IFRS

STAFF PAPER

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IASB® meeting

Project	Business Combinations under Common Control		
Paper topic	Applying a current value approach to BCUCC		
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Purpose of this paper

1. At the September 2019 meeting, the International Accounting Standards Board (Board) tentatively decided that a current value approach based on the acquisition method set out in IFRS 3 *Business Combinations* should be applied to transactions that affect non-controlling shareholders of the receiving entity—subject to an exception and an exemption[1].

2. In directing the staff to develop such an approach at the June 2018 meeting, the Board asked the staff to consider whether and how the acquisition method should be modified to provide the most useful information about transactions that affect non-controlling shareholders of the receiving entity. The Board noted that possible modifications could include requirements for the receiving entity to do one or more of the following:

    (a) recognise any consideration transferred in excess of the value received as a reduction in the receiving entity's equity (distribution) instead of including any such excess consideration in the initial measurement of goodwill;

[1] A current value approach would be applied to transactions that affect non-controlling shareholders unless equity instruments of the receiving entity are not traded in a public market and (1) all non-controlling shareholders are the receiving entity's related parties (the exception) or (2) the receiving entity chooses to apply a predecessor approach and all its non-controlling shareholders have been informed about the receiving entity applying that approach and not objected (the exemption).

(b) recognise any acquired identifiable net assets in excess of the consideration transferred as an increase in the receiving entity's equity (contribution) instead of recognising that excess as a gain on a bargain purchase in profit or loss; or

(c) provide additional disclosures.

3. This paper discusses whether, in applying a current value approach based on the acquisition method, the receiving entity should be required to identify and recognise any such distribution or contribution in its financial statements. The staff will present a paper that considers disclosure requirements for transactions within the scope of the project, including those reported applying a current value approach based on the acquisition method, at a future meeting.

Structure of this paper

4. This paper is structured as follows:

(a) staff recommendation (paragraph 5);

(b) the issue (paragraphs 6–11);

(c) overview of findings in staff's research and outreach (paragraphs 12–26);

(d) staff analysis and recommendations (paragraphs 27–42):

(i) reporting a distribution from the receiving entity's equity (paragraphs 27–39);

(ii) reporting a contribution to the receiving entity's equity (paragraphs 40–42);

(e) Appendix A—Extract from the July 2018 Agenda Paper 1A *Alternative measurement approaches* for the Accounting Standards Advisory Forum (ASAF); and

(f) Appendix B—Extract from the September 2018 World Standards-setters Conference slide deck on Business Combinations under Common Control deck.

Staff recommendation

5. This paper discusses all transactions within the scope of this project to which a current value approach is applied. The staff recommend that the current value approach for all such transactions should be the acquisition method as set out in IFRS 3, except that the receiving entity should recognise any excess fair value of the acquired identifiable net assets over the consideration transferred as an increase in the receiving entity's equity (contribution), not as a gain on a bargain purchase in profit or loss.

The issue

6. The acquisition method is built on the premise that there are negotiations between the combining or transacting parties and hence the consideration transferred reflects the fair value of the acquired business—possibly including a premium in exchange for synergies expected by the acquirer. Applying the acquisition method, the difference in fair value between the consideration transferred and the acquired identifiable net assets is recognised as goodwill (or in rare circumstances, as a gain on a bargain purchase).

7. Economically, consideration transferred in a business combination can also include an overpayment—a payment in excess of the fair value of (a) the acquired business and (b) the economic benefits embedded in expected synergies arising on the combination. IFRS 3 does not require entities to identify and recognise any such overpayments. This is because it would be difficult, if not impossible, to identify and measure an overpayment. In addition, overpayments were not considered likely in a business combination (paragraph BC382 of the *Basis for Conclusions* of IFRS 3). As a result, any such overpayments are subsumed within goodwill that is recognised on the combination and is subject to testing for impairment applying IAS 36 *Impairment of Assets*.

8. A business combination under common control may not be a result of negotiations between the combining parties but instead be directed by the controlling party. As a result, the consideration transferred may not necessarily reflect the fair value of the acquired business and synergies expected as a result of combination. Furthermore, a business combination under common control may be undertaken in order to benefit

other entities within the group rather than necessarily the receiving entity. For example, the transaction may be undertaken to minimise operating costs in the group or to obtain tax benefits for the group as a whole (or for the controlling party) and not necessarily for the receiving entity. In those circumstances, a difference between the fair value of the consideration transferred and the fair value of (a) the acquired business and (b) the economic benefits embedded in expected synergies arguably arises because there is an equity transaction—a transaction with owners in their capacity as owners—in addition to the acquisition of a business. Applying paragraph 106 of IAS 1 *Presentation of Financial Statements*, transactions with owners in their capacity as owners should be reported in the statement of changes in equity. A decrease in equity represents a distribution to the controlling party and causes a transfer of wealth from the non-controlling shareholders. An increase in equity represents a contribution by the controlling party and causes a transfer of wealth to the non-controlling shareholders. The question arises whether, and if so how, a receiving entity should be required to identify, measure and recognise any such distribution or contribution.

9. As noted in paragraph 7, IFRS 3 does not contain requirements on how any overpayment in a business combination could be identified and measured. Accordingly, if the Board were to require recognition of a distribution, the distribution would need to be measured. The staff have identified two approaches to measuring a distribution:

   (a) as the excess of the fair value of the consideration transferred over the fair value of the acquired business (previously referred to as the ceiling approach); or

   (b) by applying the requirements on testing goodwill for impairment in IAS 36 (previously referred to as the revised ceiling approach) (see Appendix B).

10. Alternatively, information about the transaction price could be provided in the notes to help users evaluate the economics of the transaction. Applying this approach, any distribution would not be identified and recognised separately but would be subsumed within goodwill that would be subject to annual impairment tests.

11. As noted in paragraph 6, IFRS 3 requires an acquirer to recognise a gain on a bargain purchase and measure it as the excess of the fair value of the acquired identifiable net assets over the fair value of the consideration transferred. That same measurement could be used for reporting a contribution if the Board were to require recognition of a contribution.

Overview of findings in staff's research and outreach

Research into current reporting practice and existing guidance

12. The guidance on reporting business combinations under common control published by accounting firms sets out the following views:

    (a) applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, business combinations under common control may be reported applying the acquisition method *as set out in IFRS 3* [emphasis added];

    (b) in some circumstances, a business combination under common control reported applying the acquisition method could include an equity transaction (ie transaction with owners in their capacity as owners)—a distribution or a contribution. One accounting firm expresses a view that in those circumstances, the acquirer could elect, as a matter of accounting policy, to recognise a distribution or a contribution measured as the difference between the fair value of the consideration transferred and the fair value of the acquired business. Another accounting firm expressed a view that any excess of the fair value of the acquired identifiable net assets over the consideration transferred should be recognised as a contribution to equity instead of being recognised as a gain on a bargain purchase in profit or loss but did not address distributions.

13. In performing a desktop review of business combinations under common control reported applying IFRS Standards[2] the staff observed that:

[2] In performing the desktop review, the staff used the financial search engine, *AlphaSense*. The search was limited to annual reports written in English and would identify the existence of business combinations under common control only if those transactions were disclosed in annual reports. The staff reviewed a total of 267 transactions.

(a) many transactions that were reported applying the acquisition method were reported applying that method as set out in IFRS 3; and

(b) some transactions that were reported applying the acquisition method were reported applying that method with modifications—instead of recognising goodwill or a gain on a bargain purchase, entities recognised those amounts in equity. One entity specifically stated in its financial statements that a difference in values exchanged is considered a deemed distribution or a deemed contribution.

Input received from the Board's consultative bodies

14. The staff discussed, whether applying a current value approach based on the acquisition method, the receiving entity should be required to identify, measure and recognise:

(a) any distribution from equity—at the June 2019 joint Capital Markets Advisory Committee (CMAC) and Global Preparers Forum (GPF) meeting and the July 2019 ASAF meeting; and

(b) any contribution to equity—at the July 2019 ASAF meeting (see Appendix A).

15. CMAC and GPF members first discussed whether, and how often, a distribution could happen in practice for business combinations under common control that affect non-controlling shareholders. CMAC and GPF members of two breakout groups stated that there will be regulatory 'protection' of non-controlling shareholders. Members of another group stated that even if there is no regulatory 'protection', there would be contractual 'protection' and hence the possible need to report a distribution is only a theoretical question. Members of the remaining group argued that reporting an 'overpayment' is a real question. An IASB Board Member noted that overpayments can also happen in business combinations that are not under common control.

16. All breakout groups expressed the view that measuring any distribution would be difficult and the resulting amount would be highly subjective and uncertain. However, members assigned different importance to the high level of measurement uncertainty

involved in measuring any distribution and hence expressed different views on whether distributions should be recognised or addressed by disclosure only:

(a) CMAC and GPF members of two breakout groups supported recognising a distribution in principle. However:

    (i) one of those groups stated that the presence of regulatory protection would usually result in no distribution.

    (ii) the other group stated that 'overpayments' can happen, and their timely recognition is important. However, that group emphasised that it is most important to provide information about the economics of the deal to help users make their own assessment of whether there is an overpayment.

(b) another breakout group reported a unanimous view among its GPF members that goodwill should not be overstated, and any distribution should be recognised despite any measurement uncertainty involved. Some CMAC members of that group supported recognising a distribution, while other CMAC members stated that they did not want to see any 'made-up' numbers in the financial statements and expressed a preference for disclosure only.

(c) the remaining breakout group stated that the question about reporting a distribution is theoretical and expressed no view.

17. Only one group commented on how to measure any distribution. That group disagreed with using the requirements in IAS 36 on testing goodwill for impairment as the basis for measuring a distribution.

18. ASAF members also discussed whether distributions in business combinations under common control would happen in practice. Most ASAF members stated that in their jurisdictions laws and regulations either directly require business combinations under common control to be undertaken at fair value (for example, capital market regulations of related party transactions) or would indirectly result in those transactions being undertaken at fair value (for example, because of tax consequences for transactions that are not conducted on market terms). Because such regulations exist, a few ASAF members did not think that a distribution in business combinations under common control would happen in practice. Two other members suggested a

rebuttable presumption that business combinations under common control affecting non-controlling shareholders are undertaken at fair value, so that when the transaction price is regulated entities are not required to ‘screen’ for distributions or contributions. However, when the rebuttable presumption is not met, those ASAF members would support recognising a distribution (or a contribution) but did not express a view on how to measure them.

19. Other ASAF members agreed in principle that information about any distribution or contribution would be useful but expressed different views about how these items should be reported:

    (a) for distributions—under half of those members expressed concerns about measurement uncertainty in measuring a distribution and did not support recognising a distribution. Other members supported recognising a distribution measured as the difference between the fair value of the consideration transferred and the fair value of the acquired business.

    (b) for contributions—over half of those members supported recognising a contribution measured applying the requirements in IFRS 3 for measuring a gain, or measured as the difference between the fair value of the consideration transferred and the fair value of the acquired business. Other members did not comment on how a contribution should be reported.

20. One ASAF member suggested that for business combinations under common control that are similar to business combinations between unrelated parties, the question about reporting distributions or contributions should not arise.

Other research and outreach

21. In April 2019, the staff requested information from ASAF members about legal requirements or regulations in their jurisdictions with regards to transaction price in business combinations under common control. Specifically:

    (a) whether there are legal requirements related to transaction price and whether such transactions are required to be conducted at fair value; and

(b) if the transaction price is regulated, whether the regulation applies to all or only some such transactions (eg whether they apply to both listed and privately held entities).

22. In May 2019, the staff reached out with a similar request for information to securities regulators through the International Organization of Securities Commissions (IOSCO). A total of 17 responses were received from ASAF members and members of IOSCO. In addition, as noted in paragraph 18, this topic was discussed at the July 2019 ASAF meeting. ASAF members who provided responses stated that legal requirements or regulations that would directly or indirectly affect transaction price in business combinations under common control exist in:

(a) civil, commercial or company law—in nine jurisdictions;

(b) stock exchange listing requirements—in eight jurisdictions; and

(c) tax law and regulations—in three jurisdictions (for example, some transfer pricing rules cause adverse tax consequences if transactions between related parties are not undertaken at fair value).

23. Responses from regulators focused on the accounting approaches applied to business combinations under common control in their jurisdictions and reiterated the concern that the lack of accounting guidance results in diversity in how these transactions are reported.

24. In addition to the outreach with ASAF members and members of IOSCO, the staff reviewed *Doing Business 2020* report published by The World Bank[3] that discusses the ease of doing business around the world. The report covers more than 200 jurisdictions and cities. The staff focused on one of the areas considered in the report in assessing the ease of doing business, *Protecting Minority Investors*[4]. *Protecting Minority Investors* methodology measures (a) the protection of minority investors from conflicts of interest through one set of indicators and (b) shareholders' rights in corporate governance through another. The score of a jurisdiction on the strength of

[3] World Bank. 2020. Doing Business 2020. Washington, DC: World Bank. DOI:10.1596/978-1-4648-1440-2 https://www.doingbusiness.org/en/reports/global-reports/doing-business-2020

[4] https://www.doingbusiness.org/en/methodology/protecting-minority-investors

minority investor protection is determined by aggregating the extent of conflict of interest regulation index and the extent of shareholder governance index.

25. Applying *Protecting Minority Investors* methodology, jurisdictions and cities could achieve the highest score of 100 points and lowest score of 0 points. The scores of jurisdictions and cities covered in the report range from the 92 points to 0 points with a median score of 58 points, and a mean score of 53.6 points[5]. There are 129 jurisdictions and cities with a score equal to or greater than 50 points, 39 jurisdictions and cities with a score between 50 points and 30 points, and 38 jurisdictions and cities with a score equal to or lower than 30 points.

26. The staff's review of the *Protecting Minority Investors* methodology indicated that jurisdictions have varying degrees of protection of non-controlling shareholders. Some jurisdictions have stronger protection mechanisms than others. Nevertheless, the staff's review suggests that in most jurisdictions covered by the report mechanisms are put in place to protect non-controlling shareholders against conflict of interest or misuse of corporate assets by companies' directors and co-owners for their personal gain.

Staff analysis and recommendations

Reporting a distribution from the receiving entity's equity

27. The staff think that in principle, if a distribution takes place in a business combination under common control, reporting such a distribution would provide relevant information to the primary users of the receiving entity's financial statements, in particular to the non-controlling shareholders affected by the transaction. In addition, it would also reflect the substance of the transaction. The staff note that paragraph 51 of IFRS 3 already requires that in applying the acquisition method, any amounts that are not part of the exchange should be identified and accounted for in accordance with the relevant IFRS Standard. Moreover, as stated in paragraph 8, applying IAS 1

[5] Median is the middle number in a sorted list or sequence of numbers. Mean is the numerical average in a given set of numbers.

transactions with owners in their capacity as owners should be reported in statement of changes in equity.

28. However, in deciding whether to require a receiving entity to recognise any such distribution, the staff think that the Board should consider the following factors:

(a) how prevalent such a scenario is likely to be in practice (see paragraph 29);

(b) whether recognising a distribution would provide a faithful representation of the transaction in the light of the significant measurement uncertainty that would be involved (see paragraphs 30–36); and

(c) whether the benefits of providing such information would justify the costs of providing it, as well as the complexity of that approach (see paragraph 37).

29. Considering the input received at the July 2019 ASAF meeting (see paragraph 18), the input received from ASAF members and regulators on the staff's request for information (see paragraphs 21–23) and the staff's review of the 2019 World Bank's Report (see paragraphs 24–26), the staff think that transactions resulting in a distribution that causes a transfer of wealth from the non-controlling shareholders to the controlling party are unlikely to be common in practice because of the existence of laws and regulations, or contractual terms, designed to protect non-controlling shareholders.

30. During April 2018–June 2018, the Board extensively discussed variations of a current value approach identified and analysed by the staff. June 2018 Agenda Paper 23 *Way forward for transactions that affect NCI*[6] summarised current value approaches that the staff had been exploring—the acquisition method, the full fair value approach, the ceiling approach and the revised ceiling approach. The latter three approaches were designed to identify and measure a distribution in a business combination under common control. At the June 2018 meeting, the Board decided not to continue exploring the full fair value approach but did not dismiss the ceiling approach and the

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[6] Slides 32–60 of the June 2018 Agenda Paper 23 *Way forward for transactions affecting NCI* discuss the current value approaches that staff have explored.

Appendix B provides an extract from the 2018 World Standard-setters conference slide deck on Business Combinations under Common Control (slides 33–37) that illustrates different current value approaches under different scenarios.

revised ceiling approach. The staff have not identified any additional approaches to measuring a distribution. Both approaches are subject to significant measurement uncertainty.

31. As noted in paragraph 9(a), applying the ceiling approach, goodwill is measured as the excess of the fair value of the consideration transferred over the fair value of the acquired identifiable net assets but is capped at the fair value of the acquired business. A distribution is measured as the excess of the fair value of the consideration transferred over the fair value of the acquired business. Accordingly, if the Board were to pursue this approach, the receiving entity would be required to measure the fair value of a business.

32. As noted in paragraph 9(b), applying the revised ceiling approach, goodwill is provisionally measured as the excess of the fair value of the consideration transferred over the fair value of the acquired identifiable net assets. The acquirer then determines whether that goodwill arising from the transaction contains a distribution applying the requirements in IAS 36 on testing goodwill for impairment as of the acquisition date. Any excess of the carrying amount of goodwill arising from the transaction over its recoverable amount is deemed a distribution and recognised as such.

33. The staff think that identifying and measuring a distribution is similar to identifying and measuring an overpayment that could also arise in a business combination not under common control. In addressing overpayment in the second phase of the Business Combination project, the Board and US Financial Accounting Standards Board (the boards) acknowledged that in principle overpayments should lead to the acquirer's recognition of an expense (or loss) in the period of the acquisition. However, as noted in paragraph 7, the boards concluded that in practice any overpayment is unlikely to be detectable or known at the acquisition date. In other words, the boards were not aware of instances in which a buyer would knowingly overpay or would be compelled to overpay a seller to acquire a business. Moreover, even if an acquirer were aware that it might have overpaid, the amount of overpayment would be difficult, if not impossible, to quantify. Thus, the boards concluded that in practice it would not be possible to identify and reliably measure an overpayment at the acquisition date. The boards stated that reporting overpayments is

best addressed through subsequent impairment testing when evidence of a potential overpayment first arises.

34. An additional complexity in a business combination under common control could arise because any excess consideration transferred could arguably in some cases represent an overpayment similar to an overpayment in a business combination (for example, if the receiving entity negotiated poorly) and in other cases it could represent a distribution (for example, if the transaction was directed by the controlling party for the benefit of the group as a whole). Distinguishing those cases could be very difficult, if not impossible, in practice.

35. The staff think that the boards' analysis and conclusions reached in Business Combinations project remain valid and equally apply to business combinations under common control. In addition, most participants at the June 2019 joint CMAC and GPF meeting and the July 2019 ASAF meeting voiced concerns about measurement uncertainty involved in measuring a distribution. Most members of those Consultative Groups did not support recognising a distribution.

36. Furthermore, as discussed in paragraph 12(b), most guidance published by the accounting firms reviewed by the staff does not address recognising a distribution in a business combination under common control reported applying the acquisition method. Similarly, as discussed in paragraph 13(a), many transactions reported applying the acquisition method reviewed by the staff were reported applying that method as set out in IFRS 3.

37. Finally, requiring entities to recognise a distribution, even if the amount of distribution could be determined in some cases, would result in additional costs and complexity in reporting and understanding information about business combinations under common control. Users consulted in the earlier outreach activities on the project suggested that the acquisition method should be applied as set out in IFRS 3[7]. Considering those factors together with the staff's conclusion in paragraph 29 that distributions that cause a transfer of wealth from the non-controlling shareholders to the controlling party are unlikely to be common in practice, the staff think that the

[7] June 2018 Joint CMAC and ASAF meeting summary, paragraph 46.

benefits of requiring entities to identify, measure and recognise such distributions would not justify the costs of doing that.

38. Accordingly, considering the analysis in paragraphs 27–37, the staff recommend that the Board does not modify the requirements of IFRS 3 to require entities to identify, measure and recognise a distribution in a business combination under common control reported applying a current value approach based on the acquisition method.

39. Instead, the staff think that useful information about the transaction price could be provided in the notes to help users assess whether the consideration transferred exceeds the fair value of the acquired interest. The staff will present a paper that considers disclosure requirements for transactions within the scope of the project at a future meeting.

Question 1 for the Board
Does the Board agree with the staff recommendation in paragraph 38 that the Board should not require entities to identify, measure and recognise a distribution in a business combination under common control reported applying a current value approach?

Reporting a contribution to the receiving entity's equity

40. The staff think that for the purposes of the discussion in this paper, the main differences between a contribution and a distribution are as follows:

    (a) a contribution in a business combination under common control transfers wealth from the controlling party to non-controlling shareholders. Accordingly, laws and regulations that are designed to protect the rights of non-controlling shareholders would not apply. However, the staff think that contributions would also be rare in practice because the controlling party is unlikely to allow a transfer of wealth to the non-controlling shareholders.

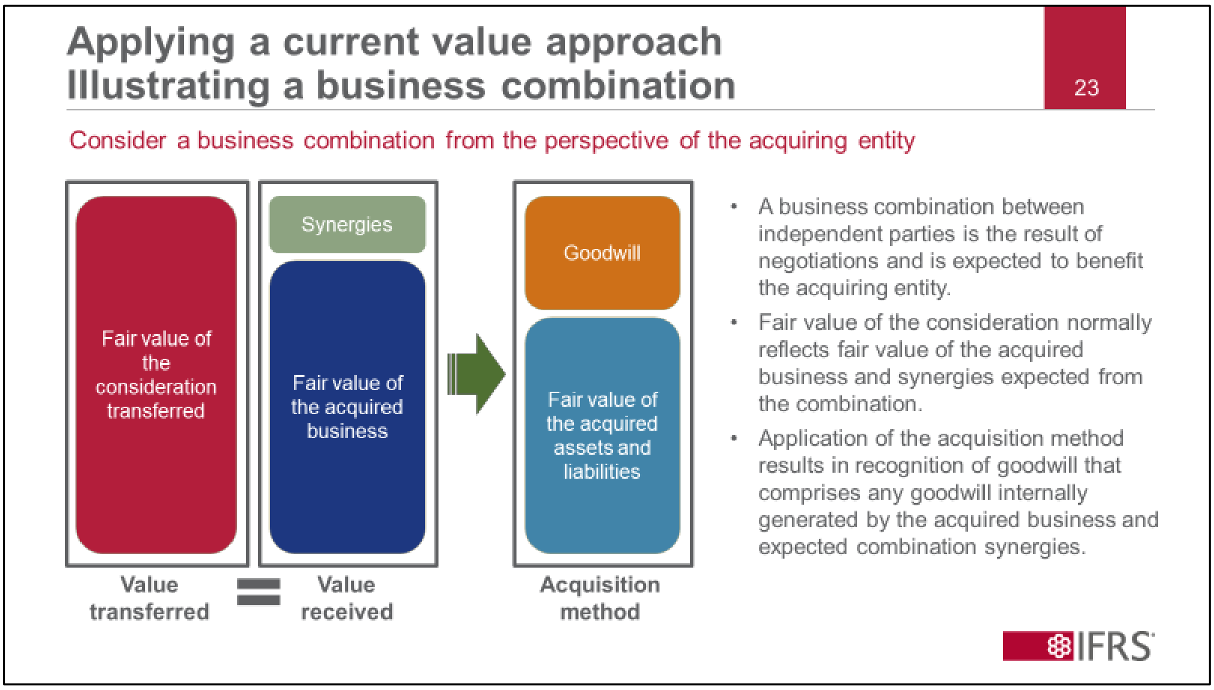
    (b) IFRS 3 addresses a scenario where the fair value of the consideration transferred is below the fair value of the acquired identifiable net assets—although IFRS 3 emphasises that such a scenario is rare. As stated in paragraph 11, applying requirements in IFRS 3, any such excess fair value of the acquired identifiable net assets is recognised as a gain on a bargain purchase in profit or loss. The staff think that in as much as an economic gain is inherent in a bargain purchase (paragraph BC371 of the *Basis for Conclusions* of IFRS 3), in a transaction under common control, that economic gain arguably represents a contribution to the receiving entity's equity by the controlling party. The staff also think that the requirements in IFRS 3 on measuring a gain on a bargain purchase could equally apply to measuring a contribution.

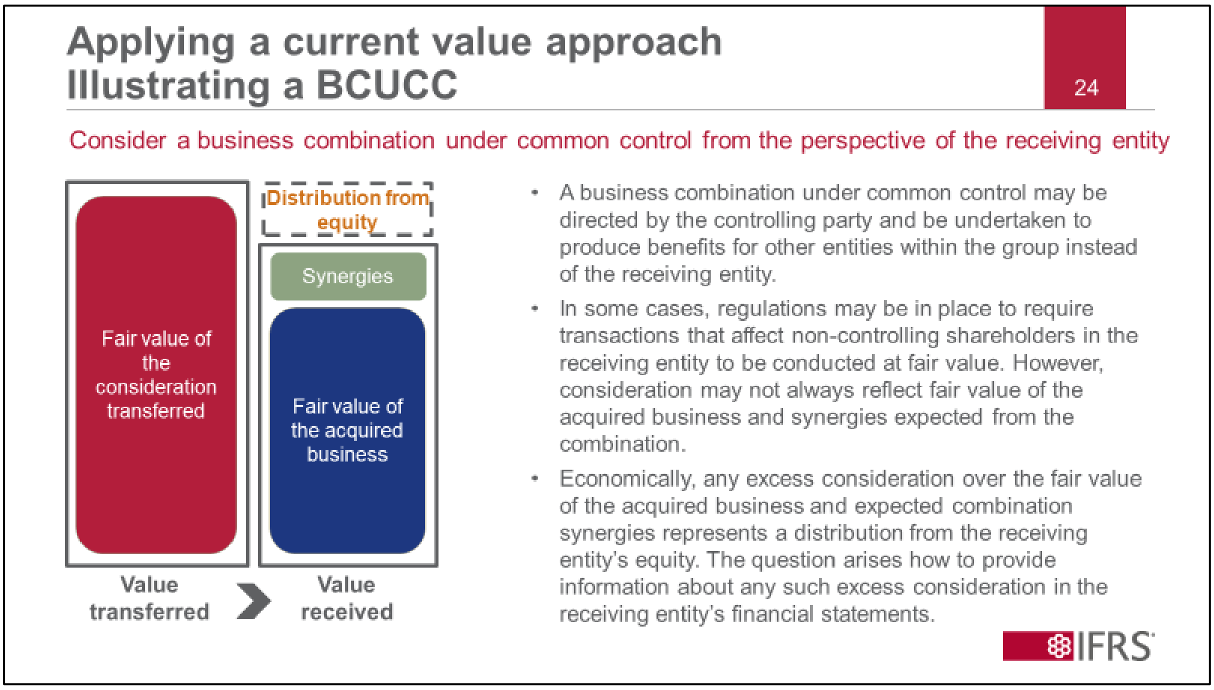
41. For the reasons set out in paragraph 40, the staff recommend that the Board requires a receiving entity in a business combination under common control reported applying a current value approach based on the acquisition method to recognise any excess fair value of the acquired identifiable net assets over the fair value of the consideration transferred as an increase in the receiving entity's equity (contribution) instead of recognising a gain on a bargain purchase in profit or loss.

42. The staff note that an asymmetric approach to reporting distributions and contributions in business combinations under common control—ie recognising contributions applying the requirements in IFRS 3 but not recognising distributions—featured in feedback from some ASAF members (see paragraph 19) and in guidance published by some accounting firms (see paragraph 12(b)).

Question 2 for the Board
Does the Board agree with the staff recommendation in paragraph 41 that a receiving entity in a business combination under common control reported applying a current value approach should recognise any excess fair value of the acquired identifiable net assets over the consideration transferred as an increase in the receiving entity's equity (contribution), not as a gain on a bargain purchase in profit or loss?

Appendix A—Extract from the July 2019 ASAF Agenda Paper 1A *Alternative measurement approaches*





Applying a current value approach
Information about a distribution in a BCUCC

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- The staff have identified two broad alternatives to providing information about a distribution in a business combination under common control in the receiving entity's financial statements.

Recognition or **Disclosure**

Recognition

- Recognition would require measuring the distribution. The staff have identified two broad approaches to measuring a distribution.

Measure as the excess of the consideration over the fair value of the acquired business

Measure by immediately testing goodwill for impairment applying the mechanics of IAS 36 *Impairment of Assets*

Both approaches to measuring a distribution are subject to measurement uncertainty.

Disclosure

- Instead of being recognised separately, any distribution is subsumed within goodwill that is subject to subsequent annual impairment tests.
- Notes to financial statements provide information about the transaction to help users evaluate its effects on the receiving entity's financial position and performance.

Applying a current value approach
Information about a contribution in a BCUCC

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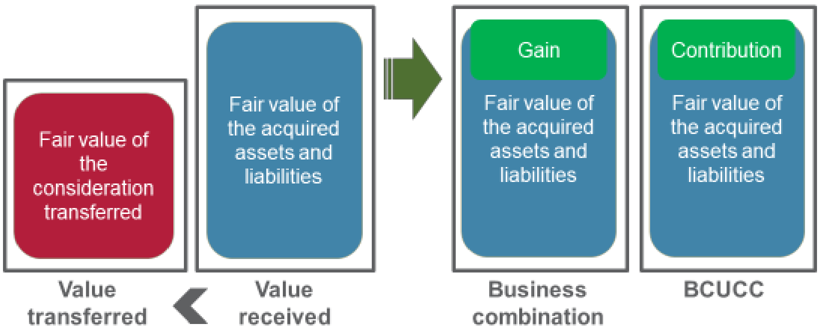
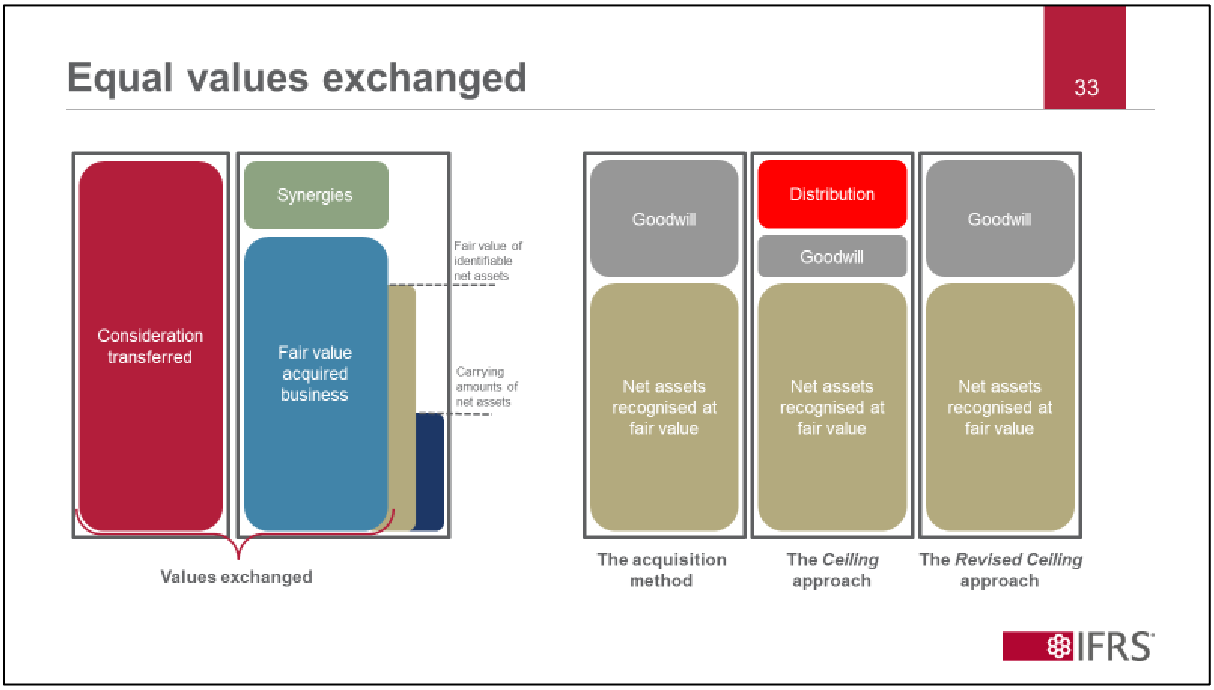
- Occasionally, an acquirer in a business combination will make a bargain purchase in which the fair value of the acquired assets and liabilities exceeds consideration transferred. Applying the acquisition method, the acquirer recognises that excess as a gain.
- In a business combination under common control, any such access represents a contribution to the receiving entity's equity rather than a gain and in the staff's view should be recognised as such.



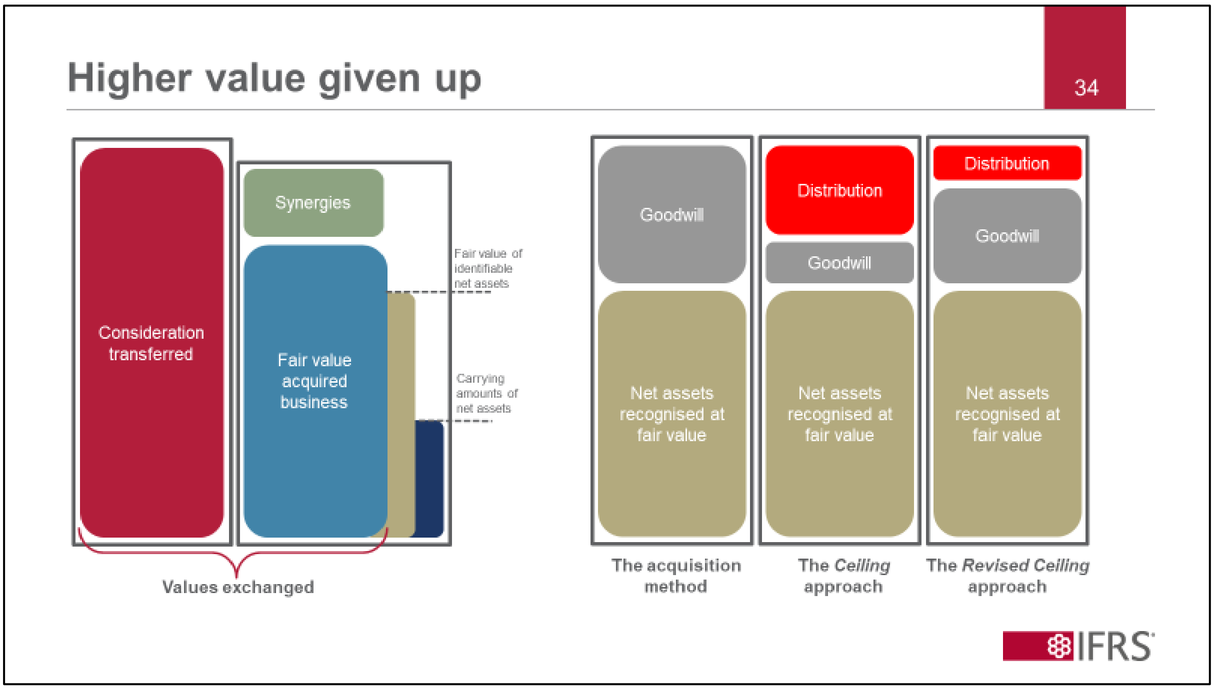
Appendix B—Extract from the 2018 World Standards-setters Conference slide deck on Business Combinations under Common Control

Comparisons of current value approaches

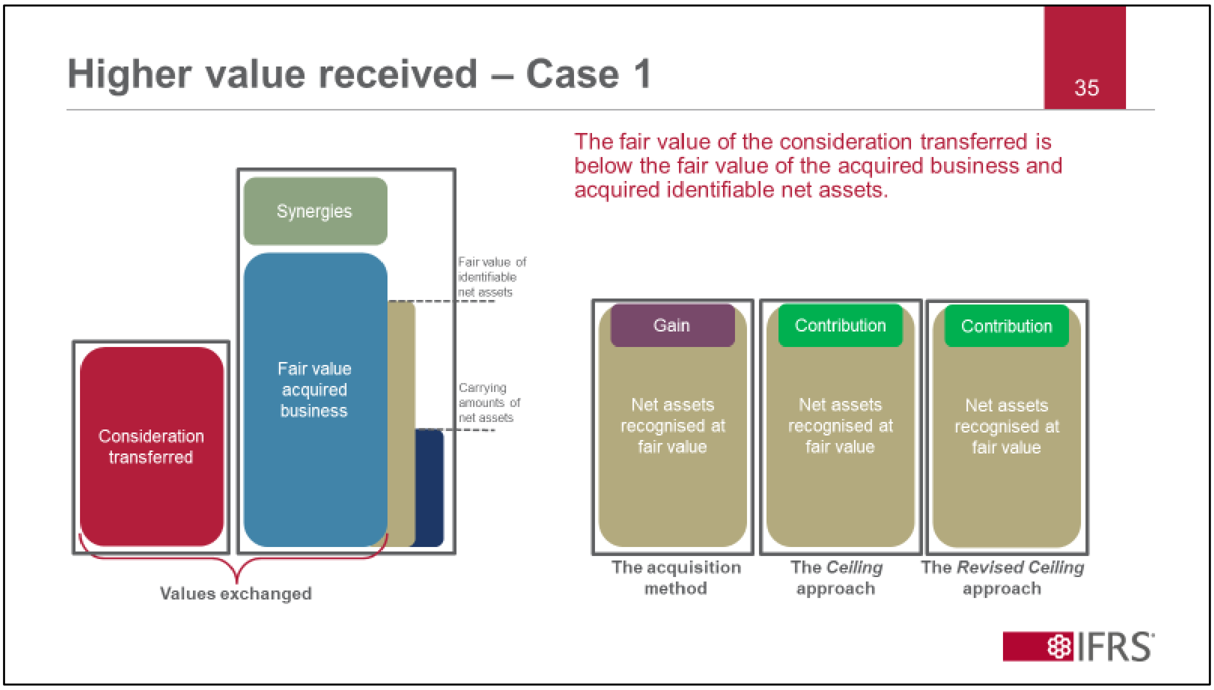
Scenario 1: Equal values are exchanged



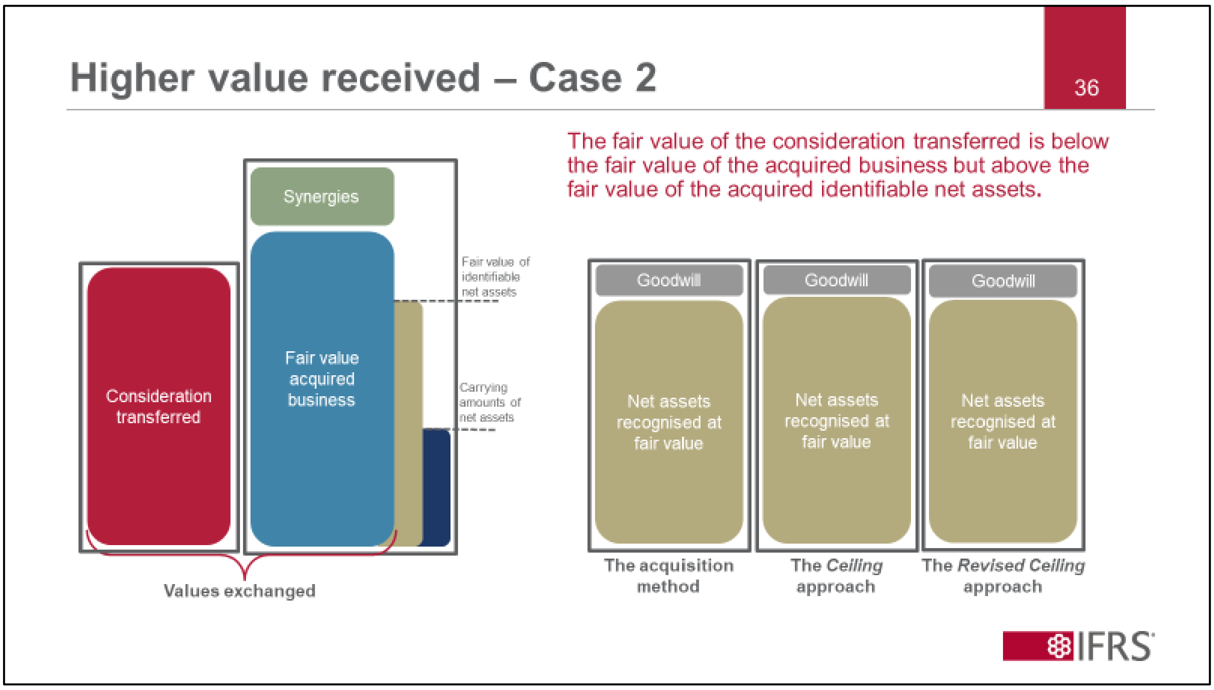
Scenario 2: Higher value is given up



<u>Scenario 3a: Higher value is received—*the fair value of the consideration transferred is below the fair value of the acquired business and below the fair value of the acquired identifiable net assets*</u>



<u>Scenario 3b: Higher value is received—*the fair value of the consideration transferred is below the fair value of the acquired business but above the fair value of the acquired identifiable net assets*</u>



<u>Scenario 3c: Higher value is received—*the fair value of the consideration transferred is below the aggregate fair value of the acquired business and expected synergies but above the fair value of the acquired business*</u>