Note: Dual Listed Companies (DLCs) – Issues for Consideration

What is a DLC?

A DLC structure is a contractual arrangement between two companies under which the activities of two companies are brought together, managed and operated on a unified basis as if they were a single economic enterprise while retaining their separate legal identities, tax residencies and stock exchange listings.

The following discussion of a DLC structure is in the context of the two parties residing in two different jurisdictions, that is, an Australian entity and a foreign entity. However, this does not preclude the possibility that two or more domestic entities may enter a DLC by agreement.

Features of a DLC

The main features of a DLC are that:

(a) each company continues to retain its separate legal identity and own its own assets. For example, in the Australian DLCs the shareholders of both companies vote as a single electorate on substantial issues affecting their combined interests ("joint decisions"), such as the appointment of directors, approval of financial statements, but vote separately on significant issues which might affect them differently, such as changes to the equalisation ratio ("separate decisions");

(b) each company maintains a separate listing and the shareholders of each company do not change as a result but there is a sharing of rights between shareholder groups, that is, shareholders of each company retain their existing shares but with an economic interest in the combined assets of both companies;

(c) the compositions of the separate boards of directors are identical or virtually identical;

(d) arrangements are put in place to satisfy regulatory and legal requirements in the home jurisdiction of each company and their adoption by the new reporting entity;

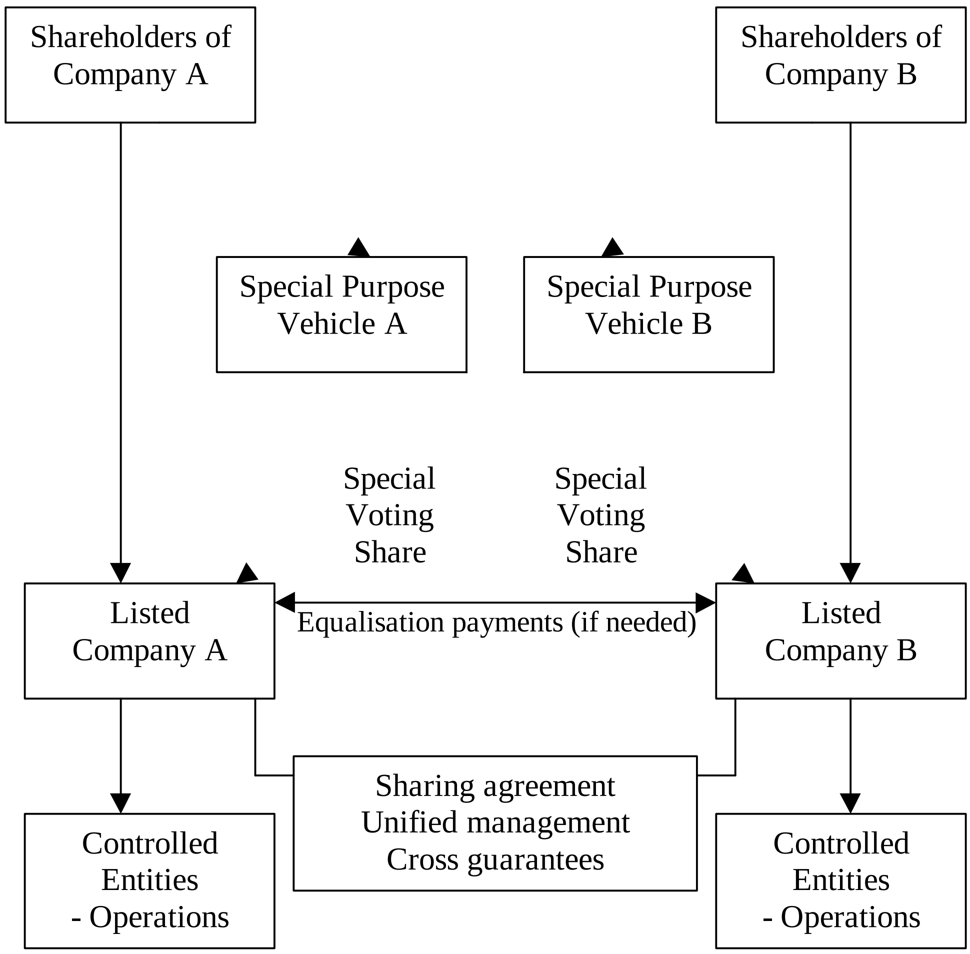
(e) there are not normally transfers of assets between the entities at the time of formation;

(f) arrangements are made to ensure the equalisation of dividends and other distributions so that shareholders of each company have equivalent dividend, capital and voting rights on a per share basis;

(g) management of the activities is undertaken on a unified basis, that is, the two companies are managed having regard to the interests of the shareholders of both companies; and

(i) cross guarantees are made by each company in favour of the other in respect of certain contractual obligations.

TYPICAL FEATURES OF DLC STRUCTURES



<u>What is the motivation for a DLC structure?</u>

Those entering DLC structures advance the following reasons for doing so:

(a) a DLC structure enables companies, particularly those based in small, capital scarce economies, whose ability to grow by acquisition is constrained by a weak and volatile currency and the lack of an acceptable "acquisition currency", to achieve business objectives of creating shareholder value and to deliver strong sustainable returns to shareholders. The DLC structure can achieve the above objectives without the respective companies and their shareholders being involved in any investment or disinvestment. The DLC has the effect of combining the assets of the participating companies to access synergy benefits and enhance value but without requiring any party to introduce or withdraw funds. This is particularly relevant where the assets of the participating companies are similar in nature: the creation of the DLC will enable the assets to be operated more efficiently without significant change in the commitments or exposures of the shareholders.

Participants in DLCs maintain that the DLC structure facilitates:

- enhancing the company's access to growth opportunities including organic growth through application of more extensive capabilities and stronger asset bases;
- achieving improved diversification, resilience to risk and enhanced scale;
- achieving increased financial strength, capacity and flexibility and access to capital on better terms because of improved financial capability, enhanced credit rating and a lower cost of capital;
- capturing synergistic benefits from rationalising the use of resources and from accessing opportunities for growth; and
- satisfying foreign investment guidelines or avoiding impediments to growth and business opportunities arising from restrictions on foreign investment.

(b) to improve access to global capital markets as a means of maintaining and enhancing shareholder value. For example, with the globalisation of investment activities international investors seek to achieve index weightings of stocks and geographical areas. If a large entity from a small/capital scarce economy were to acquire another significant entity in its industry its market capitalisation may result in investment managers being "overweight" in the stock. The effects of seeking to achieve the desirable index weighting is likely to result in a "sell-down" with a consequential reduction in the price of the stock and the destruction of shareholder value.

A DLC structure enables the participants to avoid these impediments by maintaining their individual listings, scale and index weightings. In addition, a company from a smaller capital market is able to achieve improved access to global capital markets while retaining its domestic identity. In the case of an Australian company the DLC structure provides access to growth opportunities without having to move offshore.

A DLC structure may also enable a company to become a recognised global player with the capacity to influence and shape global activities and restructuring in its industry, to attract investment and to create strong management teams with the depth and capabilities to develop the company as a significant force in its markets; and

(c) to achieve access to growth and growth opportunities in a tax advantageous way for shareholders. For example, in some jurisdictions the formation of a DLC structure is not a tax event for the company or for its shareholders. In Australia because there is no change in the shareholders or their tax status and no transfers of assets or shares the existing taxation treatment of shareholders in respect of dividend imputation and capital gains taxation is preserved. The DLC structure does not involve disposal of shares or transfer of assets with the result that shareholders are not exposed to capital gains tax and the company is not subject to stamp duties.

ISSUES

1. Is a reporting entity created when two companies (separate legal entities) form a DLC structure?

The shareholders in the two companies share common interests in a new reporting entity that are similar to the relationships of shareholders in a single company. For operational and financial reporting purposes, the two companies act as two gateways to the same group of assets. For example, the contractual agreements, identical or virtually identical boards of the two separate legal entities in a DLC structure, and the economic consequences of the DLC structure, ensure that both companies act in concert to make economic decisions in the interests of both companies and their shareholders because the resources of each of the companies are deployed for a common purpose. In addition, the financial performance of the interests of the two companies in the DLC structure is reflected in the price of their separately listed securities (save for any differences that may exist in the tax[1] or exchange control characteristics of the respective securities, an ordinary shareholder would be indifferent as to which company's shares are held). Shareholders, potential shareholders and a range of other users will require information about the financial consequences of the whole business in the DLC structure for economic decision-making purposes.

The reporting entity may also be viewed as a new economic entity because a group of assets is being combined under a unified management for the benefit of all shareholders who have an interest in the activities and performance of that economic entity. However, for reporting purposes it is of little consequence whether, consistent with SAC 1 "Reporting Entity", the DLC entity is regarded as a reporting entity or whether it is regarded as an economic entity in a more general sense than that term is used in SAC 1 and Accounting Standards. The significance of the creation of a new reporting entity is the obligation to prepare general purpose financial reports in respect of that reporting entity.

Where the participating company in a DLC is an Australian company the Corporations Act requires the preparation of separate entity and consolidated financial statements of the company and its controlled entities that comply with Australian GAAP. This also means that they must be in English, use Australian currency and be audited.

This leads to questions about the basis of accounting for the interest in the activities undertaken within the DLC entity in the separate entity financial statements and whether its consolidated financial statements, or some other basis of presentation such as combined financial statements, provide decision-useful information to its shareholders and other users where DLC reporting entity financial statements are prepared. Questions are raised as to whether the separate consolidated financial statements are relevant and, if so, which users and which of their needs are being satisfied by these financial statements. Some also question whether, in these circumstances, all the note disclosures required by accounting standards for example, segment reporting, cash flows, financial instruments etc. provide relevant and reliable information that is not misleading.

Some argue that the consolidated financial statements of a participating entity would be misleading and would not provide a true and fair view of its financial position and operations because, under the DLC structure, the interest of the shareholders in the participating entity is

1 Note that equalisation usually occurs on a net cash basis as opposed to a tax adjusted basis.

in the net assets of the DLC reporting entity, and the way in which the DLC is operated and managed, not just in the assets of the entity of which they are shareholders. In addition, consolidated financial statements would not adequately reflect the inter-relationships between the two participating entities.

Issue

Is a new reporting entity created on the formation of a DLC structure?

2. Where a DLC arrangement is created has an acquisition occurred?

Accounting Standards AASB 1015 and AAS 21 “Acquisitions of Assets” require that an acquirer be identified for all combinations of entities or operations and state that an acquisition means obtaining control of an asset in exchange for a cost of acquisition (consideration).

In a DLC arrangement neither company has acquired the other. One view expressed is that in a DLC structure there is no exchange transaction, and no cost of acquisition as consideration does not pass between the two companies: each company has agreed to combine its assets with the assets of the other. The management of each participating company has entered an arrangement to maximise the benefits from deploying the assets by undertaking to manage and operate them on a unified basis with a common purpose. Those taking this view act on the presumption that in a DLC arrangement control by one party to the arrangement does not exist unless there are compelling reasons to suggest otherwise.

Others express the view that where the DLC structure is not an exact 50:50 arrangement the shareholders of one company may, in substance, have the capacity to exercise control since they have the capacity to control, on a proportionate basis, more than 50% of the votes in respect of the activities of the newly created reporting entity. However, this approach tends to ignore the “joint” and “separate” nature of decision-making by shareholders in a DLC. Under the recent Australian/United Kingdom DLCs, the shareholders of each company vote as a single electorate on substantial issues affecting their combined interests, such as the appointment of directors and approval of financial statements, but vote separately on significant issues that might affect them differently, such as changes to the equalisation ratio. Generally in respect of joint decision matters, the shareholders of the respective participating companies would not act as separate groups with separate partisan interests. Votes might be expected to be cast on the basis of different shareholder’s commercial judgements and would not normally depend on whether the shareholder gained access to the combined assets through gateway A or gateway B.

In some cases there may be evidence that in consummating the arrangement one of the parties has “paid” a premium. The existence of a premium does not necessarily imply that one party has provided an inducement (consideration) to obtain control. For example, the shareholders of Company A may be prepared, for a variety of reasons, to accept a lower relative proportion of the DLC than would be suggested by the relative market values of Company A and Company B.

Some hold the view that AASB 1015 and AAS 21 are not applicable to a DLC because the formation of the DLC does not involve an acquisition by one entity of either shares or net assets in another entity. They also point out that since the relationship between the entities involved in the DLC reporting entity is not that of a parent/subsidiary nature, Accounting Standards AASB 1024 "Consolidated Accounts" and AAS 24 "Consolidated Financial Reports" are not applicable.

(a) Why is it important to determine whether an acquisition has occurred?

Where a DLC structure is regarded as an acquisition the purchase method of accounting for business combinations applies.

Where a DLC structure is not regarded as an acquisition Accounting Standards AASB 1015 and AAS 21 would not apply. Current practice in some jurisdictions (UK and IASB), subject to satisfying certain criteria, is to apply merger accounting and the assets and liabilities of the combining entities are recognised by the DLC at the book carrying amounts of the participating entities. Under merger accounting fair values are not reflected by the DLC and goodwill is not normally recognised.

However, under the tentative decisions taken by the IASB, the US requirements and the G4+1 proposals, an acquirer must be identified and the purchase method of accounting applied to account for all business combinations. (The IASB decided to exclude consideration of DLCs from scope of the first phase of its Business Combinations project to revise IAS 22 "Business Combinations".) If an acquirer is required to be identified it is necessary to determine the process or mechanisms that are applied to identify which of the combining entities is the acquirer. For example, preparers and others need guidance on whether the identification is based on the relative size of the entities, the initiator of the combination transaction, the sequence in which arrangements were made and changes in structure occurred, on the basis of negotiation between the parties, the domicile of the combining entities or on some other basis. This is significant because in a purchase model it governs which entity is incurring a purchase consideration (cost of acquisition), which entity's assets and liabilities are subject to the fair value exercise, the distinction between pre-acquisition and post-acquisition amounts and whose perspective is adopted in respect of post-acquisition transactions.

(b) Has a cost of acquisition been incurred?

Some argue that under the DLC arrangements neither entity incurs a cost of acquisition as no consideration passes between the parties. In effect, the shareholders of each company are agreeing to bring their respective interests together and to manage and operate them as if they formed part of a single entity. The arrangement is characterised by agreement, not by the passing of consideration, the transfer of control of the assets or by the transfer of shares.

Others argue that, conceptually, a DLC is similar to two companies contributing assets to an unincorporated joint venture. They point out that the creation of a DLC involves neither investment nor disinvestment because the assets backing pre-existing business investments are combined to make those assets more effective operationally. By combining the two sets of assets, the expectation is that more cash can be generated from future operations without changing the nature of the assets, exposures or liquidity represented by shares in either company. Those adopting this view argue that as no cost has been incurred the book values of the assets "transferred" to the DLC reporting entity should not, therefore, change.

Others express the view that each company exchanges the rights of control of its net assets contributed to the arrangements for a different class of rights because those assets are combined with those of the other company with the intention that they are operated and managed to meet the same operating and financial objectives. Some point out that this exchange of rights occurs between the shareholders of each company and not between the companies themselves.

Still others argue that in all business combinations, regardless of description or title, the principles of historical cost accounting should be applied. They note that in SFAS 141 "Business Combinations" the FASB affirmed the basic principles of historical cost accounting in reaching the conclusion that the purchase method should be used to account for all business combinations. However, others observe that the cost of acquisition is allocated to identifiable assets and liabilities acquired on the basis of their fair values at the date of acquisition. Those advancing the view that historical costs be used by a DLC reporting entity argue that the cost to the DLC reporting entity of the assets and liabilities of the combining entities is the carrying amounts in the records of the entities in the DLC reporting entity and, accordingly, the financial statements of the DLC reporting entity should be determined by adding together the individual financial statements of these entities. Under this approach the financial statements of the DLC reporting entity are prepared by combining the financial statements of the two entities comprising the DLC and adjustments for differences between the carrying amounts and the fair values of assets and liabilities of the combining entities and the measurement of goodwill are not required.

Those holding this view maintain that the forced identification of an acquirer when one does not exist, as in a DLC combination, is to require the application of fair value to the net assets of one of the combining parties with the subsequent recognition of goodwill/discount on acquisition. They note that for a two-company DLC agreement this results in a departure from applying the principles of historical cost accounting for the DLC reporting entity because the combined financial statements contain the assets and liabilities of one of the combining entities at carrying amount (historical cost) and the assets and liabilities of the other entity at the costs of acquisition which are measured on the basis of their fair values as at the date of acquisition.

(c) Is the relative size of the participating companies significant in determining whether an acquisition has occurred?

In principle, a DLC arrangement between shareholders of two companies should be capable of application irrespective of the relative sizes of the participants.

However, accounting rules for business combinations in Australia and the USA (and tentative decisions taken by the IASB) presume that in each transaction there is an acquirer and an acquiree. These rules are applied with the objective of identifying an acquirer. In some cases where an acquirer cannot be identified an arbitrary approach is to presume that the larger company is the one that obtains control and is acquiring the net assets of the smaller company. However, the application of this approach and the identification of the acquirer becomes more judgmental as the relative sizes of the two companies converge.

Financial reporting requirements in some jurisdictions require application of pooling of interests/merger accounting in the rare cases where the parties are of approximately equal size and an acquirer cannot be identified. For example:

- in the United Kingdom a 60:40 ratio is used as an arbitrary practical guideline (rebuttable presumption) to determine whether an arrangement qualifies for merger accounting. [FRS 6 "Acquisitions and Mergers" provides that a condition for merger accounting is that the relative sizes of the combining entities are not so disparate that one party dominates the combined entity by virtue of its relative size and that a party would be presumed to dominate if it is more than 50 per cent larger than each of the other parties to the combination, judged by reference to the ownership interests; that is, by considering the proportion of the equity of the combined entity attributable to the shareholders of each of the combining parties. However, this presumption may be rebutted if it can be clearly shown that there is no such dominance.]; and

- in Australia in October 2001 the Australian Securities and Investments Commission (ASIC) issued Practice Note 71 "Financial Reporting by Australian Entities in Dual Listed Company Arrangements" in which ASIC argues for the identification of an acquirer by reference to situations where there is a significant disparity in the relative sizes of the combining entities. ASIC applies as a guide the relative size variable of 1.5 times where the larger entity is regarded, in substance, as having acquired the smaller entity, with the result that Accounting Standards AASB 1015 and AAS 21 and Accounting Standards AASB 1024 and AAS 24 would apply.

However, where arbitrary rules about the relative sizes of the participants are a factor in determining the basis of accounting it is necessary to determine how and when the relative sizes are to be determined. Wherever a size test is applied, issues arise relating to when and where the line is drawn and guidance is needed to determine:

(a) the basis for determining the relative sizes of the two companies;

(b) whether the measure of relative size takes account of "grooming" and "spin-off" transactions and proposals.

Issues

(a) Assuming that there is some "special accounting" for DLCs, in qualifying for that form of accounting, does the relative size of the companies matter?

(b) If applicable, is the relative size of the companies determined on the basis of their activities and operations at the time of the agreement or is the outcome of proposed transactions such as a discontinuance of operations, a share buy-back or capital return by one of the entities taken into account?

3. General Purpose Financial Reports

(a) DLC Reporting Entity

In Australia there are no formal requirements for the DLC reporting entity to prepare financial reports or for them to be audited. However, ASIC Practice Note 71 "Financial Reporting by Entities in Dual Listed Company Arrangements" (October 2001) requires combined financial reports for the DLC reporting entity to be included as a note to the financial statements (separate entity and consolidated) of the

Australian participating entity. Three possible methods of accounting on which financial statements of a DLC reporting entity could be constructed are:

1. Purchase method (and consequent consolidation)
2. Pooling of interests/Merger method
3. 'New Basis' or 'Fresh Start' method

Australian standards apply the reporting entity concept to determine the need for general purpose financial reports and the concept of control to determine the boundaries of the reporting entity. However, Accounting Standards AASB 1024 and AAS 24 apply the concept of control in the context of a “normal” parent entity/subsidiary relationship and include requirements to separately identify the profits and equity attributable to the shareholders of the parent entity and the interests of outside shareholders.

Under a DLC structure the DLC reporting entity has not issued equity capital and, as such, neither of the participants, either directly or indirectly, hold equity capital in the DLC reporting entity and do not (normally) hold each other’s equity capital. In these circumstances, the basis for distinguishing the controlling entity and outside interests and in applying consolidation requirements is not clear. Purchase accounting and consolidation, if adopted, includes a mix of book carrying amounts of the “parent entity” and fair values in respect of the “controlled entity”.

Where consolidated financial reports of the DLC reporting entity are not prepared because of the absence of a control relationship, an alternative basis of presentation of the whole of its activities and operations is required if the information needs of shareholders of the participating companies, capital market participants and other parties dealing with the DLC reporting entity are to be satisfied.

One alternative is to apply the pooling of interests/merger method of accounting as is required in respect of qualifying business combinations in the United Kingdom and by IASB standards (IAS 22 “Business Combinations”). The effect of pooling of interests/merger accounting is that the DLC reporting entity recognises the book carrying amounts of the assets and liabilities of the participating entities in its financial reports. However, a business combination that satisfies the criteria for pooling of interests/merger accounting normally involves an exchange of rights between the companies and/or their shareholders, for example, the exchange of shares or the issue of shares in a new entity. The issue or exchange of shares does not occur in the formation of a DLC structure although a participating company may issue bonus shares to its shareholders in order to achieve equalisation arrangements.

The application of the pooling of interests/merger method is criticised because it does not require the recognition of the fair values of the assets and liabilities of the combining entities and the goodwill inherent in those entities, even though these would be taken into consideration by the shareholders in deciding whether to enter a DLC structure and in determining the merger and equalisation ratios. However, similar criticisms are also made in respect of the application of the purchase method where, say, a parent entity acquires shares in order to obtain control of another entity. The purchase method only requires the use of fair values in the application of the purchase method in relation to a subsidiary's assets and liabilities and not the assets and liabilities of the parent entity.

Some argue that neither the pooling of interests/merger accounting nor the purchase method provides current, relevant and reliable information about the net assets which are jointly managed and operated within the DLC reporting entity. They point out that a form of presentation which may satisfy these information requirements would be the preparation of combined financial statements reflecting the fair values of assets and liabilities at the creation of the DLC reporting entity (described as the "new basis" or "fresh start" method) and note that shareholders have economic interests in the DLC through their interest in the separate listed companies. However, where the "new basis" method is applied it is necessary to determine when the new economic/reporting entity is created as this will determine the date on which the fair values of the assets and liabilities managed in the DLC on a unified basis are assessed and recognised in the DLC reporting entity financial statements. They point out that the choice between the purchase and pooling of interests/merger methods of accounting and the new basis method is a choice between fair value accounting and historical cost accounting and that this choice should be made on the basis of which method provides, within a cost-benefit constraint, the most relevant and reliable information to users of the DLC reporting entity financial statements.

Others argue that although the inclusion of fair values has some attraction there is no more reason to present the DLC reporting entity financial statements on the basis of fair values than to present any other company's financial statements on this basis on the grounds that the creation of a DLC is an arbitrary trigger for such a change in the basis of measurement. Standard-setters have considered the application of the new basis method but have not required its use because of the need to develop new accounting guidance for the application of the method, the disadvantages of having two methods of accounting applicable in different situations, and the resultant lack of comparability of information if the new basis method were adopted for some combinations and not for others.

Issues

(a) *Should general purpose financial statements be prepared for the new reporting entity created under the DLC structure?*

[Note that foreign companies having securities registered on the US market are not required to prepare financial reports complying with US standards, but rather to provide a reconciliation to US GAAP. In the United Kingdom companies listed on the London Stock Exchange are not required to prepare a reconciliation where United Kingdom accounting standards are not adopted.]

(b) *Given the nature of a DLC, and that one of the entities is a foreign entity, should the general purpose financial statements of the DLC reporting entity, if prepared,:*

(i) *be expressed in Australian dollars as:*

(a) *the measurement currency;*

(b) a convenience translation;

(ii) be expressed in a foreign currency which could be the measurement currency of the foreign entity or a functional currency or currencies?

[Note: The question of functional currency and the principles that are brought to bear to determine the measurement currency, where the national currency of one of the participating entities is not used, while not an issue specific to a DLC is highlighted more in the case of a DLC.]

(b) <u>Single Entity and Economic Entity</u>

What financial statements should be prepared by the participating companies?

Issues also arise in respect of the status and presentation of the separate entity financial statements including whether or not they should be presented in conjunction with the DLC reporting entity financial reports, whether they should be lodged with the regulator rather than distributed to shareholders, and whether the same accounting requirements should be applied in their preparation.

<u>Issues</u>

(a) Should the participating companies be required to prepare:

(i) separate entity financial reports;

(ii) consolidated financial reports?

(b) Where a combined financial report of the DLC reporting entity is prepared in accordance with Australian GAAP and provided to the shareholders of the Australian participating entity, should any restrictions be placed on the provision of financial statements prepared in accordance with requirements of another jurisdiction?

(c) Is it feasible to develop requirements for:

(i) separate entity financial reports to be prepared in accordance with the national requirements of the participating entities, for example Australia and the United Kingdom; and

(ii) combined financial reports of the DLC reporting entity, expressed in a functional currency, for example USD, and a different GAAP, for example, IASB standards?

(d) On the basis that one of the entities in a DLC is a foreign entity, if combined financial statements are prepared for the DLC reporting entity:

(i) must they be prepared in accordance with Australian GAAP and Corporations Law requirements; and

(ii) if not, should a reconciliation to Australian GAAP be required?

4. Disclosure in financial statements

Issues

(a) What disclosures should be made about the DLC structure and its implications for the shareholders of the participating companies in the:

(i) DLC reporting entity financial statements;

(ii) separate financial statements of each participating company and, where required, the consolidated financial statements of their economic entities?

(b) Where DLC reporting entity financial statements are prepared, what comparative information should be provided and on what basis should it be prepared?

5. Authoritative Literature

Australia

AASB 1015 and AAS 21 "Acquisitions of Assets"

"5.1 An acquirer must be identified for all combinations of entities or operations.

12.1 'acquisition' means obtaining control of an asset, group of assets or net assets in exchange for a cost of acquisition;

'control of an asset', group of assets or net asset means the capacity of the entity to benefit from the asset, group of assets or net assets in pursuit of the entity's objectives and to deny or regulate the access of others to that benefit;"

AASB 1024 "Consolidated Accounts" and AAS 24 "Consolidated Financial Reports"

"9. 'capacity' means ability or power, whether direct or indirect, and includes ability or power that is presently exercisable as a result of, by means of, in breach of, or by revocation of, any of or any combination of the following:

(a) trusts;

(b) relevant agreements; and

(c) practices;

whether or not enforceable;"

"control" means the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity;"

"(xvi) Any of the following factors would normally indicate the existence of control by one entity of another entity:

(a) the capacity to dominate the composition of the board of directors or governing board of another entity;

(b) the capacity to appoint or remove all or a majority of the directors or governing members of another entity;

(c) the capacity to control the casting of a majority of the votes cast at a meeting of the board of directors or governing board of another entity;

(d) the capacity to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of another entity, irrespective of whether the capacity is held through shares or options; and

(e) the existence of a statute, agreement, or trust deed, or any other scheme, arrangement or device, which, in substance, gives an entity the capacity to enjoy the majority of the benefits and to be exposed to the majority of the risks of that entity, notwithstanding that control may appear to be vested in another party."

Statement of Accounting Concepts (SAC) SAC 1 "Reporting Entity"

"6. "entity" means any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives;

40. Reporting entities are all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

41. Reporting entities should prepare general purpose financial reports. Such reports shall be prepared in accordance with Statements of Concepts and Accounting Standards".

UIG Abstract 13 "The Presentation of the Financial Report of Entities Whose Securities are 'Stapled'"

"*Combined Financial Reports*

10. Unless excluded from this Consensus by paragraph 8, the reporting entity identified in paragraph 9 must prepare a general purpose financial report

which combines the separate financial reports of the entities, or economic entities, whose securities are stapled in accordance with the requirements of:

(a) Accounting Standards AASB 1024 "Consolidated Accounts" and AAS 24 "Consolidated Financial Reports" in respect of common reporting dates, appropriateness and consistency of accounting policies and elimination of inter-entity transactions and balances; and

(b) applicable Accounting Standards and UIG Consensus Views.

11. The general purpose financial report which combines the separate financial reports of the entities or economic entities whose securities are stapled must disclose:

(a) that the equity securities of two or more entities have been stapled; and

(b) the identity of the entities whose securities have been stapled; and

(c) a description of any other major features of the stapling arrangements, including any circumstances in which they can be terminated.

Separate Financial Reports

12. Where a separate general purpose financial report or consolidated financial report of any of the legal or economic entities whose securities are stapled is also prepared, that report must disclose:

(a) that an equity security of the entity has been stapled to an equity security of another entity; and

(b) the identity of the other entity or entities; and

(c) a description of any other major features of the stapling arrangements, including any circumstances in which they can be terminated."

<u>International Accounting Standards Board</u>

IAS 22 "Business Combinations"

"13. In exceptional circumstances, it may not be possible to identify an acquirer. Instead of a dominant party emerging, the shareholders of the combining enterprises join in a substantially equal arrangement to share control over the whole, or effectively the whole, of their net assets and operations. In addition, the managements for the combining enterprises participate in the management of the combined entity. As a result, the shareholders of the combining enterprises share mutually in the risks and benefits of the combined entity. Such a business combination is accounted for as a uniting of interests.

14. A mutual sharing of risks and benefits is usually not possible without a substantially equal exchange of voting common shares between the combining enterprises. Such an exchange ensures that the relative ownership interests of

the combining enterprises, and consequently their relative risks and benefits in the combined enterprise, are maintained and the decision-making powers of the parties are preserved. However, for a substantially equal share exchange to be effective in this regard there cannot be a significant reduction in the rights attaching to the shares of one of the combining enterprises, otherwise the influence of that party is weakened.

15. In order to achieve a mutual sharing of the risks and benefits of the combined entity:

(a) the substantial majority, if not all, of the voting common shares of the combining enterprises are exchanged or pooled;

(b) the fair value of one enterprise is not significantly different from that of the other enterprise; and

(c) the shareholders of each enterprise maintain substantially the same voting rights and interest in the combined entity, relative to each other, after the combination as before."

United Kingdom

FRS 6 "Acquisitions and Mergers"

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

Merger criteria requirements are set out in FRS 6 paragraphs 57-77.

Extract from Summary of FRS 6

" A combination meets the definition of a merger only if it satisfies the five criteria set out in paragraphs 6 – 11 of the FRS. These criteria relate to:

1. the way the roles of each party to the combination are portrayed;

2. the involvement of each party to the combination in the selection of the management of the combined entity;

3. the relative sizes of the parties to the combination;

4. whether shareholders of the combining entities receive any consideration other than equity shares in the combined entity;

5. whether shareholders of the combining entities retain an interest in the performance of only part of the combined entity.

Where a combination meets these criteria, acquisition accounting is not permitted as this method would not fairly present the effect of the combination."

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

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

Financial Accounting Standards Board

SFAS 141 "Business Combinations"

"*Reasons for Rejecting the Fresh-Start Method*

B81. The Board acknowledged that a case can be made for using the fresh-start method to account for business combinations that are not acquisitions, which might be defined as transactions in which an acquiring entity cannot be identified or one in which the acquiring entity is substantially modified by the transaction. Under the fresh-start method, none of the combining entities are viewed as having survived the combination as an independent reporting entity. Rather, the combination is viewed as the transfer of the net assets of the combining entities to a new entity that assumes control over them, and the history of that new entity, by definition, begins with the combination.

B83. The Board noted that if the fresh-start method were to be applied only to those two-party combinations in which an acquiring entity cannot be identified or the combining entities were equal in all respects, such combinations would be so rare – if they occurred at all – as to not justify the need for a new and separate method … Furthermore, the method may offer the potential for accounting arbitrage because the financial statement results it produces are apt to differ significantly from those that the purchase method produces.

B84. The Board concluded that the advantages of using the fresh-start method for two-party combinations such as those discussed in paragraph B81… were outweighed by the disadvantages of having two methods of accounting… The Board further concluded that an alternative to the purchase method of accounting for those combinations was not needed because it is possible to apply the purchase method to them.

Application of the Purchase Method

Accounting for Asset Acquisitions – General Concepts

B87. In reaching the conclusion that the purchase method should be used to account for all business combinations, the Board affirmed the basic principles of historical-cost accounting included in paragraphs 66-69 of Opinion 16. Specifically, the Board affirmed that an asset acquisition should be measured on the basis of the values exchanged and that measurement of the values exchanged should be based on the fair value of the consideration given or the fair value of the net assets acquired, whichever is more reliably measurable…

Identifying the Acquiring Entity

B88. The Board's decision that all business combinations in the scope of this Statement should be accounted for by the purchase method means that the acquiring entity must be identified in every business combination…"

APB Opinion No. 16 "Business Combinations"

"*Application of Purchase Method*

Principles of Historical-Cost Accounting

66. Accounting for a business combination by the purchase method follows principles normally applicable under historical-cost accounting to recording acquisitions of assets and issuances of stock and to accounting for assets and liabilities after acquisition.

67. *Acquiring assets.* The general principle to apply the historical-cost basis of accounting to an acquisition of an asset depend on the nature of the transaction:

a. An asset acquired by exchanging cash or other assets is recorded at cost – that is, at the amount of cash disbursed or the fair value of other assets distributed.
b. An asset acquired by incurring liabilities is recorded at cost – that is, at the present value of amounts to be paid.
c. An asset acquired by issuing shares of stock of the acquiring corporation is recorded at the fair value of the asset[2] – that is, shares of stock issued are recorded at the fair value of the consideration received for the stock. …

69. Accounting after acquisition. The nature of an asset and not the manner of its acquisition determines an acquirer's subsequent accounting for the cost of that asset. The basis for measuring the cost of an asset – whether amount of cash paid, fair value of an asset received or given up, amount of a liability incurred, or fair value of stock

[2] An asset acquired may be an entire entity which may have intangible assets, including goodwill.

issued – has no effect on the subsequent accounting for that cost, which is retained as an asset, depreciated, amortized, or otherwise matched with revenue.”

<u>Other</u>

G4+1 Position Paper: Recommendations for Achieving Convergence on the Methods of Accounting for Business Combinations (December 1998)

Explanation of “New-Basis” (Fresh-Start) Accounting

> “51. In contrast to the pooling and purchase methods, in which either all or one of the predecessor companies is assumed to continue, the fresh-start method assumes that none of the predecessors continue but rather that a new entity emerges from the combination. Although that new entity might bear the name of one or more of its predecessor companies, it is viewed as sufficiently different economically from its predecessors so as not to be recognisable as any one of them. The new entity differs from all its predecessor companies in matters such as geographic reach, size and scope of operations; hence none of those companies is seen as the survivor that continues in existence.
>
> 52. The creation of a new entity is consistent with the public announcements of combinations that characterise those transactions not only as marking “new beginnings” but also as leading to important new synergies that none of the predecessor companies could have obtained or benefited from independently of one another. Indeed, such combinations sometimes vault industry also-rans into front runners and, in doing so, change the dynamics of competition in an entire industry.”