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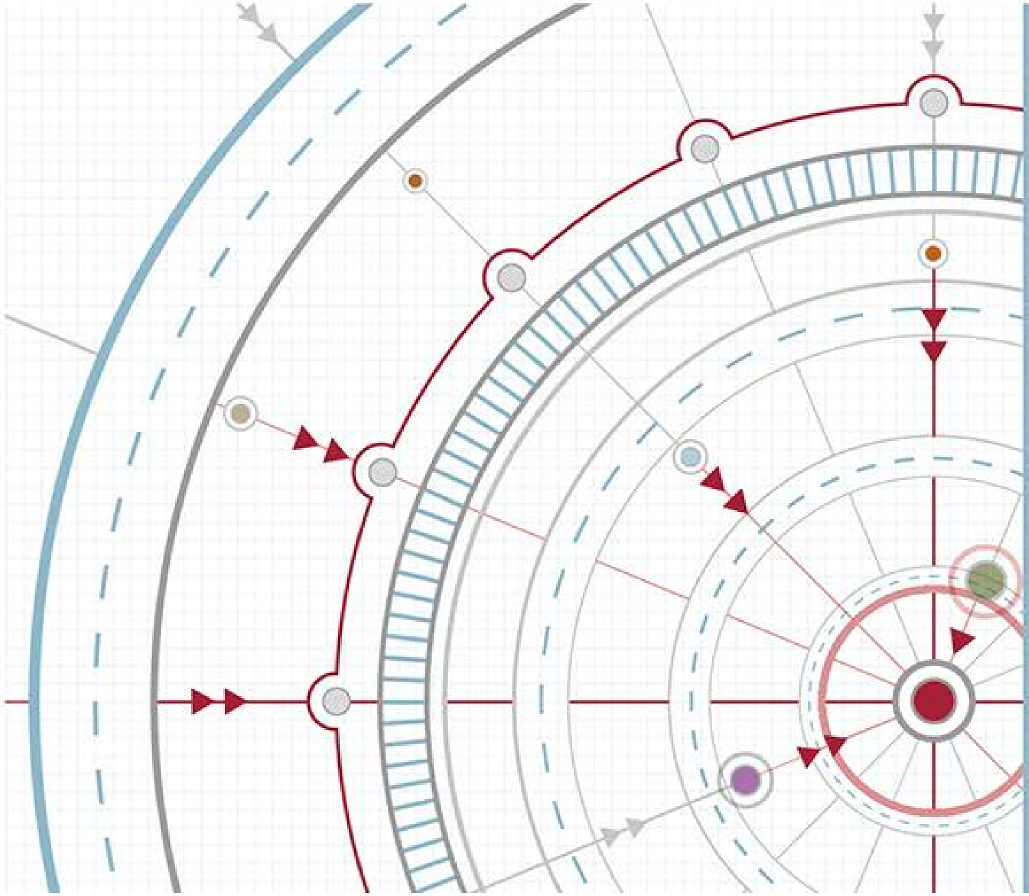

IASB Agenda ref 23A

Business Combinations under Common Control

Overview of the staff's approach

IASB Meeting – March 2019

Please print the slides in colour.

Disclaimer

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Project	**Business Combinations under Common Control (BCUCC)**		
Paper topic	Overview of the staff's approach		
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Introduction

Purpose of the paper

This paper provides an overview of the staff's approach to developing measurement alternatives for transactions within the scope of the BCUCC project. In particular, it explains how information needs of different types of primary users of receiving entity's financial statements are being considered in the project. It summarises the discussions to date, provides the context for Agenda Paper 23B *Lenders and other creditors in BCUCC* and sets out next steps.

This session is educational and the staff do not ask the Board to make decisions. The staff will ask the Board for decisions on a package of topics at a future meeting.

The papers for this meeting will also be discussed with the Capital Markets Advisory Committee (CMAC) and the Accounting Standards Advisory Forum (ASAF). The staff will summarise input received in a future paper for the Board.

Content

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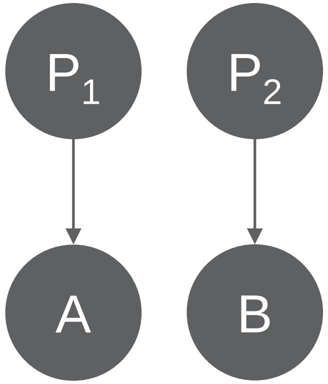
Project recap and update

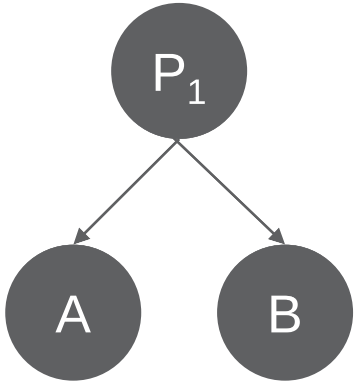
Project recap and update
The issue: diversity in practice

Before

Scenario 1
- Entity A and Entity B are controlled by different parties;
- Entity B is a business.

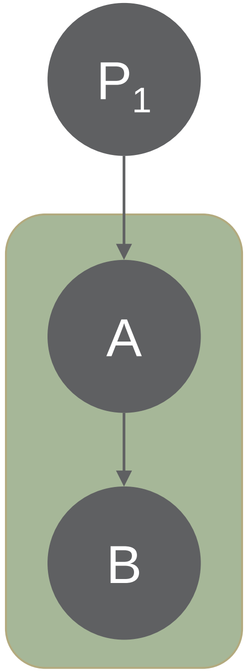


Scenario 2
- Entity A and Entity B are controlled by the same party;
- Entity B is a business.



After

Entity A acquires Entity B



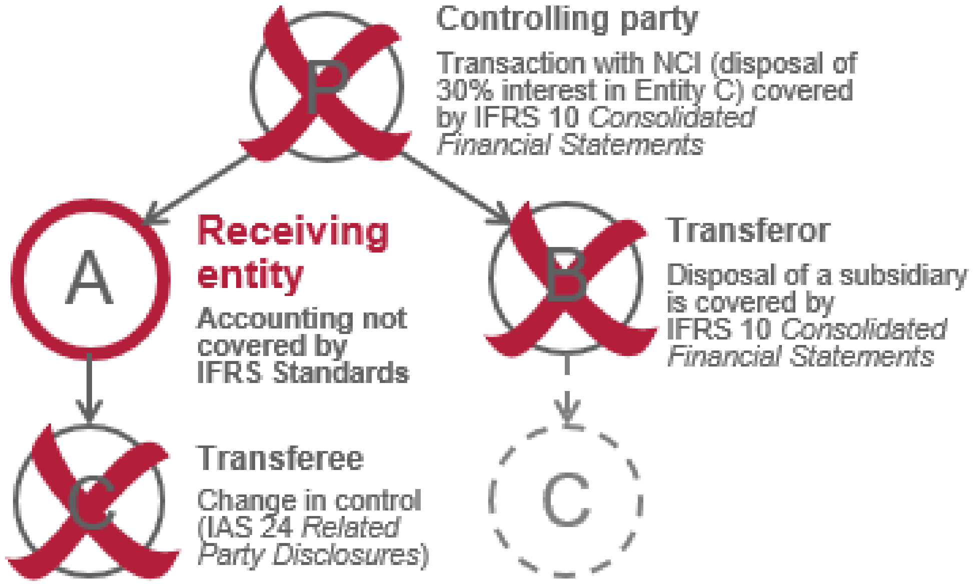
Observations

Scenario 1
- The transaction is a **business combination** not under common control
- IFRS 3 *Business Combinations* requires the **acquisition method**
- Entity A reflects identifiable assets and liabilities of Entity B at **fair value**

Scenario 2
- The transaction is a **business combination under common control**
- IFRS Standards do not specify how to account for such transactions which leads to **diversity in practice**
- Entity A reflects identifiable net assets of Entity B at **fair value** or at **predecessor carrying amounts**

Project recap and update
Focus on the primary users of information (1/2)

The project focuses on the information needs of the primary users of the **receiving entity's** financial statements. Primary users can have different or even conflicting information needs.



Entity A acquires Entity C from Entity B. Entities A, B and C are all controlled by Entity P. Entity C is a business.

The project does not consider accounting by the controlling party, the transferor or the transferee as those parties are already covered by the existing IFRS Standards.

It is also important that costs of providing and using information are justified by the benefits of that information. The cost-benefit analysis can also be different for different scenarios.

Project recap and update
Focus on the primary users of information (2/2)

Overview of primary users of the receiving entity's financial statements in a BCUCC

Existing NCI	Controlling party	Lenders and other creditors	Prospective equity investors
Typically perpetual interest in the receiving entity. Transaction may affect the value of their existing interest. Exposed to residual equity risks of the receiving entity.	Controls all combining entities before and after the transaction. Does not solely rely on the receiving entity's financial statements to meet its information needs.	Contractual maturity of the interest in the receiving entity. Transaction may affect recoverability of existing interest. Exposed to the liquidity risk of the receiving entity.	No existing interest in the combining entities at the time of the transaction. Investment decision is made for the combined entity rather than the receiving entity.

The cost-benefit analysis can be different, for example, for business combinations under common control that affect existing NCI and those that do not.

Project recap and update
Possible measurement approaches for BCUCC

Measurement approaches being explored

A current value approach based on the acquisition method
Receiving entity will reflect acquired assets and liabilities at their acquisition date fair values.

A predecessor carrying amounts approach
Receiving entity will reflect acquired assets and liabilities at their predecessor carrying amounts.

Factors considered by the staff

- *Useful information for primary users*
- *Cost-benefit analysis*
- *Complexity*
- *Structuring opportunities*

Project recap and update
Input from past discussions with ASAF

Measurement approaches for transactions within the scope of the project

Many ASAF members supported the use of a current value approach for BCUCC in some circumstances. Some members supported the use of that approach when NCI is present in the receiving entity. This is because it provide the most useful information to the NCI.

Some ASAF members suggested that a current value approach should not be restricted to the circumstances when the receiving entity's equity instruments are traded in a public market. However, those members acknowledged distinguishing when to use a current value approach for private entities when NCI is present would be difficult. Some ASAF members suggested alternative ways of making a distinction for transactions that affect NCI, for example, asking the NCI in the receiving entity whether they want current value information.

Some ASAF members supported using a current value approach in some situations for BCUCC but suggested alternative ways of determining the appropriate measurement approach instead of focussing on the information needs of primary users of the receiving entity's financial statements, for example considering the commercial substance of a BCUCC.

Project recap and update
Input from past discussions with CMAC

Information needs of the primary users of the receiving entity's financial statements

Most CMAC members agreed that a current value approach based on the acquisition method would provide the most useful information to NCI in the receiving entity. Some members emphasised that a current value approach should be applied only if NCI is 'substantive' but did not discuss what 'substantive' NCI means. Some advocated the use of the acquisition method without modifications.

CMAC members expressed mixed views on what type of information would be most useful for lenders and other creditors of the receiving entity. Some stated that a current value approach would provide the most useful information. Others stated that current value information is not essential for credit analysis.

Most CMAC members agreed with the staff's preliminary view that a predecessor approach would best meet information needs of the controlling party in BCUCC at a cost justified by the benefits of that information.

Most CMAC members expressed a view that prospective equity investors in an IPO need predecessor historical information about the combined entity offered to the public to understand trends and assess prospects for cash flows to the entity.

Project recap and update
Input from past discussions with GPF and EEG

Current practice

Information needs of the primary users of the receiving entity's financial statements

Measurement approaches to transactions within the scope of the project

Most GPF members agreed with the staff's preliminary view that a predecessor approach would best meet information needs of the controlling party in BCUCC at a cost justified by the benefits of that information.

Some GPF members expressed concerns about costs, complexity and measurement uncertainty involved in a current value approach. Some suggested that current value information can be provided in the notes to financial statements instead of recognising acquired net assets at current value.

Most EEG members stated that a predecessor approach is most commonly in their jurisdictions often due to cost-benefit consideration. They acknowledged that diversity in practice exists in applying a predecessor approach.

Some EEG members suggested that the Board focus on the information needs of external parties in BCUCC such NCI or prospective equity investors in an initial public offering (IPO) affected by the transaction.

Some EEG members agreed that in some circumstances a current value approach can provide most useful information to primary users of the receiving entity's financial statements.

Project recap and update
Where we are today

Discussed by the Board in 2018

Only some BCUCC affect NCI in the receiving entity

Most if not all BCUCC could affect lenders and other creditors in the receiving entity and prospective equity investors

Transactions within the scope of the BCUCC project

Next steps

- Transactions between **wholly owned entities**, including those that affect:
  - lenders and other creditors of the receiving entity; and
  - prospective equity investors.

Project recap and update
Approach for transactions that affect NCI (1/4)

Acquisition method

Possible modifications to consider

- **Additional disclosures**
- **Recognise a contribution instead of recognising a gain if fair value of acquired net assets exceeds consideration**
- **Recognise a distribution instead of recognising goodwill if consideration exceeds fair value of the acquired interest**

The Board directed the staff to develop an approach based on **the acquisition method** set out in IFRS 3 and to consider whether and how that method should be modified to provide the most useful information about transactions that affect NCI.

However, applying a current value approach to all transactions that affect NCI (as opposed to only those where NCI is 'substantive') may not be appropriate. This is because the benefits of proving current value information in all NCI scenarios may not always justify the costs of providing that information (eg consider a public entity with significant NCI and a private entity where a few stock options are issued to key management personnel). In addition, requiring current value approach in all NCI scenarios (but not for transactions between wholly owned entities) could give rise to structuring opportunities (eg an entity could 'choose' to apply a current value approach by issuing a few employee stock options).

Project recap and update
Approach for transactions that affect NCI (2/4)

	Require a current value approach based on the acquisition method	
	For **ALL** transactions that affect NCI	For **SOME** transactions that affect NCI
Useful information for primary users	Provides the most useful information to all NCI	Some NCI will not receive the most useful information
Cost-benefit analysis	The benefits of providing current value information may not always justify the costs	Could better reflect cost-benefit considerations
Complexity	Simple in that a single current value approach is applied to all BCUCC that affect NCI; however, a different approach may still be required for other BCUCC	More complex than a single approach for all transactions that affect NCI; however, a distinction between different BCUCC may be necessary under any approach unless the acquisition method is applied in all cases
Structuring opportunities	May give rise to structuring opportunities	Could minimise structuring opportunities depending on how the distinction is made

Project recap and update
Approach for transactions that affect NCI (3/4)

Ways of making a distinction between transactions that affect NCI

Qualitative			Quantitative
Traded equity instruments vs privately held	NCI held by related or unrelated parties	NCI opt-in or opt-out for current value	Size of NCI
Require a current value approach when equity instruments of the receiving entity are traded in a public market.	Require a current value approach except when NCI is held only by related parties of the receiving entity.	Require a current value approach when NCI opt-in for that approach (or do not opt-out of that approach).	Require a current value approach when the size of the NCI meets or exceeds a specified threshold.

Combination of qualitative and quantitative factors

Eg require a current value approach for (a) all public and (b) some private entities based on the size of NCI

Project recap and update
Approach for transactions that affect NCI (4/4)

Staff's observations

- Considering costs and benefits of providing current value information and structuring opportunities, the staff think that requiring a **current value approach for some but not all transactions that affect NCI** may be appropriate.
- If a current value approach is required for some but not all transactions that affect NCI, the staff think that making a distinction based on whether the **receiving entity's equity instruments are traded in a public market** is a viable approach to explore. This is because this approach indirectly takes into account the cost-benefit analysis and is arguably least open to structuring opportunities.
- If it is desirable to also provide current value information to NCIs in private entities in some cases, **NCI opt-in for (or opt-out from)** current value information can be explored. However, such an approach could be difficult to operationalise.
- The staff do not think that a distinction based on a quantitative threshold is appropriate.

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BCUCC between wholly owned entities

Lenders and other creditors

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BCUCC between wholly owned entities Lenders and other creditors (1/3)

Summary of work performed by the staff in understanding information needs of lenders and other creditors of the receiving entity in a BCUCC

Meetings with credit investment managers and credit analysts

Review of the corporate credit methodology of two world’s leading credit rating agencies

Review of academic papers, summaries of outreach activities with users of financial statements performed by various bodies, articles and other literature that consider information needs of lenders and other creditors

BCUCC between wholly owned entities
Lenders and other creditors (2/3)

Nature of claims

- Cash flows are determined by contractual provisions
- Typically finite contractual maturity
- Priority of claims can vary

Focus of credit analysis

- Recoverability rather than valuation
- Specific time frames rather than terminal values
- Capital structure of the entity rather than overall leverage

Information needs of debt investors and credit analysts

- Information about cash flows to the entity
- Information about recognised debt and unrecognised commitments

BCUCC between wholly owned entities Lenders and other creditors (3/3)

Our research and outreach indicated that debt investors and credit analysts use a variety of tools and techniques depending, for example, on their level of sophistication or industry focus. However, the staff identified a number of common features.

Cash flow measures or their proxies such as EBITDA, cash flow projections and cash flow-based ratios are at the heart of credit analysis. Those measures are typically derived from information in the statement of profit or loss, the statement of cash flows and notes to the financial statements. Non-cash items, notably amortisation, depreciation and impairment are not included in the cash flow analysis.

Credit analysis doesn't tend to focus on the statement of financial position. Debt investors and credit analysts need qualitative and quantitative information about both recognised debt and unrecognised commitments, including information about redemption amounts, maturity, collateral and seniority.

The essence of credit analysis of the entity is the same regardless of whether it relates to an existing or potential debt investment.

Some debt investors and credit analysts have access to private information by virtue of contractual arrangements with the entity and rely on that private information in their analysis.

Implications for BCUCC

- This information and analysis would be largely unaffected by whether a current value approach or a predecessor approach is used for BCUCC.
- Information about the amounts, maturity and seniority of debt and unrecognised commitments acquired in a BCUCC would be essential for credit analysis.

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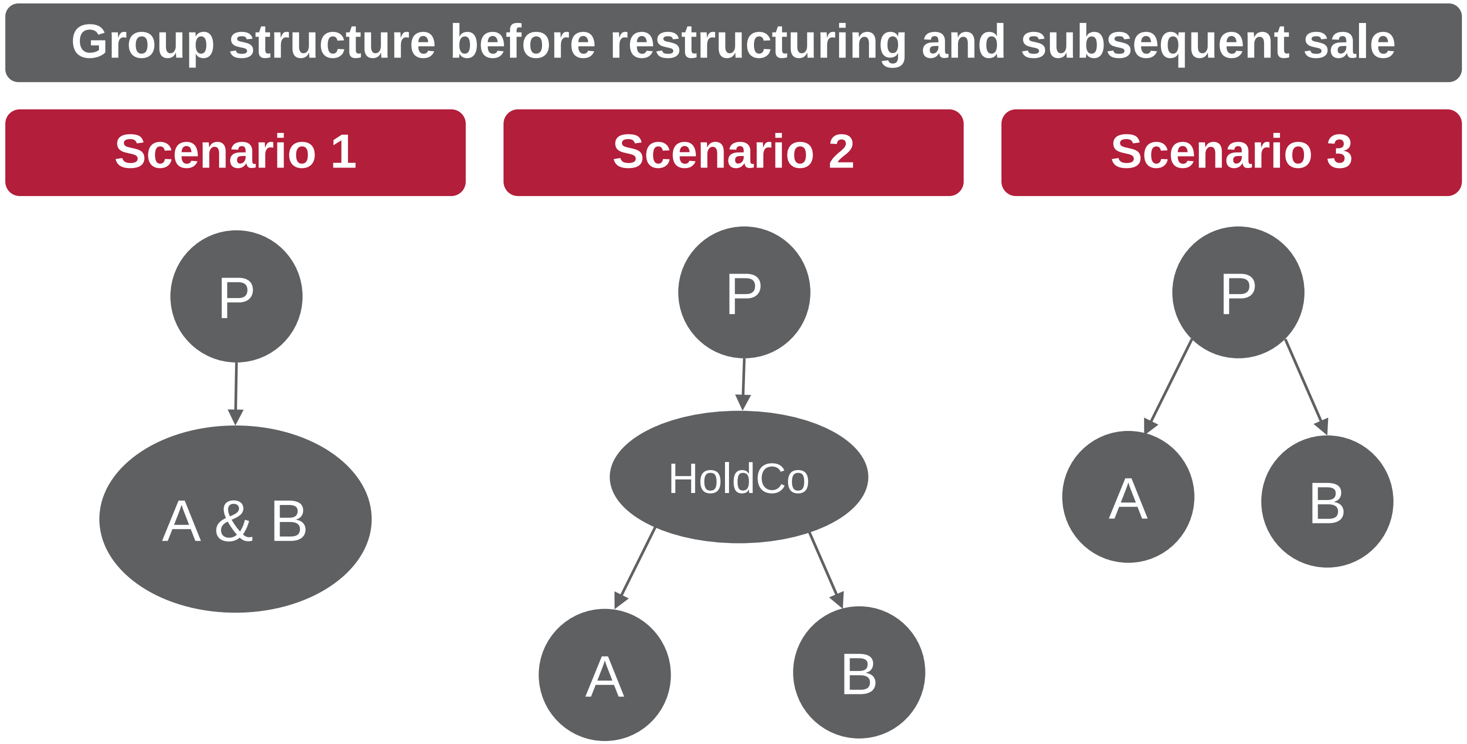
BCUCC between wholly owned entities

Prospective equity investors

BCUCC between wholly owned entities Prospective equity investors (1/4)



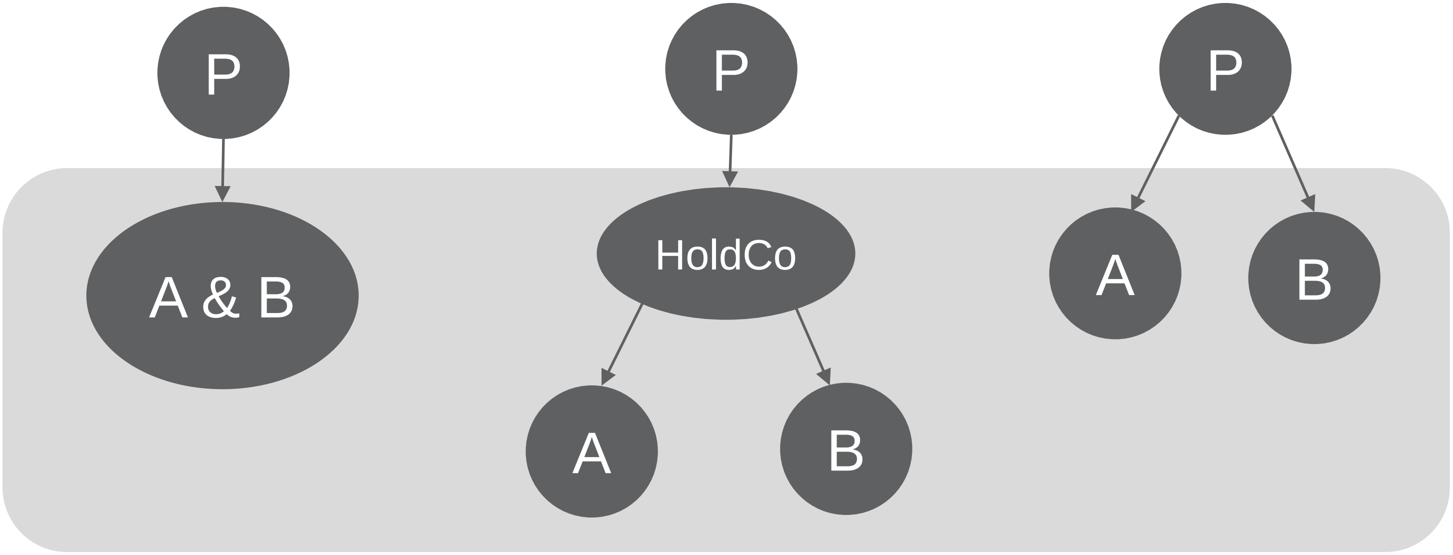
Consider the following scenarios

- Parent P controls and wholly owns businesses A and B.
- In Scenario 1, businesses A and B are contained within a single legal entity.
- In Scenario 2, businesses A and B are separate legal entities wholly owned by intermediary HoldCo.
- In Scenario 3, businesses A and B are separate legal entities directly owned by P.

BCUCC between wholly owned entities
Prospective equity investors (2/4)

Group structure before restructuring and subsequent sale

Scenario 1	Scenario 2	Scenario 3



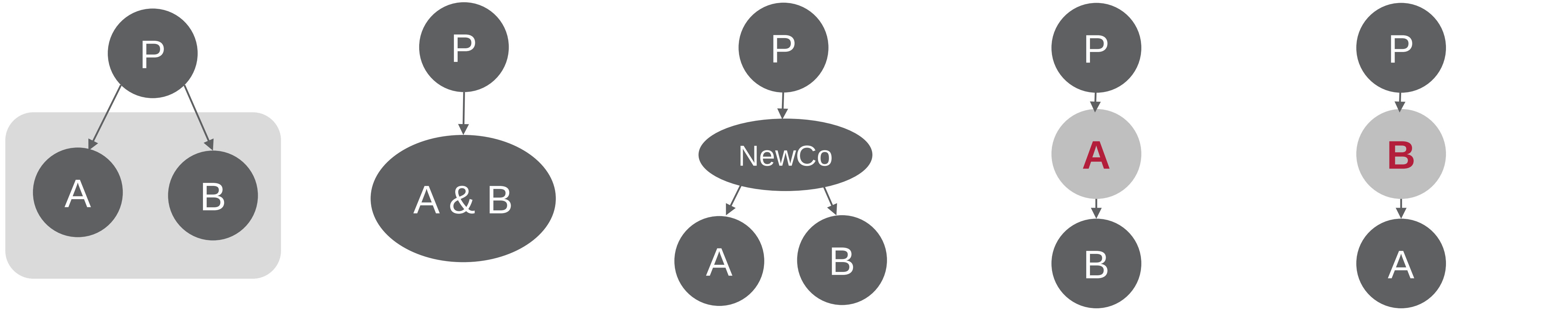
Parent P decides to sell businesses A and B together in an IPO.

- In Scenario 1, businesses A and B can be sold together as they are contained in single legal entity.
- In Scenario 2, businesses A and B can be sold together by selling HoldCo.
- In Scenario 3, Parent must undertake a legal restructuring in order to sell businesses A and B together.

BCUCC between wholly owned entities
Prospective equity investors (3/4)

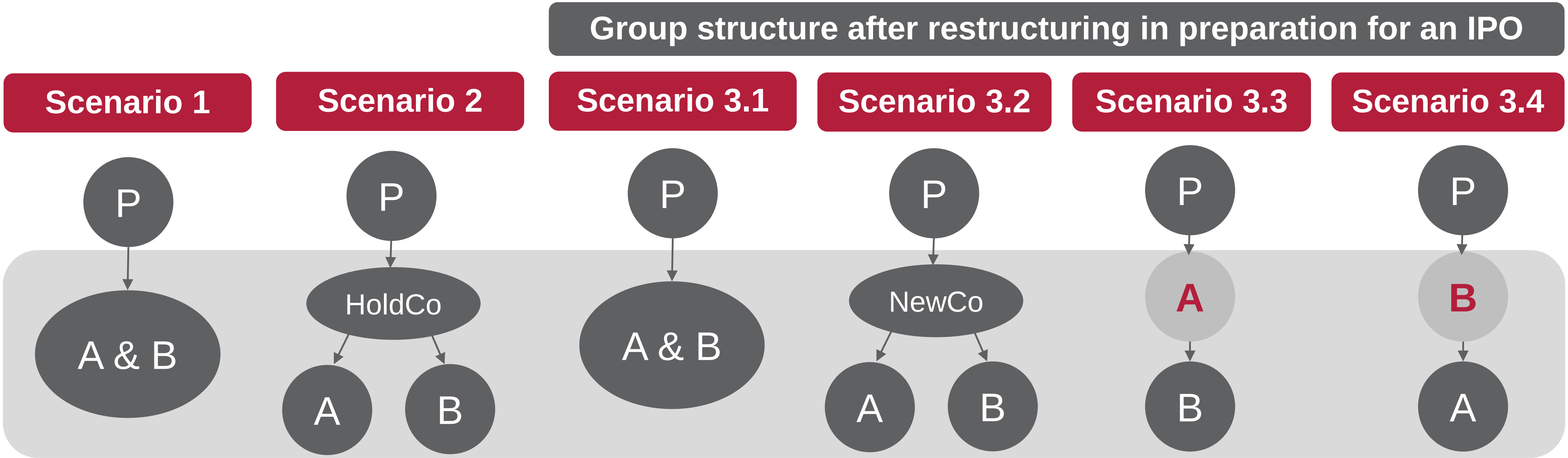
Restructuring in preparation for a sale in an IPO

Scenario 3	Scenario 3.1	Scenario 3.2	Scenario 3.3	Scenario 3.4



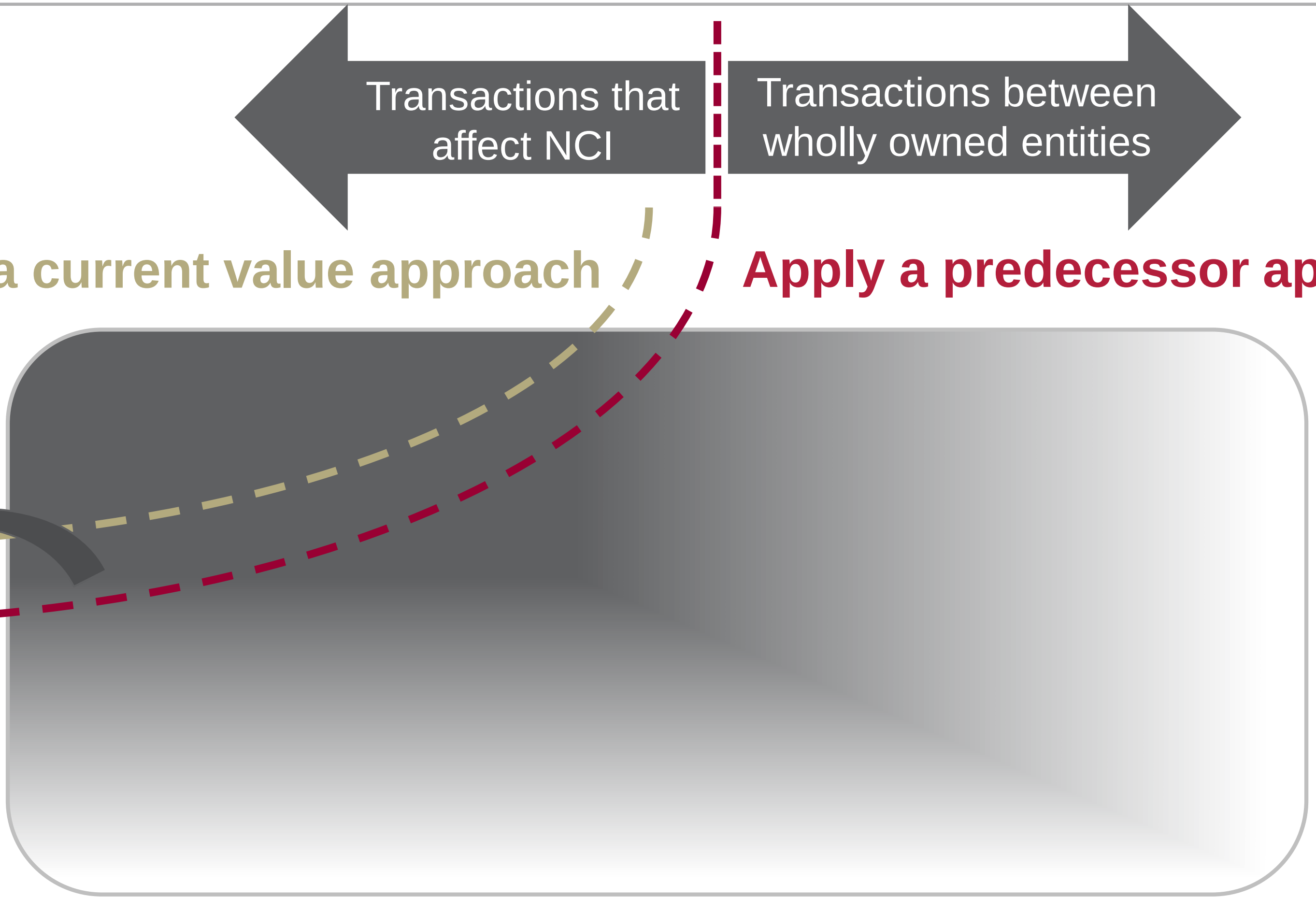
	Scenario 3.1	Scenario 3.2	Scenario 3.3	Scenario 3.4
	Legal merger of entities A and B in preparation for an IPO	NewCo is formed to acquire A and B in preparation for an IPO	A acquires B in preparation for an IPO	B acquires A in preparation for an IPO

BCUCC between wholly owned entities
Prospective equity investors (4/4)



The staff note that in all these scenarios the economic substance remains the same – businesses A and B are being sold to new investors. In Scenarios 1 and 2, the prospective investors will receive historical information about businesses A and B. Accordingly, the staff think that historical information about businesses A and B should also be provided in all sub-scenarios of Scenario 3. That information will be provided by applying a predecessor approach in all sub-scenarios of Scenario 3. The staff note that this conclusion is consistent with the advice provided by CMAC in the past (see slide 11).

Bringing it all together
Staff's observations



Apply a current value approach

Apply a predecessor approach

Apply a current value approach to **at least some transactions that affect NCI** in the receiving entity.

Further analysis if a current value approach should be applied to all transactions that affect NCI and if not, how the distinction could be made

Apply a predecessor approach to transactions between **wholly owned entities** regardless of whether lenders or other creditors are present in the receiving entity or of whether the transaction is undertaken in preparation for a sale, for example in an IPO.

Transactions within the scope of the BCUCC project

Timeline

Dec 2017	Scope of the project is finalised
Feb 2018	Direction for transactions within the scope of the project
Jun 2018	Direction for transactions that affect NCI
H2 2018 - 2019	Develop approaches for transactions within the scope of the project
H1 2020	Discussion paper expected to be published

Feedback and discussion

Does the Board have any questions or comments on the staff's analysis presented?