

STAFF PAPER

March 2019

IASB® Meeting

Project	Business Combinations under Common Control		
Paper topic	Lenders and other creditors in BCUCC		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® *Update*.

Accounting Standards Advisory Forum, April 2019, Agenda Paper 8B

This paper will be discussed at the IASB meeting in March 2019.

The March 2019 IASB meeting is educational and the staff will not ask the Board for decisions.

Purpose of the paper

1. Paragraph 1.8 of the *Conceptual Framework for Financial Reporting (Conceptual Framework)* states that individual primary users of general purpose financial statements have different, and possibly conflicting, information needs and desires. Agenda Paper 23 *Approach for transactions that affect non-controlling interest* for the December 2018 IASB meeting considered information needs of existing non-controlling shareholders (NCI) in a receiving entity in a business combination under common control. That paper argued that:
 - (a) in principle, a current value approach based on the acquisition method set out in IFRS 3 *Business Combinations* would best meet information needs of NCI in the receiving entity; but
 - (b) due to the cost constraint, a different approach, such as a predecessor approach, may be more appropriate for some transactions that affect NCI.

2. This paper explores information needs of existing and potential lenders and other creditors and discusses the implications of that analysis for accounting for business combinations under common control. In particular, it sets out the staff's observations about whether the International Accounting Standards Board (Board) could pursue:
 - (a) a current value approach for all or some transactions that affect NCI in the receiving entity; but
 - (b) a different approach, such as a predecessor approach, for transactions that affect lenders and other creditors in the receiving entity, but do not affect NCI.
3. There are many types of lenders and other creditors that can be affected by business combinations under common control. In this paper, they are collectively referred to as 'debt investors'. Different classes of lenders and other creditors can have different information needs and different levels of access to information beyond information provided in the receiving entity's general purpose financial statements. They can perform their own analysis or can rely on the analysis published by other parties such as credit rating agencies. This paper focuses on identifying the common forms of credit analysis performed by debt investors and credit analysts and the information they use in that analysis.
4. For the purposes of this paper, the terms 'lenders and other creditors' and 'debt investors' are used to refer to holders of claims against the receiving entity in a business combination under common control that the receiving entity would classify as liabilities applying IFRS Standards.
5. Agenda Paper 23A *Overview of the staff's approach* for this month's meeting explains how information needs of the controlling party and prospective equity investors will be considered in the project.
6. This paper is for information only. The staff plan to ask the Board for decisions on a package of topics at a future meeting.
7. The staff will seek input from members of the Capital Markets Advisory Committee (CMAC) on information needs of debt investors and credit analysts and of prospective equity investors in a business combination under common

control at the March 2019 CMAC meeting and will summarise the input in a future paper for the Board.

Structure of the paper

8. The paper is structured as follows:
- (a) summary of the work performed by the staff (paragraph 9);
 - (b) nature of claims held by lenders and other creditors (paragraph 10–15);
 - (c) assessing the entity’s ability to service and raise debt (paragraphs 16–28);
and
 - (d) the staff’s observations (paragraphs 29–31).

Summary of the work performed by the staff

9. In developing the paper, the staff:
- (a) discussed information needs of debt investors and credit analysts in a business combination under common control with the members of the CMAC who specialise in credit investment and analysis;
 - (b) reviewed the corporate credit methodology of two leading credit rating agencies; and
 - (c) reviewed academic papers, reports, articles and other literature that consider nature of claims held by lenders and other creditors and their information needs (see Appendix A).

Nature of claims held by lenders and other creditors

10. Based on the review of the literature discussed in paragraph 9(c), the staff identified three fundamental respects in which claims held by lenders and other creditors of the receiving entity in a business combination under common control are typically different from claims held by NCI.

- (a) contractual cash flows on a debt instrument as opposed to discretionary cash flows on an equity instrument (paragraphs 11–12);
 - (b) contractual maturity of a debt instrument as opposed to a perpetual nature of an equity instrument (paragraph 13); and
 - (c) different priority of the claims in the event of liquidation or bankruptcy (paragraph 14).
11. The amount (fixed or variable) and timing of cash flows on a debt instrument are *ex-ante* provided in the contract between the lender or other creditor and the borrower and are typically independent of the financial performance of the borrower except when the borrower is unable to meet its contractual obligations. In those cases, the lender or other creditor has the legal right to initiate legal action against the borrower but is still exposed to the risk of not recovering contractual amounts due. In contrast, holders of equity claims are exposed to both upside and downside fluctuations in the investee’s financial performance. The amount and timing of cash flows on an equity investment are not agreed in or guaranteed by a contract or law and will depend on the investee’s financial performance.
12. Due to the differences, discussed above, in the cash flow characteristics of debt and equity instruments, debt investors and credit analysts are generally less sensitive than equity investors and analysts to increases of projected cash flows above the level that is necessary to provide comfort that the borrower can service the debt. However, they are sensitive to decreases in the projected cash flows and focus in their analysis on assessing the risk of default. In contrast, equity investors and analysts are sensitive to both increases and decreases in projected cash flows as they seek to maximise the returns on their investments.
13. The contractual maturity of debt instruments is typically finite whereas equity instruments are generally perpetual. Accordingly, debt investors and credit analysts tend to focus on particular time frames in their cash flow projections whereas equity investors and analysts tend to be also interested in perpetual terminal value of the entity.
14. Finally, claims against the entity held by lenders and other creditors have a higher priority in the event of the entity’s liquidation or bankruptcy than equity claims.

However, claims held by lenders and other creditors also have different priority relative to each other based on the contractual arrangements and applicable law. As a result, debt investors and credit analysts are interested in the priority ranking of the entity's debt whereas equity investors and equity analysts tend to focus more on the entity's overall leverage.

15. To conclude, all the above characteristics of the claims held by lenders and other creditors have an influence on both the information required for credit analysis and the way the information is used. Generally, debt investors and credit analysts use information in the entity's general purpose financial statements to assess the entity's ability to service the existing debt and to raise new debt. They use that information both in assessing recoverability of the existing debt and in making decisions about providing resources to the entity, for example in negotiating a loan agreement, but the focus of their credit analysis always remains on the entity's ability to service its debt. In contrast, equity investors are generally interested in maximising the returns on their equity investments and tend to focus on valuation.

Assessing the entity's ability to service and raise debt

16. Lenders and other creditors are exposed to credit risk of their debt investments that reflects liquidity risk of the borrower. Liquidity risk is defined by IFRS 7 *Financial Instruments: Disclosures* as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled delivering cash or another financial asset. Some sources refer to solvency of the borrower. This term is not defined in IFRS Standards but is generally used with a meaning broadly similar to the definition of liquidity risk in IFRS 7. Some sources refer to liquidity risk as the entity's ability to meet its short-term obligations and solvency as the entity's ability to meet its obligations in the long term. In this paper the staff use the term liquidity risk as defined in IFRS 7 to refer to the entity's ability to meet its obligations.
17. The goal of credit analysis is the assessment of the liquidity risk of the borrower which differs from the goal of equity analysis that ultimately focuses on valuation.

As a result, core prediction models used in credit analysis tend to display the following characteristics:

- (a) predominance of cash flow analysis (paragraphs 18–24); and
- (b) focus on the total gross debt (paragraphs 25–28).

Predominance of cash flow analysis

18. As noted above, credit analysis is primarily focused on estimating the borrower's future cash flows from which debt repayments will be made rather than on valuation of the borrower's equity. The feedback received at the outreach meetings, as well as the review of the relevant literature and credit rating methodologies performed by the staff, suggest that debt investors and credit analysts use information in the entity's financial statements as a starting point for the cash flow projections in their models. The feedback also suggests that in developing those models, debt investors and credit analysts can use information provided by either a current value approach or a predecessor approach applied in a business combination under common control. In particular, they sometimes use an IFRS measure of profit as the starting point for the indirect calculation of cash flow projections. If a current value approach is applied in a business combination under common control, the recognition of the identifiable acquired net assets at fair value will result in the subsequent recognition of additional amortisation and depreciation in the statement of profit and loss which debt investors and credit analysts remove in developing cash flow projections. If a predecessor approach is applied, this particular adjustment would not need to be made in developing those cash flow projections.
19. To support their analysis, debt investors and credit analysts are also interested in information about the amount and timing of the entity's future cash outflows, in particular about short-term contractual cash outflows. In addition to projecting the entity's cash flows, debt investors and credit analysts also compare the amount and timing of payments of debt and interest with the availability of liquid assets.
20. Cash flow projections are also the foundation of some of the equity valuation models used by equity investors and analysts—for example, discounted cash flow models (DCF models). However, those models are used in equity analysis for a

different purpose and in a different context compared to credit analysis. Equity investors and analysts focus on estimating both potential upside and downside in the value of shares which may be undervalued or overvalued and whereas DCF models are widely used in practice they are not the only methods used in equity analysis. Equity investors and analysts also use dividends and earnings discount models, multiplier models and asset-based models and calculate free cash flow yields. The choice of models used depends on various circumstances but generally equity investors and analysts tend to use a combination of models to check the consistency of the outcomes of their valuation analysis. The models used in equity analysis, except for cash flow models, are generally affected by the accounting method of a business combination under common control if financial statements are used as the starting point.

21. Debt investors and credit analysts also often perform ratio analysis using both ratios based on IFRS information and ratios based on alternative performance measures. The literature reviewed by the staff suggested that there is no unifying theory on the ideal set of ratios that can be used to predict a possible default of an entity. However, the feedback received at the outreach meetings indicated that debt investors and credit analysts tend to rely most heavily on ratios based on cash flow measures such as debt payback ratios and debt service ratios. This observation was also supported by the staff's review of the credit rating methodologies.
22. The staff considered the 'key' or 'main' ratios in the corporate rating methodologies of two leading credit rating agencies that publish their proprietary rating methodology in the public domain. One of those credit rating agencies identifies ten key ratios organised in the following three categories: core debt-payback ratios, supplemental debt-payback and debt-service ratios and profitability ratios. Five of those ratios are based on a cash flow measure, and the other five are based on alternative performance measures such as EBITDA and EBIT. None of those ratios uses amounts directly taken from the statement of financial position. Some of the ratios use an input defined by the internal methodology as 'debt' and calculated by adjusting the entity's debt recognised in the statement of financial position. The other credit rating agency identifies twenty seven main ratios organised in the following three categories: profitability

and cash flows ratios, coverage ratios and leverage ratios. Fourteen ratios are based on cash flow measures, twelve are based on alternative performance measures such as EBIT or EBITDA like measures and only one is based on the statement of financial position and considers available cash compared to short-term debt. Most of the cash flow based measures used by both credit rating agencies in their ratios analysis are proprietary measures derived from the amounts required by IFRS Standards in the statement of profit or loss and the statement of cash flows and analytical adjustments calculated using both public and non-public information they have access to. Most of the resulting ratios will be largely unaffected by whether a current value approach or a predecessor approach is used to account for a business combination under common control.

23. To conclude, based on the findings in the staff's research and outreach discussed above, cash flow analysis seems predominant in credit analysis, including in the ratio analysis performed by debt investors and credit analysts. Profitability ratios are also used in credit analysis, but they tend to play a secondary or complementary role compared to cash flow analysis. A track record showing the ability of the entity's management to deliver returns and to create shareholders' value is also considered as a positive factor in credit analysis—this is because profitable entities are more likely to generate cash to settle their liabilities as they come due than loss-making entities—yet it has a limited impact on the credit assessment. A negative track record of the entity's performance would have a negative impact in the credit analysis—debt investors and credit analysts usually treat profits and losses asymmetrically because debt investments give rise to exposure to downside fluctuations in the entity's performance but do not directly benefit from the upside fluctuations.
24. The consideration of the carrying amounts included in the statement of financial position in credit analysis can be different in different sectors and in different circumstances but generally debt investors and credit analysts do not tend to focus on the statement of financial position apart from analysing the entity's debt. However, the carrying amounts of debt included in the statement of financial position are generally not sufficient for credit analysis. Instead, debt investors and credit analysts need qualitative and quantitative information about the entity's both recognised debt and unrecognised commitments.

Focus on the total gross debt

25. An entity's ability to service its debt and to raise new debt is affected not only by its ability to generate cash flows but also by its existing total gross debt, including both recognised and unrecognised commitments. Accordingly, debt investors and credit analysts need information about the amounts of those recognised and unrecognised commitments, their timing and their qualitative characteristics such as priority in liquidation or any related collateral.
26. In a business combination under common control, the receiving entity can assume new debt, unrecognised commitments or contingent liabilities which can sometimes result in an increase in its liquidity risk. Consequently, in analysing a business combination under common control, debt investors and credit analysts are interested in the assessment of its impact on:
- (a) the receiving entity's total gross debt, including both debt recognised in the statement of financial position and unrecognised commitments and contingent liabilities (paragraph 27); and
 - (b) qualitative composition of the receiving entity's total gross debt, in particular its maturity, priority ranking and collateral (paragraph 28).
27. The research and outreach conducted by the staff suggests that in assessing the total gross debt of the entity, debt investors and credit analysts are more interested in information about the nominal amounts due rather than in the fair value of the debt due to the focus on cash flows in the credit analysis. Accordingly, the carrying amounts of debt included in the receiving entity's statement of financial position applying either a current value approach or a predecessor approach will generally not be sufficient for credit analysis. Debt investors and credit analysts would be looking to supplement that information by information provided in the notes to financial statements or through other sources of information.
28. Debt investors and credit analysts are also interested in understanding the qualitative characteristics of debt and unrecognised commitments and contingent liabilities assumed in a business combination and their impact on the qualitative composition of the receiving's entity debt. For example, concentration of secured short-term debt in the acquired entity can be an indicator of a weak financial

position and a need to roll over or replace short-term debt can increase the receiving's entity liquidity risk. In contrast, predominance of long-term unsecured debt in the acquired entity can be an indication that—at least at the time when that debt was issued—the acquired entity had high credit standing and easy access to additional financing.

The staff's observations

29. Because debt investors and credit analysts use information in the manner discussed in paragraphs 18–28, the staff think that the result of those users' analysis of the entity's ability to service and raise debt would not depend greatly on whether a current value approach or a predecessor approach is applied to account for a business combination under common control. This observation was also generally supported by the feedback received in the outreach with the members of CMAC who specialise in debt investment and credit analysis. This is because:

- (a) credit analysis mainly focuses on cash flows. As discussed above, cash flow projection models and cash flow based ratios used in credit analysis are largely unaffected by whether a current value approach or a predecessor approach is used to account for a business combination under common control.
- (b) the other main area of focus in credit analysis is the entity's total gross debt, including both recognised amounts and unrecognised commitments and contingent liabilities. As noted in paragraph 27, the findings in the staff's research and outreach suggest that debt investors and credit analysts are interested in information about nominal amounts due rather than the fair value of the debt. In addition, debt investors and credit analysts are also interested in understanding the qualitative characteristics of debt and unrecognised commitments. Again, that information will not be affected by whether a current value approach or a predecessor approach to account for business combinations under common control.

30. The staff acknowledge that although analysis of cash flows and debt play a predominant role in credit analysis debt investors and credit analysts also consider the broader context, including calculating profitability ratios. Such additional ratios considered by debt investors and credit analysts can be affected by whether a current value approach or a predecessor approach is used to account for a business combination under common control. However, the findings in the staff's outreach suggest that those ratios are only used to assess a broader context and do not tend to affect the overall outcome of credit analysis.
31. Accordingly, the staff think that the Board could pursue different approaches for business combinations under common control that affect NCI in the receiving entity and those that affect lenders and other creditors in the receiving entity. Specifically, the Board could pursue:
- (a) a current value approach for all or some transactions that affect NCI in the receiving entity (discussed in December 2018 Agenda Paper 23 *Approach for transactions that affect non-controlling interest*); and
 - (b) a different approach, such as a predecessor approach, for transactions that affect lenders and other creditors in the receiving entity but do not affect NCI.

Question for the Board

Question for the Board

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

Appendix A—Summary of bibliography

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