IPSAS® 40 Summary—*Public Sector Combinations*

This summary provides an overview of IPSAS 40, *Public Sector Combinations.*

Project objective: To establish requirements for classifying, recognizing and measuring public sector combinations.

Approved: The International Public Sector Accounting Standards Board® (IPSASB®) approved IPSAS 40, *Public Sector Combinations,* in December 2016. IPSAS 40 was issued in January 2017.

Project history: The IPSASB initially considered developing two Standards on public sector combinations, covering:

(a) Entity combinations arising from exchange transactions—a limited convergence project with IFRS 3, *Business Combinations*; and

(b) Entity combinations arising from non-exchange transactions—a public sector-specific project.

The IPSASB issued Exposure Draft (ED) 41, *Entity Combinations from Exchange Transactions* (the convergence project with IFRS 3) in May 2009. Following the consultation process, the IPSASB decided not to proceed with ED 41, but to develop a single standard dealing with all public sector combinations.

This wider scope was included in the Consultation Paper (CP), *Public Sector Combinations*, issued in June 2012.

The IPSASB issued ED 60, *Public Sector Combinations*, in January 2016. IPSAS 40 reflects the comments received to ED 60.

Why the IPSASB Undertook this Project

The purpose of the IPSASB's project on public sector combinations is to establish requirements for classifying, recognizing and measuring public sector combinations.

Previously, IPSASs did not provide guidance on how to account for public sector combinations. Instead, other IPSASs explained that guidance on accounting for such combinations can be found in the relevant international or national accounting standard.

In the absence of an IPSAS dealing with public sector combinations, public sector entities looked initially to International Financial Reporting Standard (IFRS) 3, *Business Combinations*. However, IFRS 3 requires all combinations to be accounted for as acquisitions.

In developing IFRS 3, the International Accounting Standards Board (IASB) came to the conclusion that 'true mergers' or 'mergers of equals' in which none of the combining entities obtains control of the others are so rare as to be virtually non-existent in the private sector. Consequently, the IASB decided that separate accounting requirements for such combinations was not necessary.

In contrast to this view, many considered that in the public sector, mergers or amalgamations are the most common form of combination.

Many also considered that there are other differences between the circumstances in which combinations occur in in the private and public sectors.

Examples of these differences include:

- The objective of most businesses and business combinations is to generate profits, whereas the objective of most public sector entities is to deliver goods and services for community or social benefit.
- Most business combinations arise as a result of exchange transactions, whereas many public sector combinations take place by way of non-exchange transactions.
- Most business combinations are voluntary. A public sector combination may be voluntary, or may be required by legislation or other authority.

As a result, many did not consider IFRS 3 appropriate when accounting for public sector combinations.

This absence of accepted guidance created a risk of inconsistent or inappropriate reporting of public sector combinations in the general purpose financial statements (GPFSs) of public sector entities. Consequently, users might not have been able to obtain the information needed to evaluate the nature and financial effect of a public sector combination.

The IPSASB believes that IPSAS 40, will enhance consistency and comparability in how public sector combinations are reported by public sector entities.

IPSASB

Scope and Definitions

IPSAS 40 applies to any transaction or other event that meets the definition of a **public sector combination**.

A public sector combination is defined as “the bringing together of separate operations into one public sector entity.”

Scope

The scope of IPSAS 40 includes all transactions or other events that meet the definition of a public sector combination–the bringing together of separate operations into one public sector entity.

Examples of public sector combinations include:

- Nationalizations;
- Restructurings of central government ministries;
- Reorganizations of local or regional governments, for example by rearranging territorial boundaries or by combining entities; and
- Transfers of operations from one government (or governmental unit) to another.

Public sector combinations involve the bringing together of operations. The following are therefore not public sector combinations:

- The acquisition or receipt of an asset or a group of assets (along with any related liabilities) that does not constitute an operation; and
- The assumption of a liability or a group of liabilities that does not constitute an operation.

IPSAS 40 also excludes from its scope the accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself.

Definitions

Key definitions in IPSAS 40, include:

An <u>operation</u> is an integrated set of activities and related assets and/or liabilities that is capable of being conducted and managed for the purpose of achieving an entity’s objectives, by providing goods and/or services.

An <u>amalgamation</u> gives rise to a resulting entity and is either:

(a) A public sector combination in which no party to the combination gains control of one or more operations; or

(b) A public sector combination in which one party to the combination gains control of one or more operations, and there is evidence that the combination has the economic substance of an amalgamation.

An <u>acquisition</u> is a public sector combination in which one party to the combination gains control of one or more operations, and there is evidence that the combination is not an amalgamation.

Classification of Public Sector Combinations

If no party to a public sector combination gains control of one or more operations as a result of the combination, the combination is classified as an amalgamation.

If one party to a public sector combination gains control of one or more operations as a result of the combination, an entity considers the economic substance of the combination in classifying the combination as either an amalgamation or an acquisition.

The gaining of control of operations by a party to the combination is an essential element of an acquisition, but is not sufficient in itself to determine whether a combination is an acquisition.

Where one party to a public sector combination gains control of one or more operations as a result of the combination, an entity considers the economic substance of the combination in determining the appropriate classification**.** In doing so, an entity considers the following indicators:

Indicators relating to consideration

The combination may be an amalgamation where:

- Consideration is paid for reasons other than to compensate those with an entitlement to the net assets of a transferred operation for giving up that entitlement;
- Consideration is not paid to those with an entitlement to the net assets of a transferred operation; or
- Consideration is not paid because there is no-one (whether an individual or an entity) with an entitlement to the net assets of a transferred entity.

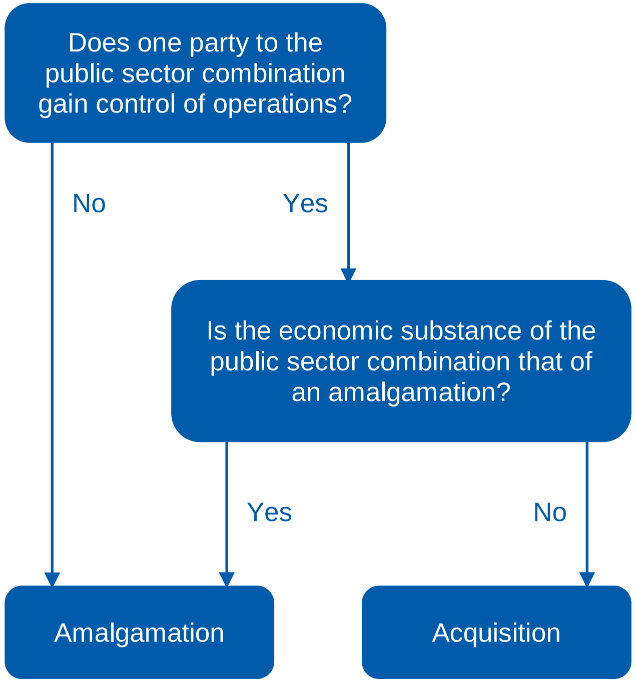
Indicators relating to the decision-making process

The combination may be an amalgamation where:

- A public sector combination is imposed by a third party without any party to the combination being involved in the decision-making process;
- A public sector combination is subject to approval by each party's citizens through referenda; or
- A combination of operations under common control occurs.

The classification approach is summarized in Figure 1 below:

Figure 1: Classification Approach



Accounting for Amalgamations

The **resulting entity** accounts for each amalgamation by applying the modified pooling of interests method of accounting.

The resulting entity is defined as “the entity that is the result of two or more operations combining in an amalgamation.”

The modified pooling of interests method of accounting is a variation of the pooling of interests method of accounting (sometimes referred to as “merger accounting”) in which the amalgamation is recognized on the date it takes place.

The modified pooling of interests method of accounting

Applying the modified pooling of interests method of accounting requires:

- Identifying the resulting entity;
- Determining the amalgamation date;
- Recognizing and measuring the assets received, the liabilities assumed and any non-controlling interest in the combining operations; and
- Recognizing and measuring components of net assets/equity and other adjustments.

The resulting entity:

- Recognizes the assets, liabilities and any non-controlling interests that are recognized in the financial statements of the combining operations as at the amalgamation date; and
- Measures them at their carrying amounts in the financial statements of the combining operations.

The carrying amounts are adjusted to conform to the resulting entity’s accounting policies (and in other limited circumstances, for example tax forgiveness).

The modified pooling of interests method of accounting recognizes the amalgamation on the date it takes place. As a consequence, no comparative information is required.

Components of net assets/equity

The resulting entity recognizes the difference between the assets and liabilities assumed in an amalgamation as one or more components of net assets/equity. IPSAS 40 does not specify which components of net assets/equity should be used; this is a matter for the professional judgment of the reporting entity.

In determining which components of net assets/equity should be reported, a reporting entity will take into account issues such as:

- What information will be most relevant to the users of the financial statements;
- Whether the reporting entity is, in substance, a new entity; and
- Whether existing reserves of the combining operations (for example, hedging reserves) are required to comply with other IPSASs.

Prior period information

IPSAS 40 permits, but does not require, a reporting entity to present prior period information. Where a reporting entity elects to present prior period information, this information is not restated. The reporting entity explains the basis on which this information is presented.

Accounting for Acquisitions

The **acquirer** accounts for each acquisition by applying the acquisition method of accounting.

The acquirer is defined as “the entity that gains control of one or more operations in an acquisition.”

Goodwill is defined as “an asset representing the future economic benefits arising from other assets acquired in an acquisition that are not individually identified and separately recognized.”

The acquisition method of accounting adopted in IPSAS 40 is that set out in IFRS 3, *Business Combinations*, supplemented by additional guidance for public sector specific circumstances.

The acquisition method of accounting

Applying the acquisition method of accounting requires:

- Identifying the acquirer;
- Determining the acquisition date;
- Recognizing and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquired operation; and
- Recognizing and measuring goodwill, a gain or a loss from an acquisition.

The acquirer recognizes, separately from any goodwill recognized, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquired operation. This may include items not previously recognized by the acquired operation.

The acquirer measures the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.

IPSAS 40 provides limited exceptions to these recognition and measurement principles. For example, contrary to IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*, the acquirer recognizes a contingent liability assumed in an acquisition where consideration is transferred.

Goodwill, loss or gain from a bargain purchase

Goodwill is usually recognized only where consideration is transferred (or there is an exchange of equity instruments, which is not common in the public sector).

Goodwill is measured as the excess of:

- The aggregate of:
  - o The consideration transferred;
  - o The amount of any non-controlling interest in the acquired operation; and
  - o In an acquisition achieved in stages, the fair value of the acquirer’s previously held equity interest.

  over
- The net of the amounts of the identifiable assets acquired and the liabilities assumed.

Goodwill is only recognized to the extent that the acquisition will result in the generation of cash inflows or a reduction in the net cash outflows of the acquirer. Any additional excess is recognized as a loss.

In a bargain purchase, the net of the amounts of the identifiable assets acquired and the liabilities assumed may exceed any consideration paid. The acquirer recognizes the resulting gain in surplus or deficit.

Changes since Exposure Draft 60, *Public Sector Combinations*

Respondents to ED 60 generally supported the proposed classification approach and proposed accounting. Consequently, IPSAS 40 incorporates limited changes from the proposals in ED 60.

The more significant changes relate to the classification approach and accounting for amalgamations.

Classification approach

Respondents supported the general approach to classifying public sector combinations in ED 60, but considered that it could be improved. In particular, respondents indicated that:

- Having a rebuttable presumption that was expected to be rebutted significantly more frequently than not was confusing;
- The approach was seen as over-emphasizing control, and setting too high a bar for classifying combinations as amalgamations; and
- In many jurisdictions, it will be easier to determine the economic substance of a public sector combination by reference to the indicators (consideration and decision making) than by reference to whether one party to the combination gained control of operations.

Consequently, the IPSASB reconsidered the way the classification approach is expressed to address these concerns, without changing the substance of the approach. References to the rebuttable presumption have been replaced by references to the economic substance of the combination. The indicators used in determining that economic substance remain unchanged from those in ED 60.

Accounting for amalgamations

ED 60 required all amounts of net assets/equity to be recognized as a single residual amount. Respondents to ED 60 identified a number of reasons where this approach might not be appropriate. The IPSASB noted these comments, in particular that the use of a single residual amount might:

- Cause consolidation difficulties; and
- Impact on a wide range of reserves, including those relating to hedging and reserves restricted by legislation, which was inconsistent with ED 60's requirement that existing classifications and designations are maintained.

Consequently, IPSAS 40 does not specify which components of net assets/equity are to be recognized.

The modified pooling of interests method of accounting recognizes the amalgamation on the date it takes place. As a consequence, no restated comparative information was required under ED 60. Respondents generally supported this approach for cost-benefit reasons, but felt that there would be some circumstances where prior period information would benefit users. Consequently, IPSAS 40 permits prior period information to be presented. Such information is not restated.

Effective Date and Project History

The effective date of IPSAS 40 is January 1, 2019.

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The effective date of IPSAS 40 is January 1, 2019, with earlier adoption encouraged.

IPSAS 40 is applied prospectively. Public sector combinations occurring prior to the application of IPSAS 40 are not restated.

Project History

To learn more about the project history, and to view the consultation documents and responses, please visit: www.ipsasb.org/projects/public-sector-combinations.