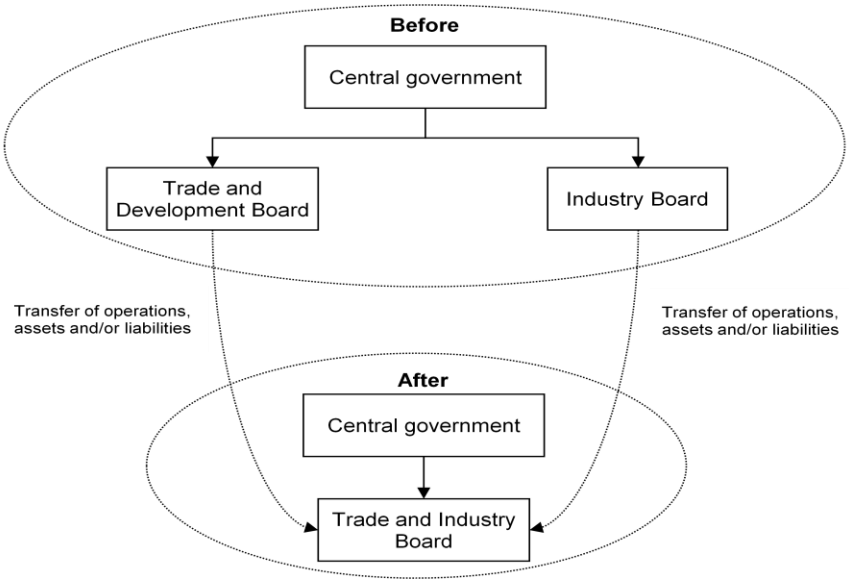
(a) The resulting operation, i.e., the operation that is the result of the amalgamation; and

(b) The combining operations, i.e., the operations which combine to form the resulting operation.

Under Common Control

3.15 An amalgamation under common control can be illustrated as follows.

Diagram 4: An Amalgamation under Common Control



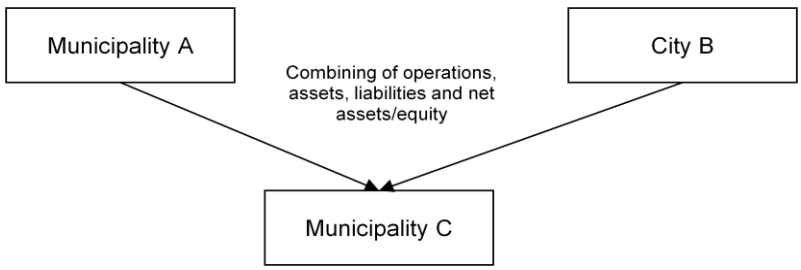
3.16 Diagram 4 illustrates an amalgamation where a Central government restructures by transferring the Trade and Development Board and the Industry Board, both of which are separate government operations and transferring the activities, assets and liabilities to a newly formed government operation, the Trade and Industry Board. The Trade and Development Board and the Industry Board are the combining operations and the Trade and Industry Board is the resulting operation.

3.17 In this example the central government meets the definition of a transferor and recipient from an entity combination because the amalgamation takes place under common control.

Not under Common Control

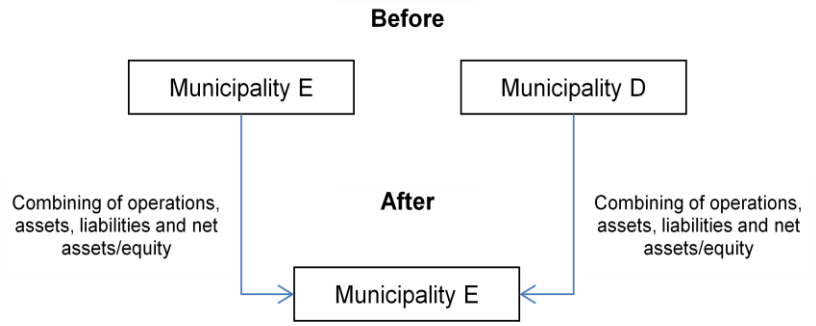
3.18 The substance of an amalgamation not under common control is that two or more operations combine and none of the combining operations gain control of the other operations. However, the form of the transaction or other event to achieve this may or may not involve the formation of a new operation. These two situations can be illustrated as follows and assume that the local government is not under the control of the central or provincial government.

Diagram 5: Amalgamation using the Formation of New Operation



3.19 Diagram 5 above illustrates an amalgamation where Municipality C is formed to combine the operations, assets, liabilities and net assets/equity of Municipality A and City B. Municipality C is the resulting operation and Municipality A and City B are the combining operations.

Diagram 6: Amalgamation using an Existing Combining Operation



3.20 Diagram 6 above illustrates an amalgamation where Municipality D and Municipality E combine together and they use the entity that is Municipality E before the amalgamation to hold the assets, liabilities and net assets/equity of the amalgamation. Municipality E after the amalgamation is the resulting operation. Municipality D and Municipality E before the amalgamation are the combining operations.

4 Measurement Bases

4.1 Existing IPSASs use a number of different measurement bases for initial recognition and measurement, dependent upon the type of asset or liability being measured and include (in no particular order):

(a) Cost, e.g., investment property, property, plant, and equipment and intangible assets. The measurement of the initial cost of these assets where they are acquired through a non-exchange transaction is fair value at the date of acquisition;

(b) Fair value, e.g., financial assets and financial liabilities;

(c) Fair value less costs to sell, e.g., biological assets; and

(d) Best estimate of the expenditure required to settle a present obligation, e.g., provision.

4.2 Existing IPSASs also use other measurement bases for subsequent measurement, again dependent upon the type of asset being measured, such as value in use, replacement cost, recoverable service amount and recoverable amount.

4.3 The amounts presented in an entity's statement of financial position are carrying amounts. Carrying amount represents the amount recognized in the statement of financial position, after deducting any accumulated depreciation and accumulated impairment losses thereon. Therefore, the carrying amount of different items in the statement of financial position will reflect different measurement bases, such as fair value or cost less

depreciation, etc. Because carrying amount is the amount presented in the statement of financial position it is not a measurement basis as such and so will be referred to as a measurement approach.

4.4 The Consultation Paper, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements* (Measurement CP), discusses historical cost, market value, and replacement cost measurement bases. It also discusses the deprival value concept which does not describe a single measurement basis, but rather a means by which a basis be selected that is relevant to the circumstances. The Measurement CP considers that there is no single measurement basis that is appropriate in all circumstances[3]. To minimize the drawbacks of using different measurement bases, it considers that a particular basis is selected only where this is justified by economic circumstances[4].

4.5 In this Consultation Paper, the discussion of market value is set within the context of fair value because fair value will equal market value where a market exists for a particular asset. Where a market does not exist, then fair value is estimated. In other words, using market value as a measurement basis for an entity combination or amalgamation does not provide a measurement basis for those assets and liabilities that are not market-based.

4.6 In the context of the financial statements of a recipient, the items to be measured when a transaction or other event results in an entity combination are the individual assets and/or liabilities of the operation or operations that are gained control of on the date the entity combination takes place[5]. Where the recipient is a single entity, the focus is still on the individual assets and/or liabilities of the operation or operations that are gained control of on the date the entity combination takes place, however the recognition is in the recipient's individual financial statements. Therefore, the measurement basis or approach needs to be appropriate for the initial recognition and measurement of individual assets and liabilities.

4.7 Similarly, in the context of the resulting operation in an amalgamation, the focus of the choice of a measurement basis or approach is on the individual assets, liabilities and net assets/equity that are combined.

4.8 In many instances, a transaction or other event that gives rise to an entity combination in the public sector will not include the transfer of any consideration. An amalgamation, by definition, does not include the transfer of any consideration. Using the cost basis in this instance would result in an amount of nil being recognized which does not provide useful information to users for accountability and decision-making purposes. Where consideration has been transferred, some basis is needed for determining the allocation of that cost to the individual assets received and liabilities assumed. The basis of allocation of cost may not reflect either the carrying amount or fair value of the individual assets

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3 CF CP Measurement, paragraph 1.5.

4 CF CP Measurement, paragraph 1.6.

5 The difference arising from the individual assets received and liabilities assumed, minority interests (if any), and the consideration transferred (if any) are dealt with in a later section of this Consultation Paper.

and/or liabilities that are gained control of on the date of the entity combination. This allocation approach also does not provide useful information.

4.9 The IPSASB considers that cost is not an appropriate measurement basis to use for an entity combination or amalgamation for the reasons stated in the previous paragraph. Additionally, the IPSASB also considers that market value is not an appropriate measurement basis to use for an entity combination or amalgamation because it, by definition, only provides a measurement basis for market-based assets and liabilities. Measurement bases that relate to subsequent measurement are also inappropriate because it is the initial measurement of the transaction or other event that gives rise to an entity combination or amalgamation that is required. Therefore, the measurement approach and basis that are explored to recognize an entity combination or an amalgamation are carrying amount and fair value.

4.10 To assess the relative merits of carrying amount and fair value, the discussion below considers each in the context of the objectives of financial reporting and the qualitative characteristics proposed in CF–ED 1 Conceptual Framework Phase 1. The qualitative characteristics of information included in general purpose financial reports of public sector entities are relevance, faithful representation, understandability, timeliness, comparability, and verifiability. The constraints on information are materiality, cost-benefit and the need to achieve an appropriate balance between the qualitative characteristics.

Carrying Amount

4.11 The *Glossary of Defined Terms* defines carrying amount, as follows.

"**Carrying amount of an asset** is the amount at which an asset is recognized in the statement of financial position, after deducting any accumulated depreciation and accumulated impairment losses thereon."

"**Carrying amount of a liability** is the amount at which a liability is recognized in the statement of financial position."

4.12 Where a recipient gains control of one or more operations, the amounts recognized by the recipient could be the carrying amount of the individual assets and liabilities recognized by the transferor; in other words, the amounts recognized in the financial statements of the operation or operations that was or were transferred. For the resulting entity in an amalgamation, it could use the carrying amount of the assets, liabilities and net assets/equity recognized by the combining operations.

Fair Value

4.13 The *Glossary of Defined Terms* defines fair value, as follows.

"The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

4.14 For an entity combination, the recipient would recognize all identifiable assets and liabilities of the newly controlled operation at fair value. And for an amalgamation, the

resulting operation would recognize all identifiable assets and liabilities[6] of the combining operations at fair value.

Existing Requirements for Similar Transactions

4.15 Existing IPSASs include requirements for the acquisition of individual assets and liabilities with or without the transfer of consideration. Generally, assets received in exchange transactions are recognized initially at cost[7] or fair value[8]. The cost recognized for assets acquired in non-exchange transactions is fair value at the date of acquisition[9]. Generally, liabilities are initially measured at the best estimate of the expenditure required to settle a present obligation[10] or fair value[11].

Considerations when choosing a Measurement Basis or Approach

4.16 The question is what measurement basis or approach is useful to users of financial statements for accountability and decision-making purposes. Carrying amount provides users with a measure of the value of the resources recognized prior to the entity combination or amalgamation. Using carrying amount has the advantage of having a high degree of verifiability because the amounts are already known and are readily available. This minimizes the time and cost to prepare the financial statements. Users will find this information easily understandable. The disadvantages of using the carrying amount are that assets and liabilities may be overstated or understated in relation to their fair value.

4.17 The advantage of using fair value is that it provides users with a measure of the current value of the resources that the recipient gained control of as a result of the entity combination or the resulting entity receives as a result of an amalgamation.

4.18 The use of carrying amount means there may be additional assets and liabilities that have not been recognized, e.g., an internally-generated intangible asset, such as software. This contrasts with using fair value as a measurement basis, because all identifiable assets and liabilities are recognized under that basis.

4.19 The disadvantages of using fair value vary depending on how difficult it is to determine the fair value of the individual assets received and liabilities assumed. Public sector entities may have specialized assets for which there is an absence of a deep and liquid market. For many liabilities, it is unlikely that there will be any kind of market in which to obtain a market value. In this situation, fair value would need to be estimated. For

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6 The net assets/equity of the combining operations is considered separately.

7 For example, investment property (IPSAS 16.26), property, plant, and equipment (IPSAS 17.26) and intangible assets (IPSAS 31.31).

8 For example, the initial recognition of financial assets is at fair value, plus, in the case of financial assets not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition of the financial asset (IPSAS 29.45).

9 For example, inventories (IPSAS 12.16), investment property (IPSAS 16.27) and property, plant, and equipment (IPSAS 17.27).

10 For example, provisions (IPSAS 19.44) and liabilities in respect of the inflow of resources arising from a non-exchange transaction (IPSAS 23.57).

11 For example, some financial liabilities (IPSAS 29.45).

assets, there are several approaches that can be used to estimate fair value, such as depreciated replacement cost, reproduction cost or service units approach. An estimate of fair value is usually costly and time consuming to prepare and may not be understandable. It is less likely that users will understand the limitations of making an estimate and its underlying assumptions. Some would argue that where there is an absence of a deep and liquid market, the costs of determining fair value may be prohibitive and this has an obvious impact on the cost-benefit constraint.

4.20 Furthermore, fair value is usually seen as an exit value which reflects the amount that will be derived from the asset, often from its sale. The IASB has recently completed its project on fair value measurement and, as a result, has amended its definition of fair value to clarify that fair value of an asset relates only to its sale and not to the asset's value derived through its use by the entity[12]. Generally, public sector entities retain assets and obtain value (service potential or economic benefits) through assets' use rather than sale. This limits the usefulness of fair value (as now defined by the IASB) in public sector entities.

4.21 The selection of measurement basis or approach is discussed in the sections relating to entity combinations and amalgamations.

5 Entity Combinations under Common Control

5.1 [To do.]

6 Entity Combinations not under Common Control

6.1 [To do.]

7 Amalgamations

7.1 This section discusses the accounting treatment for amalgamations. Section 2 defines an amalgamation as:

"A transaction or other event where two or more operations combine and none of the combining operations obtain control of the other operations."

7.2 One of the differences between an amalgamation and an entity combination is that the resulting operation is the result of two or more operations combining, i.e., no operation gains control of any of the other operations. In other words, no recipient can be identified. Some consider that a recipient can always be identified and this is the approach taken in IFRS 3 where guidance is included to apply in situations where there is no clear indication as to which of the combining businesses is the acquirer[13].

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12 The amended definition of fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date," IFRS 13, *Fair Value Measurement*, Appendix A.

13 IFRS 3, paragraphs 6 and 7, and Appendix B, paragraphs B13–B18.

7.3 The economic substance of the resulting operation is that of a new entity, formed from the net assets of the combining operations. However, the structure of an amalgamation can differ dependent on other factors, such as legislative requirements. An amalgamation may or may not involve the use of a new entity as the resulting operation.

7.4 The relative size of the combining operations is not an important factor in determining whether the transaction or other event is an amalgamation. Rather, it is that there is no gaining of control by one operation of the other operations involved in the amalgamation.

7.5 An amalgamation may be imposed by a higher level of government to be a cost-effective and efficient provision of public services. An amalgamation may also be undertaken voluntarily to maintain sustainable services.

7.6 The consideration of the accounting treatment for the resulting operation and the combining operations is set out below. The approach taken does not distinguish between amalgamations that take place under common control and amalgamations that take place not under common control.

Resulting Operation Accounting

What is the Appropriate Measurement Basis or Approach?

7.7 Section 4 considers that the appropriate measurement approach or basis to use for an entity combination or an amalgamation is either carrying amount or fair value.

Carrying Amount

7.8 An advantage to using carrying amount in the resulting operation is that it is a practical and low cost approach that is easily understandable. Some consider that carrying amount is an appropriate measurement approach to use because there is no relative change in the use of assets and so there is no need to change their valuation. Furthermore, the majority of amalgamations are not market-based transactions.

Fresh Start Accounting (Uses Fair Value)

7.9 Fresh start accounting has been raised as a potential method of accounting for amalgamations. In fresh start accounting[14], fair values are attributed to the individual assets and liabilities of all parties to the amalgamation, i.e., all the combining operations. In addition, assets and liabilities not previously recognized by the combining operations are recognized in the resulting operation. This approach to the measurement of an amalgamation can be contrasted with an entity combination where the measurement basis or approach is applied only to the assets and liabilities of the newly controlled operation.

7.10 An advantage of using fresh start accounting is that it provides users with a measure of the current value of the resources arising from the amalgamation. This information can be a faithful representation and be relevant to users for decision-making and accountability purposes.

[14] Fresh start accounting does not appear to be currently applied in any jurisdiction.

7.11 A disadvantage of using fresh start accounting is that, for specialized assets, fair value needs to be estimated rather than being an observed market value. Users may not easily understand how fair value has been calculated. In addition, because it applies fair value to the assets and liabilities of all the combining operations, the fair value exercise is much bigger. Some would argue that where there is an absence of a deep and liquid market, the costs of determining fair value may be prohibitive and so for practical cost-benefit reasons this is a disadvantage to using the fresh start approach.

7.12 In an amalgamation, there is usually no market trigger to the transaction or other event. In other words, no purchase and sale takes place, instead operations combine.

Potential Preliminary View

7.13 In the resulting operation, the IPSASB considers it is appropriate to use carrying amount for the recognition and initial measurement of the individual assets and liabilities of the combining operations. The reason for this view is because an amalgamation is not a market-based transaction and so the use of the fresh start accounting approach is not appropriate. Carrying amount is a practical and low cost approach that is easily understandable to users.

What Happens to the Net Assets/Equity of the Combining Operations?

7.14 In an amalgamation, the combining operations are a part of the resulting operation and the resulting operation is, in substance, a new operation. There is no inflow or outflow to an existing operation. Instead, there is the formation of a new operation. The existing net assets/equity of the combining operations are combined to reflect the net assets/equity of the resulting operation, consistent with the combining of the individual assets and liabilities of the combining operations into the resulting operation.

Potential Preliminary View

7.15 In the resulting operation, the IPSASB considers it is appropriate for the existing net assets/equity of the combining operations to be combined to reflect the net assets/equity of the resulting operation.

Accounting Treatment in the Combining Operations

7.16 Where an amalgamation is proposed, the process to achieve this may cover more than one reporting period. Although the combining operations know they will be combined with another operation or operations sometime in the future, they still need to prepare financial statements until the date of the amalgamation. Should these financial statements be prepared on a going concern basis?

7.17 IPSAS 1[15] requires that financial statements are prepared on a going concern basis unless there is an intention to liquidate the entity or to cease operating, or if there is no realistic alternative but to do so. The fact that the combining operations will cease to exist on the date of the amalgamation may have an effect on the basis of preparation of the financial

[15] IPSAS 1, paragraph 38.

statements and may suggest that the financial statements should not be prepared on a going concern basis.

7.18 However, an alternative view is that a presumption could be made that the resulting operation will continue to undertake the same activities as the combining operations because the resulting operation needs to fulfill the responsibilities it has accepted from the combining operations. If that is the situation, then the combining operations should continue to prepare their financial statements on a going concern basis, i.e., continue to measure assets and liabilities in accordance with applicable IPSASs, until the date of the amalgamation.

Potential Preliminary View

7.19 The IPSASB considers that the combining operations should continue to prepare their financial statements on a going concern basis before the amalgamation takes place. This is because the resulting operation continues needs to fulfill the responsibilities it has accepted from the combining operations.