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STAFF PAPER

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Project	**Business Combinations under Common Control**		
Paper topic	Approach for transactions that affect non-controlling interest		
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Purpose of this paper

1. In April and May 2018, the International Accounting Standards Board (Board) discussed current value approaches for business combinations under common control that affect non-controlling interest (NCI) in the receiving entity. In June 2018, the Board directed the staff to develop an approach based on the acquisition method set out in IFRS 3 *Business Combinations* and to consider whether and how that method should be modified to provide the most useful information about business combinations under common control that affect NCI.

2. The staff remind the Board that the approach being developed will apply to the receiving entity in the transaction rather than any other entity in the group.

3. This paper discusses:

   (a) whether a current value measurement approach based on the acquisition method set out in IFRS 3 (further referred to as 'a current value approach') should be applied to all or some business combinations under common control that affect NCI in the receiving entity (further referred to as 'transactions that affect NCI'); and

   (b) if a current value approach is applied to only some transactions that affect NCI, how the distinction could be made.

4. This paper is for information only and there are no questions for the Board. This paper will also be discussed at the December 2018 ASAF meeting. The staff will provide the Board with a verbal update on the feedback received from ASAF members.

5. At future meetings, the staff will ask the Board to make decisions on the following interrelated topics:

   (a) whether a current value approach should be applied to all or some transactions that affect NCI and if it is only applied to some of those transactions, how the distinction should be made;

   (b) whether and how the acquisition method set out in IFRS 3 should be modified for transactions to which a current value approach is applied (see paragraph 1); and

   (c) which approach, or approaches, should be applied to the remaining population of transactions within the scope of the project, including transactions that affect lenders and creditors in the receiving entity and transactions that involve formation of a NewCo.

Structure of the paper

6. The paper is structured as follows:

   (a) summary of the feedback received to date (paragraphs 7–12);

   (b) applying a current value approach to transactions that affect NCI (paragraphs 13–21):

      (i) alternative A—applying a current value approach to *all* transactions that affect NCI (paragraphs 13–16);

      (ii) alternative B—applying a current value approach to *some* transactions that affect NCI (paragraphs 17–19);

      (iii) summary of staff's observations (paragraphs 20–21);

   (c) possible approaches to making a distinction between transactions that affect NCI (paragraphs 22–23):

      (i) alternative B1—a qualitative approach (paragraphs 24–35);

(ii) alternative B2—a quantitative approach (paragraphs 36–43);

(iii) alternative B3—a combination of qualitative and quantitative approaches (paragraphs 44–46); and

(iv) summary of staff's observations (paragraphs 47–49).

Summary of the feedback received to date

7. In June 2018, measurement approaches for business combinations under common control were discussed at the joint meeting of the Capital Markets Advisory Committee (CMAC) and the Global Preparers Forum (GPF). Most CMAC and GPF members agreed with the view that a current value approach would provide the most useful information for NCI of the receiving entity. However, some members emphasised that a current value approach should be applied only if NCI is 'substantive'. The members did not discuss how to distinguish 'substantive' NCI from 'non-substantive' NCI.

8. Some members, mainly preparers, did not agree with the use of a current value measurement approach for business combinations under common control. They expressed concerns about costs, complexity and measurement uncertainty that would be involved in applying a current value approach. They argued that it would be difficult to distinguish 'substantive' NCI from 'non-substantive' NCI and therefore a so-called predecessor method should be applied in all cases.

9. The staff provided a verbal summary of the feedback from CMAC and GPF members at the June 2018 IASB meeting. The Board took that feedback into account when directing the staff to pursue a current value approach for transactions that affect NCI.

10. In July 2018, measurement approaches for business combinations under common control were discussed with the Accounting Standards Advisory Forum (ASAF). Some ASAF members agreed with the view that a current value measurement approach would provide the most useful information to NCI in the receiving entity. Some ASAF members suggested it is important to consider whether particular characteristics of NCI (eg size or nature) would affect the selection of the appropriate measurement approach. They argued that if the NCI is 'non-substantive' the benefits of applying a current value measurement approach may not outweigh the costs.

11. Some ASAF members noted that applying a current value approach will involve measurement uncertainty. One ASAF member disagreed with using a current value measurement approach because of the measurement uncertainty involved and because business combinations under common control may not take place at fair value.

12. In September 2018, measurement approaches for business combinations under common control were discussed at the World Standard-setters conference (WSS conference). Two thirds of the participants who provided their view agreed that a current value approach would provide the most useful information to NCI in the receiving entity. Most of the remaining participants who provided their view supported the use of a predecessor method. One participant supported the use of a historical cost approach (ie allocating the cost of combination to acquired identifiable assets and liabilities).

Applying a current value approach to transactions that affect NCI

Alternative A—applying a current value approach to all *transactions that affect NCI*

Advantages of Alternative A

13. In principle, the staff think that a current value approach based on the acquisition method set out in IFRS 3 would always provide the most useful information about a business combination under common control to NCI in the receiving entity. The Board has already concluded in developing IFRS 3 that the acquisition method provides the most useful information about business combinations. It follows that to the extent that business combinations under common control are similar to business combinations within the scope of IFRS 3, the same method would provide the most useful information (and to the extent those transactions are or could be different, the acquisition method might be modified).

14. Hence, if the Board were to require a current value approach based on the acquisition method for all transactions that affect NCI, that would best meet the information needs of all NCI. Arguably those information needs do not differ based on the size of NCI or the nature of NCI. In addition, using a single current value approach for all transactions that affect NCI is simple and would prevent entities from structuring

transactions in order to achieve a particular accounting treatment by changing the size or the nature of NCI. Structuring opportunities would effectively give entities a choice of accounting treatment which is what this project is looking to address. Finally, using the acquisition method as the basis for a current value approach would provide a familiar foundation as that method is already described in IFRS 3, applied in practice and understood.

Disadvantages of Alternative A

15. However, requiring a current value approach for all transactions that affect NCI would not take into account:

    (a) the cost constraint—although information needs of each non-controlling shareholder are the same regardless of the size or nature of NCI in the receiving entity, the overall cost-benefit assessment would arguably be different for a scenario when NCI constitutes only a few employee stock options issued to the key management personnel compared to a scenario when NCI comprises a dispersed public holding of a significant stake in the receiving entity. More broadly, the staff think that the cost-benefit analysis is different for business combinations under common control and other business combinations. This is because the controlling party is in a different position compared to non-controlling shareholders and that affects both the overall balance of information needs and the implications of the cost constraint on providing information.

    (b) access to information—although information needs of each non-controlling shareholder are the same regardless of the size or nature of NCI, the access to information about the transaction is arguably more limited for a public shareholder than for a member of the key management personnel or a private investor singlehandedly holding a significant stake in the entity. Applying paragraph 1.5 of the *Conceptual Framework for Financial Reporting*, the primary users of general purpose financial reports are those investors who ‘cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need’. Furthermore, the staff note that some types of NCI could even have the ability to influence the terms of the transaction and whether it takes place at all.

16. In addition, although requiring a current value approach for all transactions that affect NCI would prevent structuring transactions by *changing* the size or the nature of the existing NCI (see paragraph 14), it would allow structuring transactions to achieve a desired accounting outcome by *creating* NCI—for example, by issuing a few shares to a related party—unless a single current value approach is required for all business combinations under common control, including combinations between wholly owned entities. The staff do not currently expect to recommend a single current value approach for all business combinations under common control.

Alternative B—applying a current value approach to <u>some</u> transactions that affect NCI

Advantages of Alternative B

17. To address the disadvantages of requiring a current value approach for all transactions that affect NCI (see paragraphs 15-16), the Board could decide to require that approach only for some such transactions and to require a different approach (eg a predecessor method) in the other cases. In particular, doing that would enable the Board to better reflect the cost constraint by requiring a current value approach only in those circumstances when the benefits of providing current value information justify the costs of providing it. Taking that approach could also enable the Board to take into account different access to information about business combinations under common control that different types of NCI in the receiving entity might have.

18. In addition, depending on how the distinction is made, the Board could *minimise* structuring opportunities by requiring a current value approach only in some rather than in all NCI scenarios. This is because it is arguably easier for an entity to go from a 'no NCI' scenario to a 'some NCI' scenario for example, by issuing a few employee stock options, than it is to go from a 'no NCI' scenario to, for example, a public NCI scenario. The staff think that there is no approach that would completely *eliminate* structuring opportunities. Even if the Board were to require the acquisition method set out in IFRS 3 for all business combinations, including all business combinations under common control, that would enable entities to carry out

transactions under common control, for example, to step up the carrying amounts of the assets in the financial statements of the receiving entity to their fair values.

Disadvantages of Alternative B

19. However, requiring a current value approach for only some transactions that affect NCI would mean that in the other scenarios, NCI would not receive the most useful information in the receiving entity's general purpose financial statements. In addition, making a distinction between different NCI scenarios is arguably a more complex approach than requiring a single current value approach for all NCI scenarios. However, the complexity of making a distinction between different types of business combinations would arguably always be present—unless the Board were to decide to require the acquisition method set out in IFRS 3 for all business combinations, including all business combinations under common control.

Summary of staff's observations

20. In summary, neither Alternative A nor Alternative B is ideal and each has its advantages and disadvantages. To summarise staff's observations:

(a) the most useful information—requiring a current value approach for all transactions that affect NCI would result in the most useful information (see paragraphs 13-14) provided to non-controlling shareholders in the receiving entity's general purpose financial statements in all cases. In contrast, requiring that approach only in some cases would exclude the most useful information from the receiving entity's general purpose financial statements in the other scenarios. However, in making the distinction between different NCI scenarios, the Board could choose to take into account whether and when NCI could have access to information other than in the receiving's entity general purpose financial statements or even be able to influence the transaction in the first place (see paragraphs 15(b) and 17).

(b) the cost constraint—requiring a current value approach for all transactions that affect NCI would fail to take into account that the cost constraint would apply differently in different scenarios. This is because although information needs of non-controlling shareholders do not depend on the size or nature of NCI, the outcome of the cost-benefit assessment could arguably be different for different transactions that affect NCI (see paragraph 15(a)). In contrast, requiring a current value approach for only some transactions that affect NCI would enable the Board to take into account the cost constraint in a more targeted way. As an aside, the staff note that the outcome of the cost-benefit assessment for business combinations under common control might also be different from the outcome of that assessment for business combinations within the scope of IFRS 3. This is because the controlling party unlike other shareholders arguably does not need to rely on the receiving entity's general purpose financial statements for much of the information it needs. Hence, an approach different from a current value approach, for example, a predecessor method, could be most appropriate for some types of business combinations under common control.

(c) structuring opportunities—all approaches would give entities opportunities to structure transactions for example, by creating or changing the size or nature of NCI. The staff think that in principle, depending on how the distinction is made, requiring a current value approach for some transactions that affect NCI could provide fewer structuring opportunities than all other approaches (see paragraph 16).

(d) complexity—in principle, any distinction between types of business combinations creates more complexity than requiring the acquisition method for all business combinations. However, the staff do not think that such an approach is viable due to the cost constraint and structuring considerations.

21. On balance, on the basis of the analysis in paragraphs 13-20, the staff think that the Board should consider requiring a current value approach for only some transactions that affect NCI. Doing that would also reflect the feedback received at the June 2018 joint CMAC and GPF meeting and at the July 2018 ASAF meeting.

Possible approaches to making a distinction between transactions that affect NCI

22. If the Board decided to make a distinction between transactions that affect NCI, in principle that could be done in one of the following ways:

    (a) alternative B1—a qualitative approach (paragraphs 24–35);

    (b) alternative B2—a quantitative approach (paragraphs 36–43); or

    (c) alternative B3—a combination of qualitative and quantitative approaches (paragraphs 44–46).

23. The following paragraphs provide staff analysis of advantages and disadvantages of each approach.

Alternative B1—a qualitative approach

24. The Board could decide to make a distinction between transactions that affect NCI in the receiving entity solely based on qualitative factors. The staff have identified two possible ways of making such a distinction that the Board could explore:

    (a) based on whether the receiving entity's equity instruments are traded in a public market (paragraphs 25–28); and

    (b) based on the type of non-controlling shareholders (paragraphs 29–34).

A distinction based on whether the receiving entity's equity instruments are traded in a public market

25. The Board could consider requiring a current value approach when the receiving entity's equity instruments are traded in a public market. Such a distinction would be similar to distinctions made in IAS 33 *Earnings per Share* and IFRS 8 *Operating Segments*[1].

26. The staff have identified the following advantages of this approach:

[1] IAS 33 *Earnings per Share*, paragraph 2(a)(i)/(b)(i), "whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets"
IFRS 8 *Operating Segments*, paragraph 2(a)(i)/(b)(i), "whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)"

(a) it would provide the most useful information for NCI in public entities[2]. Providing the best information to public non-controlling shareholders is consistent with the focus of regulatory environments that tend to subject public interest entities to particular scrutiny in order to protect that public interest.

(b) it would automatically rule out most if not all scenarios when NCI is insignificant and hence reflect the quantitative perspective without creating a 'bright line'. This is because many public markets have minimum listing requirements (see paragraph 40 for the discussion of the review performed by the staff). As a result, this approach would also inherently take into account the cost constraint by requiring a current value approach only if NCI is public and hence of sufficient size that minimum listing requirements are met.

(c) it builds on the approaches that are already described in the existing IFRS literature, applied in practice and understood.

(d) in the staff's view, it is least open to structuring opportunities. Going public is a complex and costly process. Hence the staff do not think entities are likely to undertake that process with the sole objective of creating a public NCI as a way of achieving a particular accounting treatment for a future transaction under common control affecting that public NCI.

(e) looking ahead, the staff note that a similar approach could be applied to the scenarios when the receiving entity's debt instruments are traded in a public market if the Board were to decide to also make a distinction between some scenarios that affect lenders and other creditors in the receiving entity and other such scenarios. Applying consistent approaches to transactions that affect NCI and transactions that affect lenders and other creditors is attractive for both conceptual and practical reasons.

[2] In this paper, we use the term 'public entities' to refer to entities whose equity instruments are traded in a public market.

(f) it is a clear and relatively simple distinction for entities to apply and for users of financial statements to understand.

27. The disadvantage of a qualitative approach based on whether the receiving entity's equity instruments are traded in a public market is that it would not provide the most useful information to NCI in private entities[3] even when such NCI is significant to the receiving entity. However, as noted in paragraph 15(b), the staff think that some NCI in private entities might rely on general purpose financial statements of those private entities less than NCI in public entities rely on general purpose financial statements of those public entities. This is because NCI in private entities would often be held by either related parties, including key management personnel, as defined in IAS 24 *Related Party Disclosures* of that entity or of its controlling party, (further referred to as 'related parties') or by professional investors attracted through a private placement. Such parties might have access to information other than through the receiving entity's general purpose financial statements either by virtue of their related party relationship with the receiving entity or as a result of the negotiations leading up to the private placement.

28. On balance, the staff think that if the Board were to decide to pursue a qualitative approach to making a distinction between transactions that affect NCI, a distinction based on whether the receiving entity's equity instruments are traded in a public market is a viable approach to explore.

A distinction based on the type of non-controlling shareholders

29. The Board could consider making a distinction between transactions that affect NCI based on the type of non-controlling shareholders. For example, the Board could decide to require a current value approach for all transactions that affect NCI not held by related parties, including the key management personnel, of the receiving entity or of its controlling party. Alternatively, the Board could decide to extend an exception from applying a current value approach to transactions where NCI is held by employees of the receiving entity or of its controlling party even if they do not

[3] In this paper, we use the term 'private entities' to refer to entities whose equity instruments are not traded in a public market.

meet the definition of the key management personnel (further referred to as 'employees').

30. An advantage of either of those approaches is that they would capture more transactions that affect NCI than an approach based on whether the receiving entity's equity instruments are traded in an active market and hence provide the most useful information to a larger number of affected NCI.

31. However, arguably neither of the approaches based on the type of non-controlling shareholders would take into account the cost constraint as effectively as the approach based on whether the receiving entity's equity instruments are traded in a public market would. This is because the distinction based on the type of non-controlling shareholders would require applying a current value approach even when NCI in the receiving entity is very small as long as that NCI is not held by related parties or by employees of the receiving entity or of its controlling party.

32. The scope of an exception from applying a current value approach based on the type of non-controlling shareholders would likely affect meeting the information needs of those NCI as follows:

    (a) if the exception is limited to NCI held by related parties—such NCI might arguably have access to information other than in the receiving entity's general purpose financial statements by virtue of their related party relationship with the receiving entity (see paragraph 27). The staff note that paragraph BC1.22 of the *Conceptual Framework for Financial Reporting* specifically discusses the ability of key management personnel to access additional financial information.

    (b) if the exception is extended to NCI held by employees—such NCI are unlikely to have access to additional information outside of the receiving entity's general purpose financial statements. On the other hand, employees would sometimes be holding a passive investment, for example, as a result of receiving employee share-based payments awards, instead of making a separately considered decision to invest in the entity. However, that would not change their information needs if they wanted to monitor the value of their share-based payments awards or make decisions about when to exercise any share options received as part of such awards.

33. In addition, the scope of the exception from applying a current value approach based on the type of non-controlling shareholders would affect structuring opportunities as follows:

    (a) if the exception is limited to NCI held by related parties, such an approach would be very open to structuring opportunities. This is because it would be relatively easy for an entity to issue share-based payment awards to employees and qualify for applying a current value approach.

    (b) if the exception is extended to NCI held by employees, such an approach would be less open to structuring opportunities. This is because it would be more difficult for an entity to secure a private placement of its shares with unrelated parties or to go for an initial public offering (IPO).

34. Finally, the staff note that if the exception is limited to NCI held by related parties, such an approach would be easy for the Board to articulate and easy to apply and understand because related parties are already defined in IAS 24. In contrast, if the exception is extended to NCI held by employees, such a distinction would be more difficult for the Board to articulate and could be more difficult for the entities to apply.

35. On balance, the staff consider a qualitative approach based on type of non-controlling shareholders less attractive than the approach based on whether receiving entity's equity instruments are traded in an active market.

Alternative B2—a quantitative approach

36. The Board could consider making a distinction between transactions that affect NCI in the receiving entity using a quantitative approach. Under this alternative, a current value approach is applied when the relative size of the NCI in the receiving entity meets a particular quantitative threshold (for example, when NCI in the receiving entity is 10% or more). A different approach (eg a predecessor method) is applied when the quantitative threshold is not met.

37. The staff have identified the following advantages of a quantitative approach:

(a) it could take into account the cost constraint by requiring a current value approach only when NCI is sufficiently large;

(b) it would capture both public and private entities; and

(c) it would be a simple approach to apply and understand.

38. The staff have identified the following disadvantages of a quantitative approach:

(a) it would lack a conceptual basis apart from the application of the cost constraint;

(b) it would rely on a threshold that is necessarily arbitrary;

(c) it could result in excluding some public entities from applying a current value approach; and

(d) it would be very open to structuring opportunities.

39. If the Board were to consider setting a quantitative threshold, the staff think that it would be desirable to require a current value approach for as many public entities as possible. As discussed in paragraph 26(a), providing the best information to public non-controlling shareholders would be consistent with the focus of regulatory environments that tend to subject public interest entities to particular scrutiny in order to protect public investors in those entities.

40. In order to identify such a threshold, the staff reviewed listing requirements of the world's twenty largest stock exchanges by market capitalisation covering 92.1% of the global market capitalisation (as of August 2018) [4]. In reviewing those listing requirements:

(a) the staff identified minimum public float requirements expressed as a percentage of shares issued or outstanding to be offered to public in an IPO in fourteen stock exchanges covering 41.3% of the global market capitalisation. Those minimum public float requirements range from 20% to 30% of shares issued or outstanding. Accordingly, if the Board were to set a quantitative threshold for the size of NCI in the receiving

[4] https://www.world-exchanges.org/our-work/statistics?activate

entity at 20% or more that would cover public entities listed on those fourteen stock exchanges.

(b) the staff have not identified minimum public float requirements expressed as a percentage of shares issued or outstanding to be offered to public in an IPO in remaining six stock exchanges, that include NYSE and NASDAQ, covering 50.8% of the global market capitalisation. Those stock exchanges stipulate minimum listing requirements expressed as, for example, minimum number of shares or minimum market value to be offered to the public. The staff have not been able to estimate whether and which of those six public markets would be covered for any particular quantitative threshold that the Board may set for the size of NCI in the receiving entity.

41. Further, the Board could consider setting the quantitative threshold as:

(a) a point-in-time NCI percentage. Under this approach, the NCI percentage would be assessed on a particular date (eg at date of the business combination under common control); or

(b) an over time/average NCI percentage. Under this approach, the NCI percentage would be assessed over a particular period (eg over 12 months preceding the date of the business combination under common control). The average may be determined as a simple average or as a weighted-average.

42. A point-in-time threshold is a simpler approach and conceptually more attractive because it focuses on providing most useful information to non-controlling shareholders that are actually affected by the transaction and effectively takes into account the cost constraint (eg if NCI at the time of business combination under common control is 10% or more, a current value approach must be applied). An over time threshold is more complex and conceptually less attractive because it does not focus on NCI that are actually affected by the transaction and may not be effective in taking into account the cost constraint (eg an entity may meet a threshold of 10% average NCI over 12 months preceding the date of business combination under common control but have NCI of only 2% at the time of business combination under common control). Both approaches would be open to structuring opportunities.

43. On balance, based on the analysis in paragraphs 36-41, the staff do not think that an approach that solely relies on a quantitative threshold is a viable approach.

Alternative B3—a combination of qualitative and quantitative approaches

44. The Board could consider making a distinction between transactions that affect NCI using a combination of qualitative and quantitative approaches. Under this alternative, a current value approach is applied when NCI in the receiving entity exhibits a particular qualitative or quantitative characteristic (or both). For example, the Board could require a current value approach for all public entities as well as when NCI in a private entity is 10% or more at the time of the transaction. A different approach (eg a predecessor method) is applied when those characteristics are not met.

45. This alternative could allow the Board to both maximise the advantages of the qualitative and quantitative approaches and to address some of the disadvantages. In particular, such an approach could allow the Board to capture all public and some private entities and would result in providing the most useful information to a large number of affected NCI while taking into account the cost constraint. However, such an approach would inevitably be more complex than a solely qualitative or a solely quantitative approach and would be open to structuring opportunities around the quantitative threshold.

46. On balance, the staff think that if the Board did not want to limit the most useful information being provided to non-controlling shareholders in public entities only, the Board should explore a combination of a qualitative and quantitative approaches.

Summary of staff's observations

47. The staff note that no approach to accounting for business combinations under common control is perfect in all respects. Any approach would require 'drawing a line' unless all business combinations (ie all business combinations in the scope of IFRS 3 and all business combinations under common control) are accounted for applying the acquisition method. In its turn, 'drawing a line' between types of transactions could create opportunities for structuring transactions to achieve a particular accounting outcome and effectively leave to entities some choice in

selecting the accounting treatment which is what this project is aiming to reduce or eliminate.

48. On balance, the staff think that making a distinction between transactions that affect NCI solely based on whether the receiving's entity equity instruments are traded in a public market is a viable approach to explore. This approach results in most useful information being provided to all public non-controlling shareholders, inherently takes into account the cost constraint, builds on the existing IFRS requirements, is simple and least open to structuring and could be aligned with the approach to transactions between wholly owned entities when such transactions affect lenders and creditors in the receiving entity. This approach would not result in providing the most useful information to non-controlling shareholders in private entities but relies on the assumption that at least in some cases investors in private entities can obtain information about the transaction other than through the receiving entity's financial statements either in negotiating the private placement to begin with or via a related party relationship with the receiving entity or its controlling party.

49. The staff do not consider making a distinction between transactions that affect NCI based on solely quantitative factors an attractive approach. Such an approach would result in the most useful information being provided to non-controlling shareholders in both public and private entities as long as the quantitative threshold is met. However, such an approach lacks conceptual basis apart from taking into account the cost constraint and is most open to structuring opportunities. The staff think that if the Board wanted current value information to be provided to non-controlling shareholders in private entities in some cases, the Board should explore a combination of a qualitative and quantitative approaches.

Question for the Board

Questions for the Board
Does the Board have any questions or comments on the staff's analysis presented in this paper?