Q&A No. 2011 - 02

PFARS 3.2 – Common Control Business Combinations

Issue

How should business combinations involving entities under common control be accounted for, given that these are outside the scope of PFARS 3, Business Combinations?

Background

Business combinations involving entities under common control are excluded from the scope of PFARS 3, Business Combinations (PFARS 3.2(c)). There are, however, no specific rules under existing PFARS which prescribe how common control combinations shall be accounted for. This Q&A seeks to provide guidance in accounting for common control combinations in order to minimize diversity in current accounting practices until further guidance is provided by the International Accounting Standards Board (IASB).

A business combination is a “common control combination” if the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory. This means that the same party or parties have the ultimate control over the combining entities or businesses both before and after the business combination.

Some examples of common control combinations include:

- combinations between subsidiaries of the same parent;
- the acquisition of a business between entities in the same group; and,
- the insertion of a new parent company at the top of a group.

Common control combinations are typically accounted for using the “pooling of interests method” and, in some cases where there is commercial substance to the transaction, using the “acquisition method” under PFARS 3.

Consensus

1. PAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, requires that in the absence of specific guidance in PFARS, management shall use its judgment in developing and applying an accounting policy that is relevant and reliable (PAS 8.10). The most relevant and reliable accounting policies for common control business combination would either be:

   a. the pooling of interests method; or
   b. the acquisition method in accordance with PFARS 3.

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1 Judgment is required to assess whether the common control is transitory or not. The conclusion that common control is transitory may lead to the inclusion of the business combination within the scope of PFARS 3 so that it shall be accounted for using the acquisition method.

2 A related guidance on the application of pooling of interests method shall be covered by a separate PIC Q&A.
2. The pooling of interests method is widely accepted in accounting for common control combinations. This method is prescribed under the US generally accepted accounting principles (GAAP) and permitted under the UK GAAP. The relevant guidance on pooling of interests method is provided under Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 805-50.

3. Common control business combinations shall be accounted for using either the pooling of interests method or the acquisition method. However, where the acquisition method of accounting is selected, the transaction must have commercial substance from the perspective of the reporting entity.

4. When evaluating whether the transaction has commercial substance, the following factors may be considered:
   a. the purpose of the transaction;
   b. the involvement of outside parties in the transaction, such as non-controlling interests or other third parties;
   c. whether or not the transaction is conducted at fair value;
   d. the existing activities of the entities involved in the transactions;
   e. whether or not the transaction is bringing entities together into a “reporting entity” that did not exist before;
   f. where a new company is established, whether it is undertaken as an integral part of an Initial Public Offering (IPO) or spin-off or other change in control and significant ownership; and,
   g. the extent to which an acquiring entity’s future cash flows are expected to change as a result of the business combination in which:
      i. the configuration (risk, timing, and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
      ii. the entity-specific value of the portion of the entity’s operations affected by the transaction changes as a result of the combination; and
      iii. the difference in item i and item ii above is significant relative to the fair value of the assets exchanged.

5. Since the acquisition method results in a reassessment of the value of the net assets of one or more of the entities involved and/or the generation of goodwill, there must be commercial substance to the combination before it can be applied. PFRS contains limited circumstances when net assets may be restated to fair value and restricts the recognition of internally generated goodwill, and common control business combination cannot be used to circumvent this limitation by applying the acquisition method.

6. The accounting policy for common control business combination shall be applied consistently for similar transactions.
7. The following shall be disclosed in addition to required disclosures under applicable PAS/PFRS:

   a. accounting policy applied for common control business combination and the rationale for applying that policy;
   b. any significant/relevant details on the common control business combination;
   c. if the pooling of interests method is applied, an entity shall likewise disclose how the methodology was applied; and,
   d. if the acquisition method is used, an entity shall disclose the factors considered to support its conclusion that the transaction has commercial substance.

**Effective Date**

The consensus in this Q&A is effective for annual financial statements beginning on or after January 1, 2012. Earlier application is encouraged.

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Q&A approved by PIC: **August 24, 2011** (Original signed)

**PIC Members**

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  * Wilfredo A. Baltazar  
  * Judith V. Lopez  
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  * Wilson P. Tan  
  * Lyn I. Javier/Reynold E. Afable  
  * Normita L. Villaruz

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