IFRS

STAFF PAPER

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IASB® Meeting

Project	Business Combinations under Common Control
Paper topic	Update on lenders and other creditors in BCUCC

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Purpose of the paper

1. In March 2019, the International Accounting Standards Board (Board) discussed the information needs of existing and potential lenders and other creditors and the implications of that analysis for accounting for business combinations under common control. The session was educational and the Board was not asked to make decisions.

2. In the paper for that meeting (Agenda Paper *23B Lenders and other creditors in BCUCC* reissued as Agenda Paper 23C for this meeting), the staff concluded that the Board could pursue:

   (a) a current value approach for all or some transactions that affect non-controlling interest (NCI) in the receiving entity; but

   (b) a different approach, such as a form of predecessor approach, for transactions that affect lenders and other creditors in the receiving entity, but do not affect NCI.

3. The purpose of this paper is:

   (a) provide an update on the input received at the March 2019 Capital Markets Advisory Committee (CMAC) and Emerging Economies Group (EEG) meetings; and

(b) ask if the Board agrees that it need not pursue a single measurement approach for transactions within the scope of the project that affect NCI in the receiving entity and those that affect lenders and other creditors in the receiving entity but do not affect NCI.

4. The staff will also provide the Board with an oral update on the input received at the April 2019 Accounting Standards Advisory Forum (ASAF) meeting.

5. In this paper, the terms ‘lenders and other creditors’ and ‘debt investors’ are used to refer to existing and potential 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.

6. This paper focuses on the information needs of lenders and other creditors of the receiving entity and does not consider the cost constraint. As discussed in Agenda Paper 23A *Update on the staff’s approach*, the staff will consider the implications of applying the cost constraint in various circumstances in future papers for the Board.

Structure of the paper

7. The paper is structured as follows:

   (a) summary of the work performed to date (paragraph 8);

   (b) summary of the analysis of information needs of lenders and other creditors (paragraphs 9–15);

   (c) input received at the March 2019 CMAC and EEG meetings (paragraphs 16–19); and

   (d) the staff’s conclusion and question for the Board (paragraphs 20–22).

Summary of the work performed to date

8. In developing the paper and leading up to this Board meeting, the staff:

   (a) held individual discussions on information needs of debt investors and credit analysts in a business combination under common control with those members of CMAC who specialise in credit investment and analysis;

(b) reviewed the corporate credit methodology of two leading credit rating agencies;

(c) reviewed academic papers, reports, articles and other literature that consider the nature of claims held by lenders and other creditors and their information needs, including the following publications that reflect the results of outreach activities with users of financial statements (see Appendix A in Agenda Paper 23C *Lenders and other creditors in BCUCC* for complete bibliography):

   (i) *How credit analysts view and use the financial statements* published by the Financial Reporting Council. The paper reflects the input received in a series of meetings with credit analysts and bond fund managers; and

   (ii) *The use of information by capital providers, Academic literature review* published by the European Financial Reporting Advisory Group (EFRAG) and the Institute of Chartered Accountants of Scotland (ICAS)[1]. The paper is based on a comprehensive review of literature on the use of information by capital providers and reflects the input received in outreach activities with users of financial statements.

(d) discussed the staff's conclusions at the March 2019 CMAC and EEG meetings and at the April 2019 ASAF meeting.

Summary of the analysis of information needs of lenders and other creditors

9. Agenda Paper 23B for the March 2019 IASB meeting explored information needs of existing and potential lenders and other creditors in a receiving entity and the

[1] This academic literature review was presented by the authors at the January 2014 Board meeting: https://www.ifrs.org/news-and-events/calendar/2014/january/international-accounting-standards-board/

implications of that analysis for accounting for business combinations under common control.

10. The staff identified three respects in which claims held by lenders and other creditors are typically different from equity claims and the implications of those differences for the typical focus of credit analysis as follows:

(a) for a debt instrument, the cash flows are contractual and the holder is exposed to the credit risk of the issuer, that is the risk that the holder will incur a financial loss if the issuer fails to discharge its obligation under the contract. As a result, debt holders and credit analysts focus on the issuer's ability to service the existing debt and to raise new debt. In performing that analysis, they are sensitive to decreases in the projected cash flows but are typically less sensitive to increases in the projected cash flows above the level that provides comfort that the issuer can service the debt. In contrast, for an equity instrument, the cash flows are discretionary and holders of equity claims are exposed to both upside and downside fluctuations in the prospects of the net cash inflows to the investee. Thus, holders of equity claims tend to focus in their analysis on valuation (paragraphs 11–12 of Agenda Paper 23C).

(b) the contractual—and typically finite—maturity of a debt instrument results in a focus on particular time frames in the cash flow projections made in credit analysis. In contrast, because of the perpetual nature of an equity instrument, equity investors and analysts are also interested in the terminal value of the entity beyond the period for which explicit cash flow projections are made (paragraph 13 of Agenda Paper 23C).

(c) different priority of claims held by lenders and other creditors in the event of liquidation results in the need to assess how those claims rank relative to each other as well as the need to assess the issuer's overall leverage. Equity claims have lower priority in liquidation than claims held by lenders and other creditors. As a result, equity investors and analysts tend to focus in their analysis on the investee's overall leverage (paragraph 14 of Agenda Paper 23C).

11. Some claims classified as liabilities applying IFRS Standards may expose their holders to risks similar to those borne by holders of equity claims (eg a convertible bond settled in cash based on the price of the issuer's shares would create for its holder an equity-like exposure). However, for analysis of information needs of lenders and other creditors in a business combination under common control the staff focused on typical features of debt instruments. If need be, special cases will be considered by the staff at a later stage once the general model has been developed.

12. As noted in paragraph 10(a) and in paragraph 15 of Agenda Paper 23C, debt investors and credit analysts use information in general purpose financial statements to assess entities' ability to service the existing debt and to raise new debt. As a result, core prediction models used in credit analysis tend to display the following characteristics:

    (a) a predominance of cash flow analysis, including in developing cash flow projections and in performing ratio analysis; and

    (b) a focus on nominal amounts and qualitative characteristics of the total gross debt, including unrecognised commitments and contingent liabilities.

13. As explained in paragraphs 18–28 of Agenda Paper 23C, these forms of analysis would be largely unaffected by whether a current value approach or a form of predecessor approach is used to account for business combinations under common control. In contrast, the models used in equity analysis, except for cash flow models, would generally be affected by the accounting method applied to a business combination under common control if financial statements are used as a starting point in those models.

14. In addition to cash flow analysis and analysis of the entity's total gross debt, debt investors and credit analysts also consider profitability ratios and ratios based on the statement of financial position, in particular debt to equity ratios. The staff acknowledge that such ratios will be affected by the method used to account for a business combination under common control. However, these ratios typically play a complementary role in credit analysis compared to cash flow analysis and tend to have only a limited impact on the credit assessment.

15. The staff acknowledge that different debt investors and credit analysts can have additional information needs or use different models in their analysis depending, for example, on the terms of a particular debt agreement, the issuer's industry or the level of sophistication of the analysis. For example, a secured lender in the receiving entity will be interested in monitoring the value of the collateral, usually a specific asset or a group of assets of the receiving entity. However, the carrying amounts of those assets would not be affected by the accounting method applied to the business combination under common control.

Input received at the March 2019 CMAC and EEG meetings

16. Information needs of lenders and other creditors, and the implications of that analysis for determining which accounting method to use for business combinations under common control, were discussed at the March 2019 CMAC meeting. The staff asked whether CMAC members agree with staff's conclusion that the result of credit analysis would be largely unaffected by whether a current value approach or a form of predecessor approach is used to account for business combinations under common control.

17. CMAC members who commented on the topic—including members specialising in credit analysis— agreed with that conclusion. One member specialising in credit analysis emphasised that in his experience credit ratings are typically determined at the controlling entity level rather than at the receiving entity level. This further supports the conclusion that the results of the credit analysis for the receiving entity would largely be unaffected by whether a current value approach or a form of predecessor approach is used by the receiving entity to account for a business combination under common control. No members objected to that conclusion.

18. One member agreed with the staff's conclusion that cash flows analysis is the primary focus of debt providers and credit analysts but noted that valuation information may also be useful for credit analysis in some circumstances. However, that member acknowledged that such consideration is secondary to the focus on cash flows and on gross debt in credit analysis.

19. The staff's analysis of the information needs of lenders and other creditors of the receiving entity in a business combination under common control was also discussed at the March 2019 EEG meeting. The EEG members generally agreed with the staff's conclusion that the result of the credit analysis would be largely unaffected by whether a current value approach or a form of predecessor approach is used in a business combination under common control.

The staff's conclusion and question for the Board

20. Because debt investors and credit analysts use information in the manner discussed in paragraphs 12–15, 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 form of predecessor approach is applied to account for a business combination under common control (paragraph 29-31 of Agenda Paper 23C). This is because:
    (a) credit analysis mainly focuses on cash flows. Cash flow projection models and cash flow based ratios used in credit analysis are largely unaffected by whether a current value approach or a form of 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 nominal amounts and qualitative characteristics of the entity's total gross debt, including both recognised amounts and unrecognised commitments and contingent liabilities. Again, that information will not be affected by whether a current value approach or a form of predecessor approach is used to account for business combinations under common control.

21. As discussed in paragraphs 16–19, this conclusion was generally supported at the March 2019 CMAC and EEG meetings.

22. Accordingly, the staff think that the Board need not pursue a single approach 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 but do not affect NCI. 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 form of predecessor approach, for transactions that affect lenders and other creditors in the receiving entity but do not affect NCI.

Question for the Board
Does the Board agree with the staff's conclusion in paragraph 22 that it need not pursue a single approach 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 but do not affect NCI?