BDO BULLETIN

COMBINING PORTFOLIO COMPANIES: DEMYSTIFYING THE ACCOUNTING IMPLICATIONS

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INTRODUCTION

Strategic restructurings are behind many successful private equity exits. To unlock value, boost investor returns, and strengthen exit readiness, private equity firms often reorganize their portfolio companies. Sometimes, they merge businesses held in the same fund; other times, they combine companies from different funds under a single entity.

When these transactions occur, private equity firms and their portfolio companies must determine whether the transaction results in a business combination or a transaction between entities under common control. Correctly classifying these transactions can be complex; however, the resulting accounting significantly affects the financial statements. Reaching appropriate conclusions is important for accurate and timely financial reporting and audit procedures.

KEY TAKEAWAYS

- Combining portfolio companies within the same fund may result in a common control transaction.
- Combining portfolio companies from separate private equity funds (even within the same family of funds) often results in a business combination.
- Reaching a conclusion requires analyzing whether the portfolio companies are under common control, as determined under U.S. GAAP.
- Common control occurs when one person or entity has control (as determined under U.S. GAAP) both before and after the transaction, which may be under the voting model or the variable interest entity (VIE) model.
- The VIE model requires both power and economics for control to exist.
- The accounting outcome significantly affects asset valuation, goodwill recognition, and historical financial statement presentation.

BUSINESS COMBINATION VS. COMMON CONTROL: WHY DOES IT MATTER?

The accounting for business combinations significantly differs from the accounting for common control transactions. Therefore, when combining portfolio companies that are held in the same fund, or in two different funds of the same private equity firm (often referred to as a family of funds), it is important to determine which accounting model applies.

First, it is important to understand how “business combination” and “common control transaction” are used in practice:

- Business Combination: A transaction in which an acquirer obtains control of a business, which is *“an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants”* (ASC 805, *Business Combinations*).
- Common Control Transaction: The transfer of net assets (or a business) or the exchange of equity among entities under the control of the same ultimate parent, which could be an entity; individual; or common control group, such as a married couple. To be a common control transaction, the same entity or person must control both companies both before and after the transaction (ASC 805, *Business Combinations — Related Issues*).

If a change in control occurred, the transaction may require business combination accounting. However, if a change in control did not occur, it is accounted for as a common control transaction.

Some portfolio companies and private equity firms might prefer business combination accounting because the financial statements will reflect the current fair values of the acquiree’s net assets. Other portfolio companies and private equity firms might prefer carryover basis (as is required in a common control transaction) because it facilitates greater comparability of the companies’ performance pre- and post-transaction. However, the accounting for the acquisition of one portfolio company by another is not a free choice; rather, the accounting is determined by an evaluation of the facts and circumstances, which can be time-consuming. Reaching the right conclusion requires gathering all relevant information, including governing documents and capitalization tables, not only of the portfolio companies involved, but often also for the funds and their general partners (GPs).

BUSINESS COMBINATIONS	COMMON CONTROL TRANSFER OF A BUSINESS
The accounting acquirer[1] recognizes net assets acquired, generally at their acquisition date **fair values**, with some exceptions.[2] Noncash consideration issued and noncontrolling (or minority) interests outstanding after the transaction are both also measured at fair value. These valuations can be time-consuming.	The receiving entity[1] records the acquired portfolio company’s net assets at their **carrying values** (or at the parent’s basis if different from carrying value). In this context, the “parent” would typically be the fund that previously controlled the acquired portfolio company (for example, “Fund 2” as shown in Example 1-1).
The accounting acquirer recognizes **goodwill** for the excess of the sum of (i) the fair values of the consideration transferred, (ii) the noncontrolling interest, and (iii) the acquirer’s previously held equity interest, over the net assets acquired.[3]	The receiving entity records any difference between the consideration transferred (including equity issued) and the carrying value of the transferred portfolio company’s net assets as an equity **contribution or distribution**.
The accounting acquirer recognizes the business combination on the date it obtained control of the acquiree, which typically is the closing date of the transaction, with no retrospective revision to the financial statements. Accounting policies and fiscal year ends are generally conformed **prospectively**.	The receiving entity generally revises its financial statements as if it had controlled the acquired portfolio company for all periods presented. This may require **retrospectively** conforming accounting policies and fiscal year ends.

[1] The accounting acquirer (or, alternatively, the receiving entity for accounting purposes in a common control transaction) is not always the same as the legal acquirer. Additional analyses may be needed to make these determinations.

[2] See Chapter 4 of BDO’s Blueprint, Business Combinations Under ASC 805, for recognition and measurement exceptions.

[3] In the rare circumstances where the consideration transferred is less than the net assets acquired, the accounting acquirer recognizes a bargain purchase gain.

BUSINESS COMBINATIONS	COMMON CONTROL TRANSFER OF A BUSINESS
Transaction costs are expensed.	Transaction costs are generally presented as a reduction in equity.

For more guidance on the accounting for common control transactions and business combinations, see BDO's Blueprint, Business Combinations Under ASC 805. That publication also includes guidance when the portfolio companies do not meet the accounting definition of a business (for example, when substantially all the fair value of the gross assets acquired relates to a single identifiable asset or group of similar assets).

In addition to potential tax considerations, private equity investors also need to be aware of the financial reporting income tax accounting implications.

HOW IS COMMON CONTROL DETERMINED UNDER U.S. GAAP?

To determine whether a transaction is a business combination or a common control transaction, the following decision framework can be used:

Who controlled each business before the transaction? *(Apply VIE or voting model, as applicable)*	→	Who controlled each business after the transaction? *(Apply VIE or voting model, as applicable)*	→	Did the same party control both businesses before and after the transaction? Yes = Common control No = Business combination

U.S. GAAP (ASC 810, *Consolidation*) includes two models for evaluating control:

- Under the **VIE** model, an entity has a controlling financial interest in a legal entity if the reporting entity has **both** the **power** to direct the most significant activities of the legal entity, and **economics** (the obligation to absorb the VIE's losses or the right to receive benefits from the VIE that could potentially be significant to the VIE).
  - ASC 810 does not provide any bright lines when assessing the economics criterion. While practice generally considers economics of 10% or more to be significant when shared proportionately, all facts and circumstances must be considered. Decision-maker (service provider) fees are excluded when evaluating economics if the arrangement includes only terms, conditions, and amounts that are customarily present in arrangements for similar services negotiated at arm's length, are commensurate with the level of services provided, and there is no risk of loss.
- Under the **voting model**, a reporting entity generally has a controlling financial interest in a legal entity if it controls more than 50% of the voting shares of a corporation or more than 50% of the kick-out rights of a limited partnership (or an entity with a similar governance structure — for example, a limited liability company with a managing member).

Whether the VIE model or the voting model applies is not a free choice; the facts and circumstances dictate which model applies to a particular transaction.

To be a common control transaction, the same entity or person must have a controlling financial interest in both portfolio companies, both before and after the transaction.

The concept of "control" as described under U.S. GAAP that is used for evaluating whether a transaction is a business combination or not differs from other definitions of "control" within U.S. GAAP — for example, the definition of "control" used for revenue recognition. The concepts of "control" and "common control" may also differ from other definitions used for regulatory, independence, or other purposes.

WHEN IS TRANSFERRING A COMPANY A COMMON CONTROL TRANSACTION?

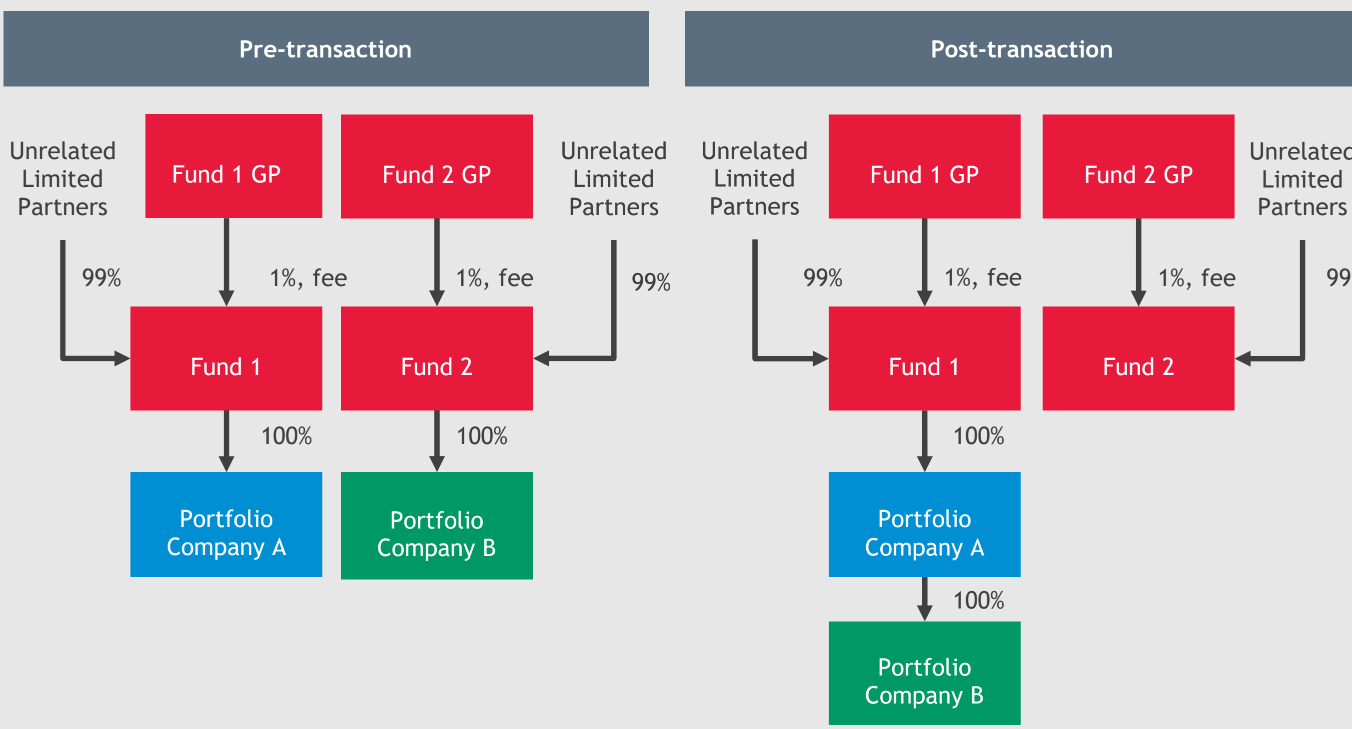
A transaction combining two or more portfolio companies from **different funds** that are managed by the same entity (or in the same "family of funds") is generally not a common control transaction, even if the same GP or a common investment manager has decision-making rights over the funds. This is because private equity funds often meet the definition of a VIE. A private equity fund generally is a VIE because a simple majority of the limited partners typically does not have the substantive ability to remove the GP, nor do the limited partners have other substantive participating rights such as the ability to veto investment decisions. This also means that the GP has power. Under the VIE model in ASC 810, an entity must meet **both** the power and economics criteria to have a controlling financial interest in another entity. However, power is only one of two required elements for control. Even when the GP meets the first required element (power), it often lacks sufficient economics in the funds to meet the second required element for control. Therefore, transferring a portfolio company from one fund to another is often **not** a common control transaction even if the fund has a controlling financial interest in the portfolio company, because the GP does not control the funds as determined under U.S. GAAP. Example 1-1 illustrates the common control analysis in this scenario for a simplified private equity structure.

In contrast, a transaction in which two portfolio companies **within the same fund** are combined is much more likely to be a common control transaction if the fund has power and economics over each of the portfolio companies both before and after the transaction. Determining whether common control exists requires exercising professional judgment based on the facts and circumstances. Differences in removal rights, investment veto decisions, fees, carried interest, and other facts and circumstances can significantly affect the conclusions reached. Example 1-2 illustrates a transaction in which two portfolio companies within the same fund are combined that is a common control transaction.

EXAMPLE 1-1: TRANSFERRING A PORTFOLIO COMPANY FROM ONE FUND TO ANOTHER — BUSINESS COMBINATION

FACTS

Fund 1 owns 100% of the equity of Company A. Fund 2 owns 100% of the equity of Company B. Both funds share the same investment manager, which receives only customary management fees. The GPs holds a 1% equity interest and receives carried interest.



In this fact pattern, assume that the same fund family established Fund 1 and Fund 2 and they are both VIEs. (For simplicity, the diagrams do not show an investment manager or the structure above the GP level.) The fee includes only terms, conditions, and amounts that are customarily present in arrangements for similar services negotiated at arm's length, are commensurate with the level of services provided, and have no risk of loss. Accordingly, the fee is not a variable interest and is excluded when evaluating whether the GP has economics.

In addition, assume that Portfolio Company A acquires and obtains control of Portfolio Company B, which was previously controlled by Fund 2. The portfolio companies are wholly owned by their respective funds, and both meet the definition of a business in U.S. GAAP.

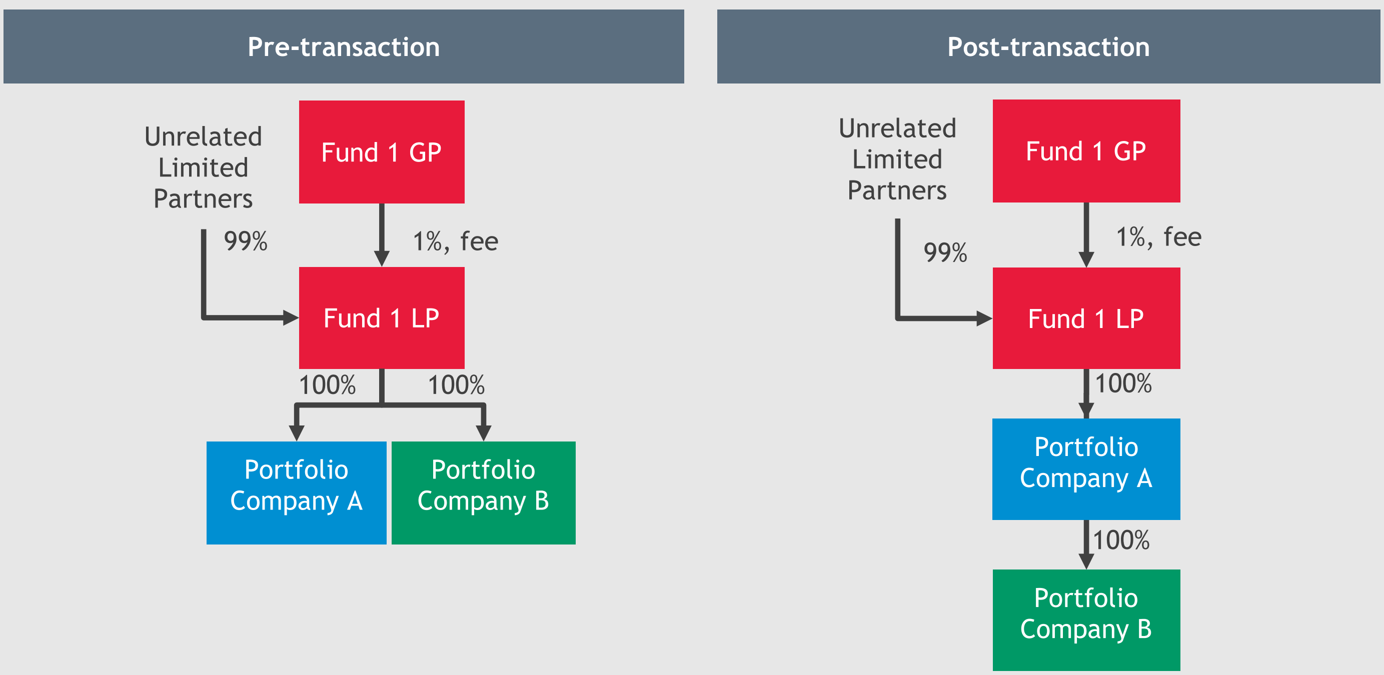
CONCLUSION & ANALYSIS

Even though both funds are managed by the same investment manager, the transaction is a business combination because the GPs lack sufficient economics in the funds to have control under the VIE model. Therefore, Fund 1 and Fund 2 are not under common control and Portfolio Company A's acquisition of Portfolio Company B is not a common control transaction.

EXAMPLE 1-2: COMBINING TWO PORTFOLIO COMPANIES WITHIN THE SAME FUND — COMMON CONTROL

FACTS

In this fact pattern, assume the same facts as in Example 1-1, except that Fund 1 owns 100% of the equity of both Company A and Company B before the transaction. Portfolio Company A acquires 100% of the equity and obtains control of Portfolio Company B.



CONCLUSION & ANALYSIS

This is a common control transaction because Company A and Company B are both controlled by Fund 1 before and after the transaction. (Company A controls Company B post-transaction, and Fund 1 controls Company A.)

However, if the portfolio companies are not wholly owned by Fund 1, more analysis would be needed to determine whether the fund has a controlling financial interest in each portfolio company before the transaction, and whether that conclusion changes after the transaction. If the fund does not have both power and economics in both entities both before and after the transaction, it is a business combination.

BDO INSIGHTS: IDENTIFYING COMMON CONTROL RELATIONSHIPS

When one portfolio company acquires another, it is often necessary to gather information about the relationships between upper-tier entities (that is, the funds and GPs) to evaluate whether they are under common control. As discussed above, this evaluation can significantly affect how the acquiring portfolio company accounts for the transaction (at fair value or carrying value) and the level of effort required to account for the transaction.

Because the portfolio company management generally is not involved in managing the funds, it can be especially challenging to determine whether common control exists between entities. This evaluation often requires professional judgment based on the facts and circumstances. A portfolio company cannot assume it is under common control with another portfolio company just because they both have the same GP or managing member, or are managed by the same (group of) advisors or funds, even if those parties approved the transaction.

IS COMMON CONTROL THE SAME AS COMMON MANAGEMENT?

Common control differs from common management. Common management (although not defined in U.S. GAAP) generally refers to the circumstance in which legal entities have a common CEO or decision maker (for example, a manager). On the other hand, common control generally requires a single person or entity to have a controlling financial interest in both entities. When two entities are under common control, they are often also under common management, but the inverse is not always true. Two entities can be under common management but not under common control. For example, this is often the case when two funds have the same GP or investment adviser, but that entity does not have significant economics in the funds (as evaluated under U.S. GAAP).

WHAT ARE COMMON PITFALLS IN COMMON CONTROL ANALYSES?

- Assuming that common management is the same as common control: Common management refers solely to decision-making, with no regard to the economic element that is required for control under U.S. GAAP.
- Assuming that common ownership is the same as common control: Common ownership, which is when two or more parties own the same legal entities in the same or different proportions, is **not** synonymous with common control.
- Performing the common control analysis with incomplete information: Missing information about upper-tier entities (such as the fund or GP) or about agreements between common owners can lead to incorrect conclusions. For example, if common owners have an agreement to vote in concert or to proxy their votes to one another, such an arrangement may lead to a conclusion that a transaction is under common control.
- Basing common control conclusions solely on the fact that portfolio companies have the same private equity management company or advisor: Such entities often do not have a controlling financial interest in the funds or either of the portfolio companies as determined under U.S. GAAP.
- Assuming the private equity firm’s principal owners have a controlling financial interest in all downstream entities: Private equity firms often have one or more individuals (principal owners) with interests in various entities within the firm. However, this does not necessarily mean they have a controlling financial interest in the portfolio companies (as defined in U.S. GAAP).

For more guidance on the VIE and voting models, see BDO's Blueprint, **Control and Consolidation Under ASC 810**.

FASB PROJECT: COMMON CONTROL

In January 2026, the Financial Accounting Standards Board (FASB) added a project to its agenda to define the term "common control." Readers should monitor developments at the **FASB website** when considering how this project could affect current practice.

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