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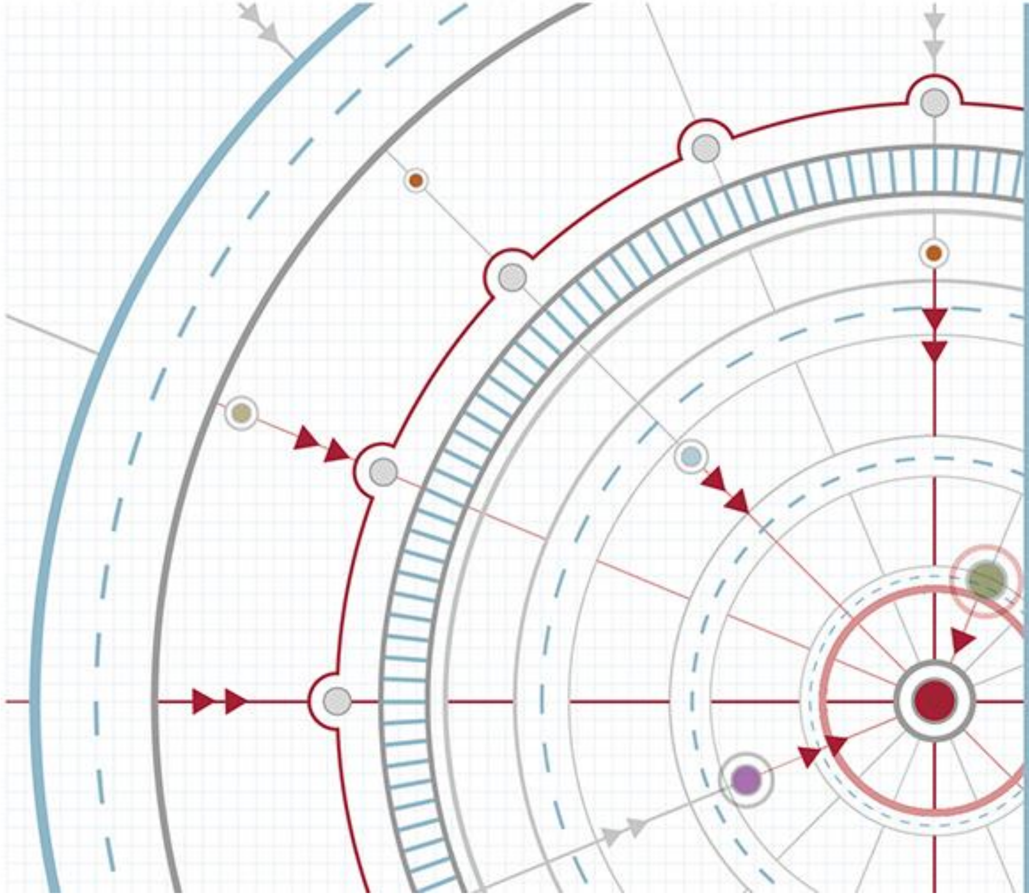

Business Combinations under Common Control (BCUCC)
Alternative measurement approaches

Accounting Standards Advisory Forum
July 2019
ASAF Agenda Paper 1A

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board or IFRS Foundation.

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Purpose of the session

The staff seek ASAF members' views on:

- updated analysis of ***when*** a current value approach and a predecessor approach should be applied to transactions within the scope of the project; and
- particular aspects of ***how*** a current value approach and a predecessor approach should be applied.

Content

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Project recap and update

Why we are doing the project

Issue

IFRS Standards **do not specify** how to account for business combinations under common control. As a result:

- Transactions are reported in different ways
- Lack of comparability

Objective

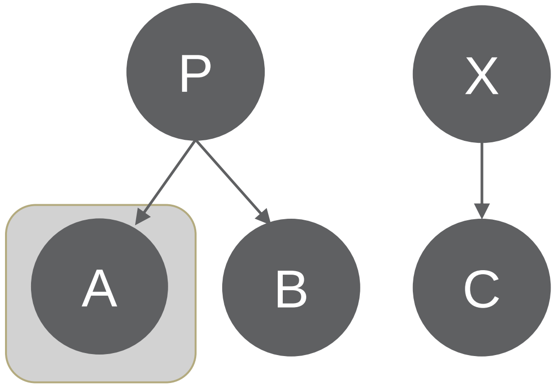
Develop **requirements** that would **improve comparability and transparency** of accounting for business combinations under common control and group restructurings by the receiving entity.

Business combinations under common control are common in practice, in particular in emerging economies (see Appendix A).

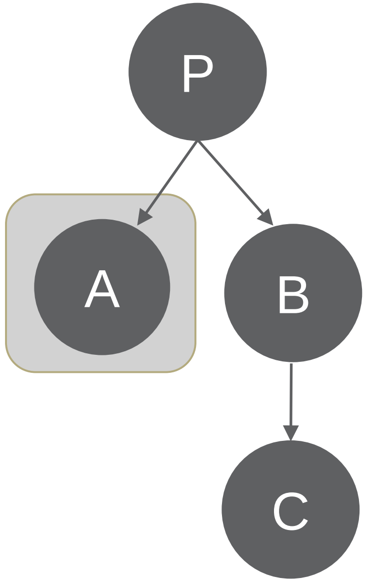
The issue: diversity in practice

Before

Scenario 1
Entity A and Entity C are controlled by different parties

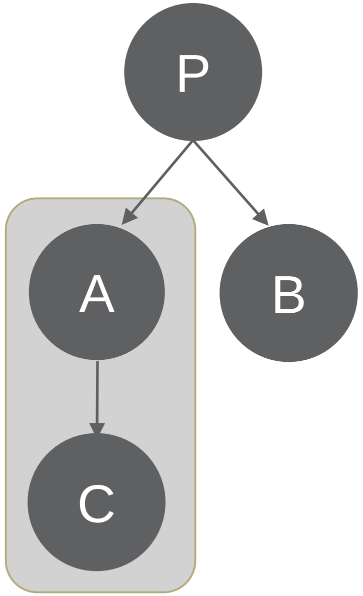


Scenario 2
Entity A and Entity C are controlled by Entity P



After

Entity A acquires Entity C



Reporting by Entity A

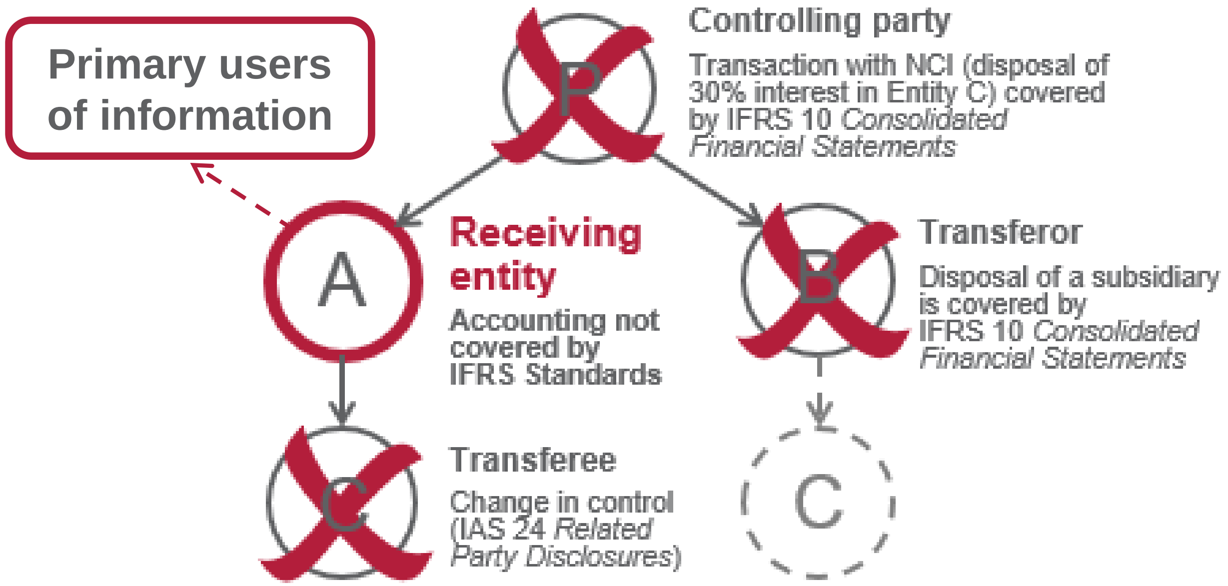
Scenario 1:

- The transaction is a **business combination**
- IFRS 3 *Business Combinations* requires the acquisition method
- Entity A reflects assets and liabilities of Entity C at **fair value**

Scenario 2:

- The transaction is a **business combination under common control**
- IFRS Standards do not specify how to account for such transactions
- Entity A reflects assets and liabilities of Entity C at **fair value** or at **predecessor carrying amounts**

Focus of the project



- The project addresses reporting by the **receiving entity** in a business combination under common control. It **does not consider reporting by the controlling party,** the transferor or the transferee. Reporting by those parties is already addressed in IFRS Standards.
- The project focuses on information needs of the **primary users** of the receiving entity's financial statements. Primary users include **existing and potential investors, lenders and other creditors**. Primary users can have different information needs.

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

Developing measurement approaches for BCUCC

Conceptual Framework for Financial Reporting

Existing requirements, practice and consultations

Measurement approaches being explored

A current value approach based on the acquisition method

Recognise acquired assets and liabilities at their fair values.

A predecessor approach

Recognise acquired assets and liabilities at their predecessor carrying amounts.

Considerations in the analysis

Nature of transactions

Useful information

Cost-benefit analysis

Complexity and accounting arbitrage

At its April 2019 meeting, the Board directed the staff to continue developing measurement approaches for transactions within the scope of the project based on the above considerations.

Summary of work performed by the staff

Summary of the work performed by the staff in exploring measurement approaches for transactions within the scope of the project

Review of national requirements and guidance, guidance published by accounting firms, recent consultation documents issued by national standard-setters, academic papers, reports, articles and other relevant literature

Outreach with national standard-setters, regulators, users and preparers, including meetings with members of the Capital Markets Advisory Committee (CMAC) who specialise in credit analysis

Review of the corporate credit methodology of two leading credit rating agencies

Desktop review of current reporting practice using financial search engine AlphaSense

Input from past discussions
Transactions that affect NCS

Topic	Input from past discussions
Applying a **current value approach** to transactions that affect non-controlling shareholders (NCS) of the receiving entity.	Many ASAF members supported the use of a current value approach when NCS are present in the receiving entity. Some ASAF members suggested that a current value approach should be applied only when NCS are substantive. A few ASAF members supported a predecessor approach in all circumstances. Most members of CMAC and the Global Preparers Forum (GPF) agreed that a current value approach would provide most useful information for NCS of the receiving entity. Some members emphasised that a current value approach should be applied only when NCS are 'substantive'. Some members, mainly preparers, argued that substantive NCS would be difficult to define and therefore a predecessor approach should be applied in all cases.
Applying a current value approach to **some but not all** transactions that affect non-controlling shareholders (for example, only when **equity instruments of the receiving entity are traded** in a public market).	Some ASAF members suggested that a current value approach should not be restricted to the circumstances when the receiving entity's equity instruments are traded in a public market. Some discussed an approach similar to the exemption from producing consolidated financial statements in IFRS 10 *Consolidated Financial Statements*, ie NCS would decide whether they require current value information. CMAC and GPF members did not discuss how to define 'substantive' NCS. CMAC members who commented on the distinction based on whether equity instruments of the receiving entity are traded in a public market agreed it is a viable approach. No CMAC members objected to that view.

Input from past discussions
Transactions that do *not* affect NCS

Topic	Input from past discussions
Transactions that do not affect non-controlling shareholders but affect **lenders and other creditors** of the receiving entity.	All ASAF and CMAC members who commented on the topic, including CMAC members specialising in credit analysis, agreed that the outcome of credit analysis would be largely unaffected by whether a current value approach or a predecessor approach is applied, and supported the use of a predecessor approach for transactions that affect lenders and other creditors of the receiving entity.
Transactions that do not affect non-controlling shareholders of the receiving entity but could affect **potential equity investors**, for example in an IPO.	All ASAF members who commented on the topic supported the use of a predecessor approach for transactions that affect potential equity investors in an IPO. Some members requested the staff to explore whether and how information needs of existing NCS and of potential equity investors in an IPO are different. CMAC members stated that potential equity investors in an IPO need predecessor historical information about the combined entities offered to the public to understand trends and assess prospects for future cash flows.
A **single approach** for all transactions in the scope of the project or **different approaches** for different transactions.	Most ASAF members who commented on the topic agreed that the Board could pursue different approaches for transactions that affect NCS in the receiving entity and those that do not. No ASAF members disagreed with the use of a predecessor approach for transactions that do not affect NCS. A few ASAF members advocated the use of a predecessor approach for all transactions within the scope of the project.

Board’s tentative decisions

No need to pursue a single approach for all transactions within the scope of the project

Transactions that affect non-controlling shareholders of the receiving entity

Start with the acquisition method for transactions that affect NCS and consider whether and how that approach should be modified, for example by requiring:

(1) additional disclosures;
(2) recognition of a contribution to equity instead of recognising a gain; or
(3) recognition of any *excess* consideration as a distribution instead of including that excess in goodwill.

Transactions that do *not* affect non-controlling shareholders

The Board could pursue:

(1) a current value approach for all or some transactions that affect NCS of the receiving entity; and

(2) 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 non-controlling shareholders.

Where we are today

Transactions that affect non-controlling shareholders of the receiving entity

Transactions that do *not* affect non-controlling shareholders of the receiving entity

A current value approach

A predecessor approach

A current value approach for at least ***some*** transactions that affect NCS

Transactions within the scope of the BCUCC project

A predecessor approach for all other transactions within the scope, including those that affect lenders and other creditors of the receiving entity and those undertaken in preparation for a sale, for example in an IPO.

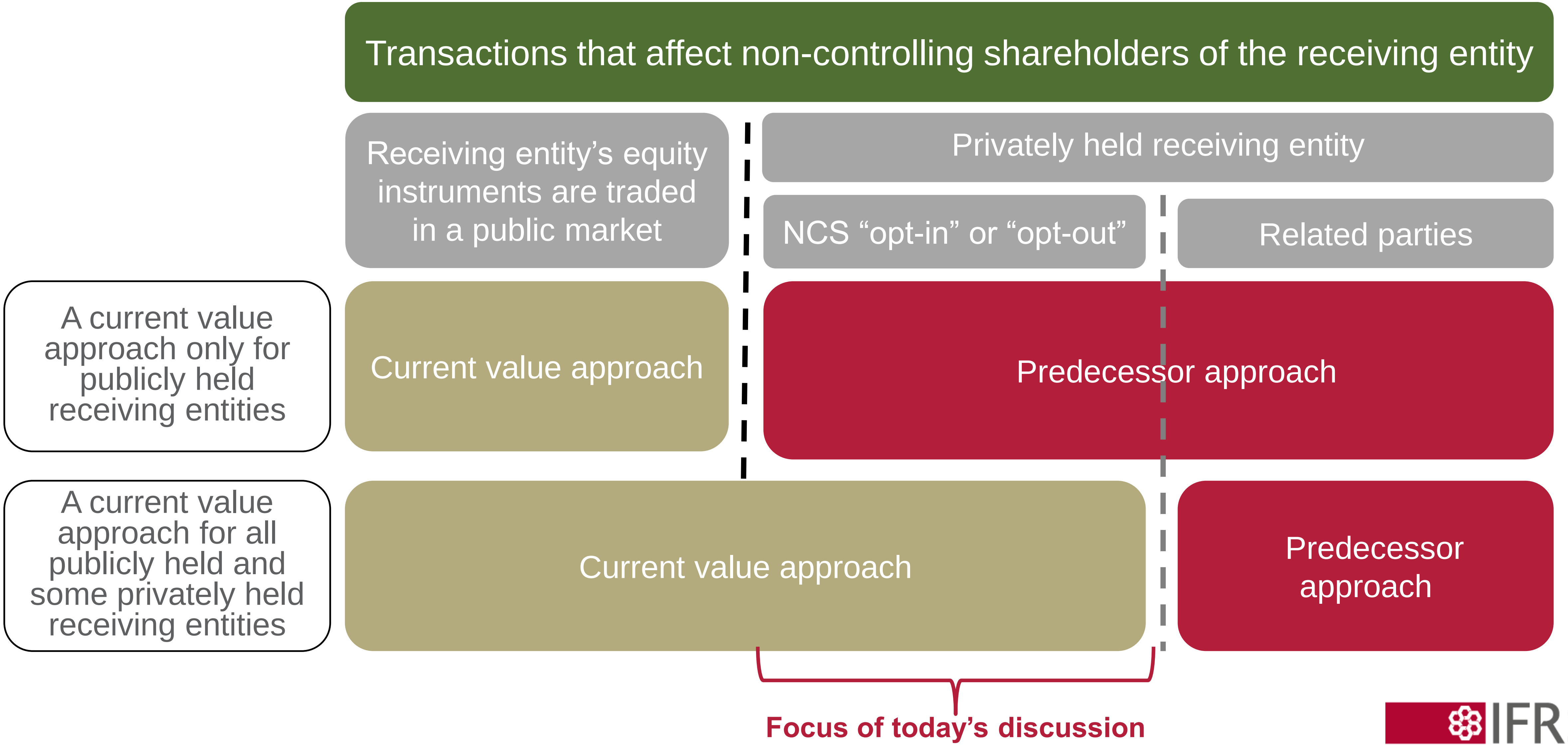
Further analysis of whether a current value approach is applied to ***all*** transactions that affect NCS and if not, how the distinction could be made

Next steps

Follow up on transactions that affect NCS	See Slides 16-17	Future IASB meeting	As stated on Slide 10, some ASAF members suggested that a current value approach should not be restricted to publicly held receiving entities and suggested an approach similar to the exemption from producing consolidated financial statements in IFRS 10.
Are transactions that do not affect NCS different from those that do?	See Slide 18 and AP1B	June 2019 IASB education session	
Information needs of potential equity investors, eg in an IPO	See Slide 19	Future IASB meeting	As stated on Slide 11, some ASAF members asked the staff to explore whether and how information needs of existing NCS and of potential equity investors are different.
How a current value approach should apply	See Slides 21-27	June 2019 joint CMAC and GPF meeting Future IASB meeting	The staff will provide a verbal update to ASAF members on the input received from CMAC and GPF members.
How a predecessor approach should apply	See Slides 28-38		

Follow up on *when* alternative approaches are applied

Follow up on transactions that affect NCS



Private NCS not related to the receiving entity

	NCS 'opt-in' for current value	NCS 'opt-out' from current value
How it works?	A predecessor approach is applied unless at least some NCS inform the receiving entity that they wish to receive current value information	A current value approach is applied unless all NCS do not object to receiving predecessor information
Pros	• Meets information needs of non-controlling shareholders • Similar to the existing exemption from presenting consolidated financial statements in para 4(a)(ii) of IFRS 10 • Does not create concerns over accounting arbitrage opportunities for the receiving entity	
Cons	• May be difficult to operationalize (eg questions may arise in relation to communication protocol and the time limit for NCS explicit consent or objection) • May not always effectively consider the cost constraint efficiently (eg a current value information provided when NCS hold a small percentage in the receiving entity)	

Transactions that do *not* affect NCS

The staff think that transactions that do not affect NCS are different from the ones that do

Transactions that affect non-controlling shareholders	Transactions that do *not* affect non-controlling shareholders
Acquisition of a residual interest (equity claim) in the transferred entities, or businesses, for non-controlling shareholders.	**No acquisition** of a residual interest (equity claim) in the transferred entities, or businesses, by non-controlling shareholders.
The identification of an acquirer **is possible** and **results in useful information** about the transaction.	The identification of an acquirer **may not be possible** or **may not result in useful information** about the transaction.

See Agenda Paper AP1B (June 2019 IASB Agenda Paper 23A) *Transactions that do not affect non-controlling shareholders*

Information needs of potential equity investors

	Non-controlling shareholders	Potential equity investors
Economic decisions	Hold or sell an existing investment	
	Place a new investment	Place a new investment
Assessing the prospects for future net cash inflows	Generally use accounting data as input to valuation models (DCF models, free cash flow yields, dividends and earnings discount models and multiplier models) to assess prospects for the future net cash inflows and total potential return of a share. Both existing and potential equity investors generally use the same valuation models.	
Assessing management's stewardship of the entity's economic resources	Need information to monitor management's stewardship and decide whether they can trust management with further capital.	

The staff's research indicates that both existing and potential equity investors focus on valuation in their decisions to hold, buy or sell and generally share the same information needs.

Follow up on *when* alternative approaches apply Questions for ASAF members

- **Question 1 *Transactions that affect non-controlling shareholders of the receiving entity***

In your view, should a current value approach be required only when a receiving entity's equity instruments are traded in a public market or should it be extended to privately held receiving entities? If the latter, do you support the opt-in or opt-out approach (see Slide 17) or a different approach for privately held entities (eg a quantitative threshold for percentage of NCS in the receiving entity)?

- **Question 2 *Transactions that do not affect non-controlling shareholders of the receiving entity***

Do you agree with the staff's observations in AP1B summarised on Slide 18 that transactions that do not affect non-controlling shareholders of the receiving entity are different from those that do? If not, why?

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How to apply a current value approach

Applying a current value approach
Start with the acquisition method

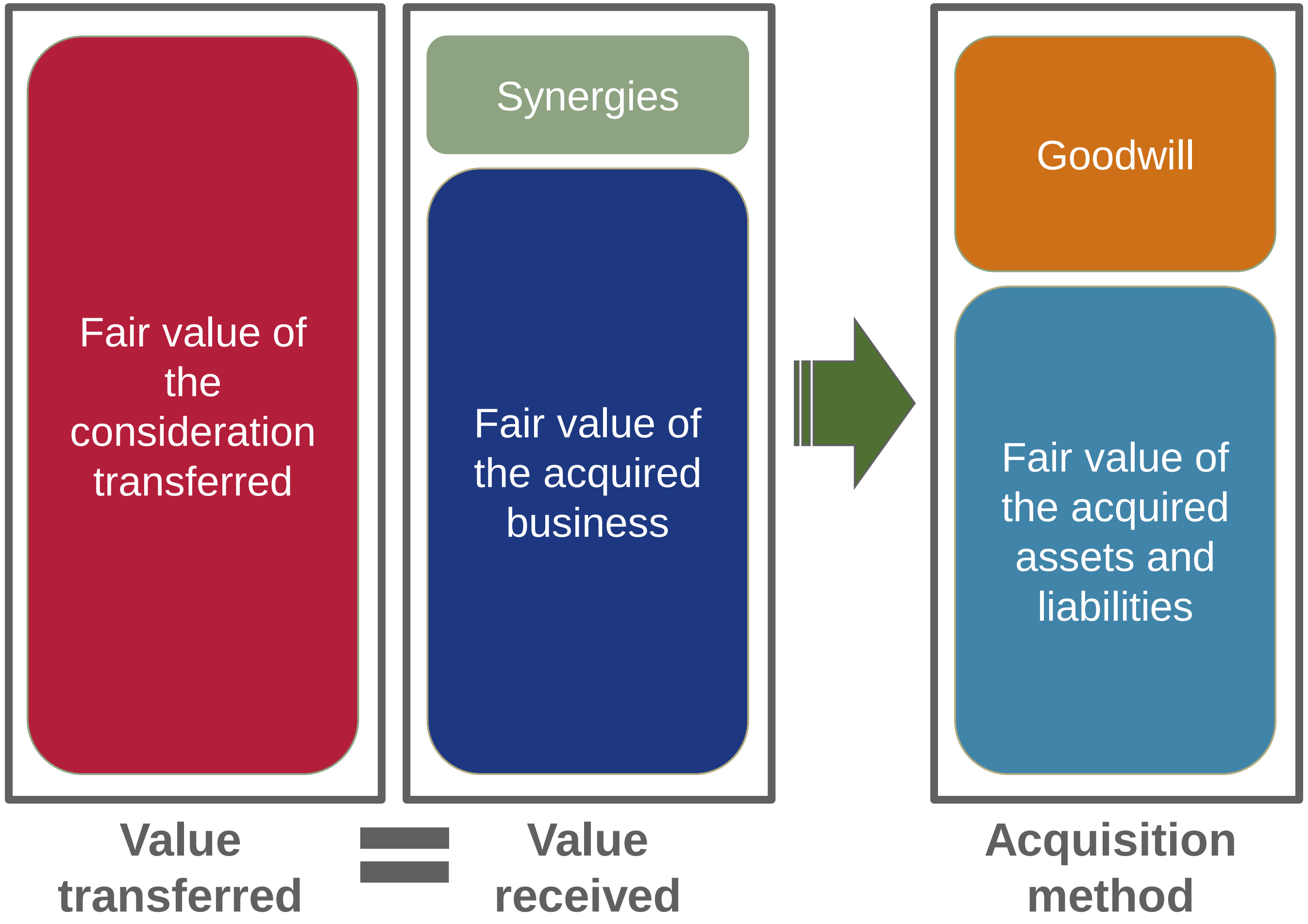
The Board is developing a current value approach based on the acquisition method for transactions that affect non-controlling shareholders of the receiving entity.

To the extent those transactions are similar to business combinations, similar information should be provided and to the extent they are different, different information should be provided.

Distribution	Disclosures	Contribution
If the consideration transferred exceeds the fair value of the acquired interest, recognise a distribution from the receiving entity's equity?	Provide additional disclosures to help users of the receiving entity's financial statements understand the effects of the transaction?	If the fair value of the acquired net assets exceeds the fair value of the consideration transferred, recognise a contribution to the receiving entity's equity instead of recognising a gain?

Applying a current value approach
Illustrating a business combination

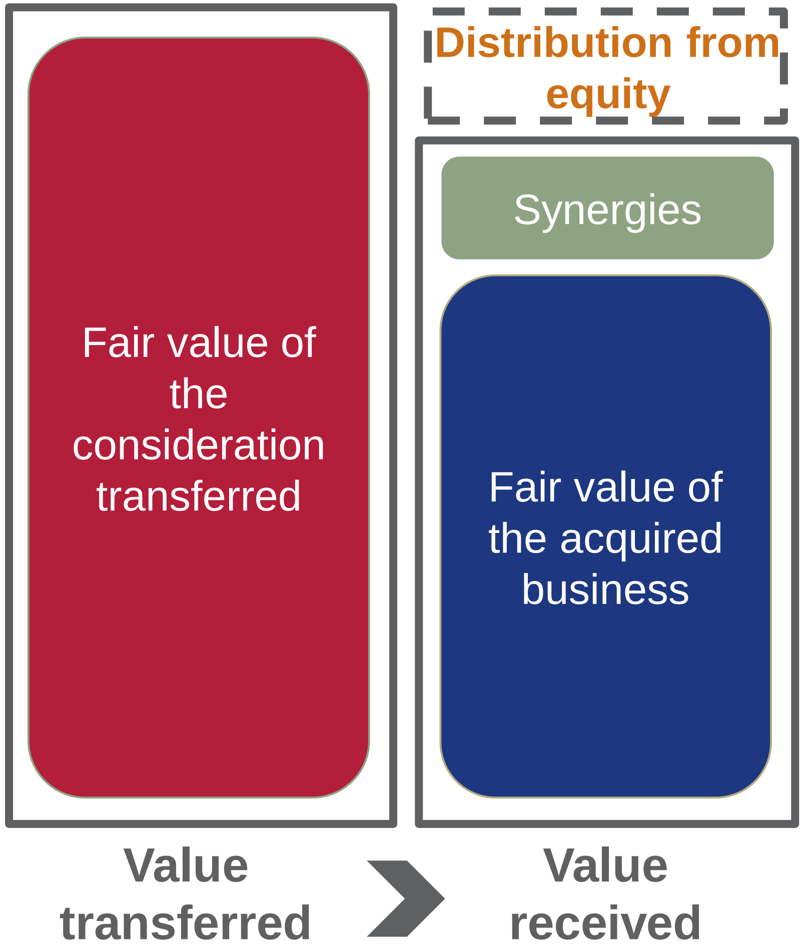
Consider a business combination from the perspective of the acquiring entity



- A business combination between independent parties is the result of negotiations and is expected to benefit the acquiring entity.
- Fair value of the consideration normally reflects fair value of the acquired business and synergies expected from the combination.
- Application of the acquisition method results in recognition of goodwill that comprises any goodwill internally generated by the acquired business and expected combination synergies.

Applying a current value approach
Illustrating a BCUCC

Consider a business combination under common control from the perspective of the receiving entity



- A business combination under common control may be directed by the controlling party and be undertaken to produce benefits for other entities within the group instead of the receiving entity.
- In some cases, regulations may be in place to require transactions that affect non-controlling shareholders in the receiving entity to be conducted at fair value. However, consideration may not always reflect fair value of the acquired business and synergies expected from the combination.
- Economically, any excess consideration over the fair value of the acquired business and expected combination synergies represents a distribution from the receiving entity's equity. The question arises how to provide information about any such excess consideration in the receiving entity's financial statements.

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

- 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

- 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*

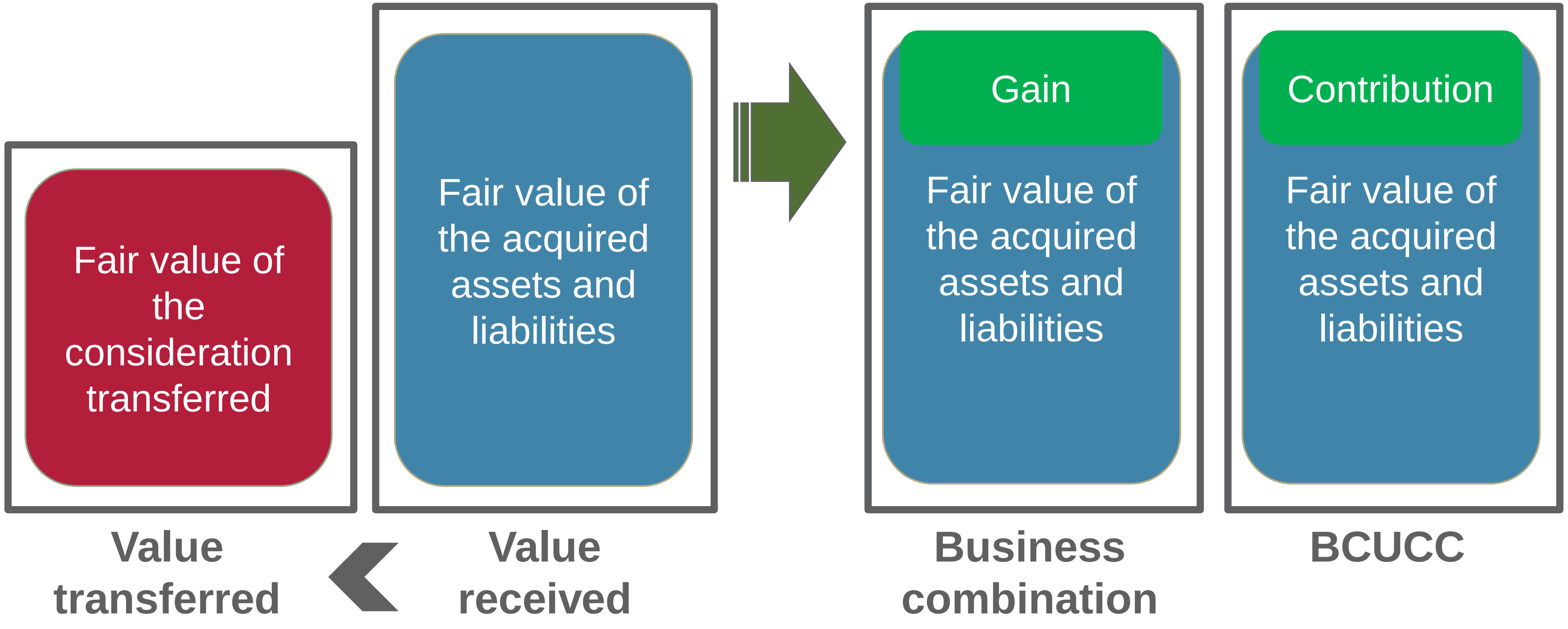
Both approaches to measuring a distribution are subject to measurement uncertainty.

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

- 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.



How to apply a current value approach Questions for ASAF members

A current value approach is considered for transactions that affect NCS

- **Question 3 *Regulation of the transaction price***

Are there legal requirements in your jurisdiction related to the transaction price in a BCUCC and if so, what are they and which transactions do they apply to (see Slide 24)?

- **Question 4 *Reporting a distribution***

Which alternative identified on Slide 25 for providing information about a distribution in a business combination under common control do you prefer, and why?

- **Question 5 *Reporting a contribution***

Do you agree that in a business combination under common control any excess of fair value of the acquired assets and liabilities over consideration transferred should be recognised as contribution to the receiving entity's equity (see Slide 26)?

How to apply a predecessor approach

Applying a predecessor approach

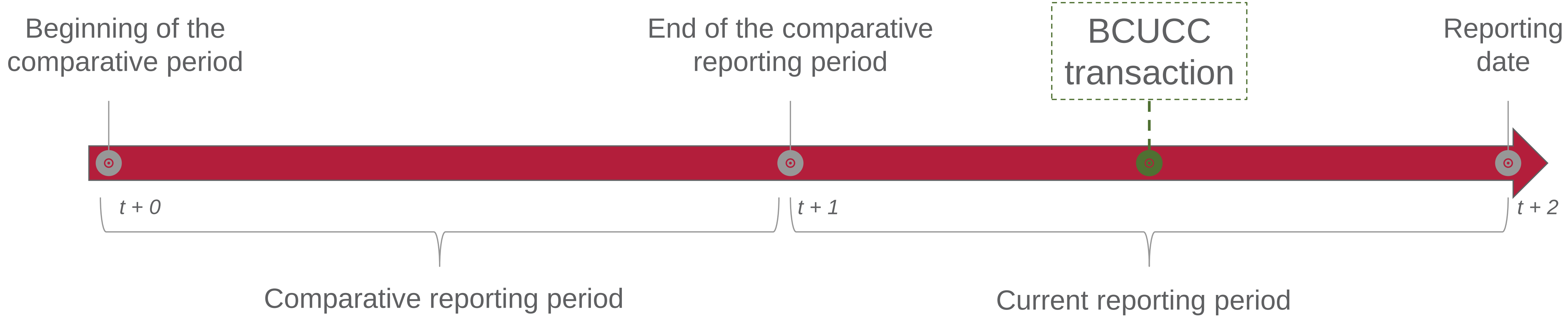
The Board decided that it could pursue a predecessor approach for transactions that do not affect non-controlling shareholders of the receiving entity.

Predecessor approach is a family of approaches. There is diversity in how a predecessor approach is applied in practice, in particular in relation to providing pre-combination information.

Pre-combination information	Predecessor carrying amounts	Presentation in equity
Entities reflect a business combination under common control from the date it occurred or as if the entities were combined from the beginning of the comparative period—or from a date when entities were first under common control, if later.	Entities recognise acquired assets and liabilities at their predecessor carrying amounts. In some cases, the carrying amounts at the transferred entities are used and in other cases the carrying amounts at the controlling party. Applying the reporting entity concept, the staff expect to recommend the former.	Any difference between the consideration transferred and the predecessor carrying amounts of the acquired assets and liabilities is recognised in equity. Presentation in equity is generally not prescribed by the Board.

Focus of today's discussion

Current practice on pre-combination information



Diversity in practice in providing pre-combination information

Alternative A

- Acquired assets, liabilities and results of operations are recognised from **the beginning of the comparative period.**
- Pre-combination information is provided for all combining entities.

Alternative B

- Acquired assets, liabilities and results of operations are recognised **from the date of the transaction**.
- Pre-combination information is provided only for the receiving entity.

Does the previous reporting entity continue?

- The staff think that Alternative A and Alternative B could result in the same information depending on whether the transaction results in (1) continuation of a previous reporting entity in a new legal form; or (2) a new set of assets, liabilities and results of operations reported together for the first time.

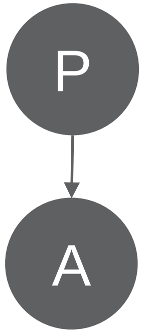
Providing pre-combination information

Continuation of a previous reporting entity		**A new set of net assets put together**	
Alternative A	**Alternative B**	**Alternative A**	**Alternative B**
Previous reporting entity		All combining entities/ businesses	Receiving entity only
Scenarios 1a and 2a on Slides 32 and 34		Scenarios 1b, 2b and 2c on Slides 33, 35 and 36	

Pre-combination information Scenario 1a

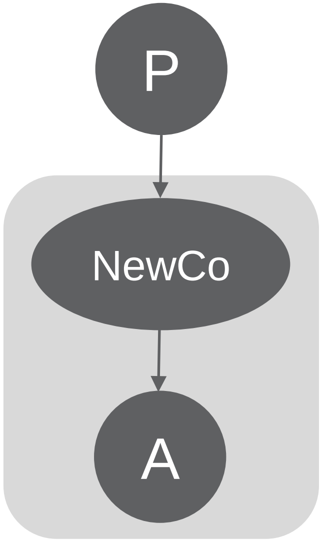
Before BCUCC

- Parent P controls and wholly owns Entity A.
- **Entity A is a reporting entity**.



After BCUCC

- NewCo is formed to issue shares to Parent P in exchange for all shares of Entity A.
- NewCo is a reporting entity.



Analysis

NewCo represents a **continuation** of Entity A.

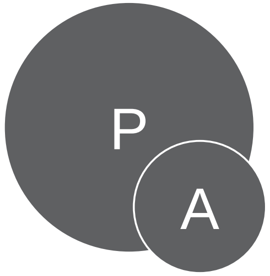
Alternative A
NewCo will provide pre-combination information for Entity A (from Entity A's FS).

Alternative B
NewCo will provide pre-combination information for Entity A (from Entity A's FS).

Pre-combination information Scenario 1b

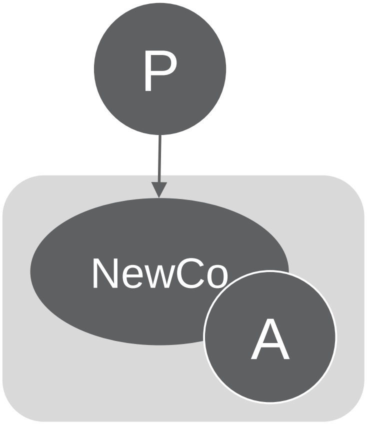
Before BCUCC

- Entity P controls and owns Business A.
- **Business A is NOT a reporting entity**.



After BCUCC

- NewCo is formed to issue shares to Entity P to acquire all assets and liabilities of Business A from Entity P.
- NewCo is a reporting entity.



Analysis

A **new set** of assets, liabilities and results of operations are reported together for the **first time** (because Business A is not a reporting entity).

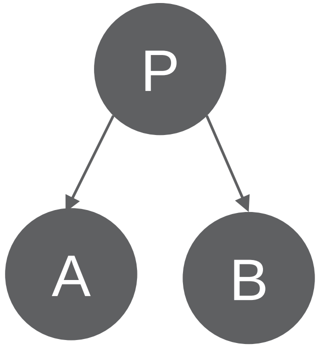
Alternative A
NewCo will provide carveout pre-combination information about Business A.

Alternative B
NewCo will not provide pre-combination information about Business A.

Pre-combination information Scenario 2a

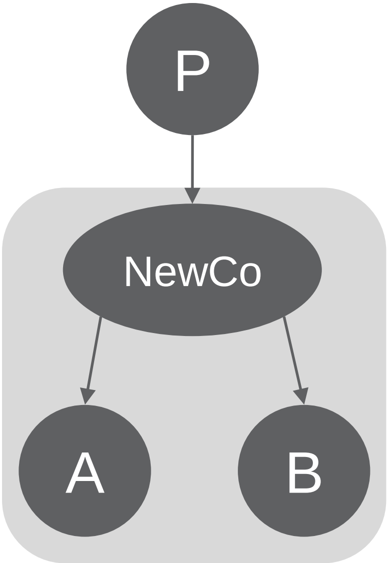
Before BCUCC

- Parent P is a holding company. It controls and wholly owns Entities A and B. **Investments in Entities A and B are Parent P's only assets**.
- Parent P is a reporting entity and presents consolidated financial statements.



After BCUCC

- NewCo is formed to issue shares to Parent P in exchange for all shares of Entities A and B.
- NewCo is a reporting entity.



Analysis

NewCo represents a **continuation** of Parent P as investments in Entities A and B are Parent P's only assets and Parent P is a reporting entity that presents consolidated FS.

Alternative A

NewCo will provide pre-combination information for both Entities A and B (from Parent P's consolidated FS).

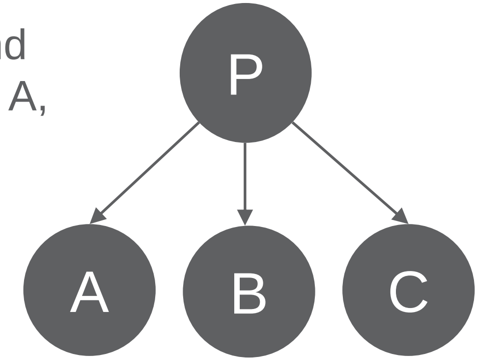
Alternative B

NewCo will provide pre-combination information for both Entities A and B (from Parent P's consolidated FS).

Pre-combination information Scenario 2b

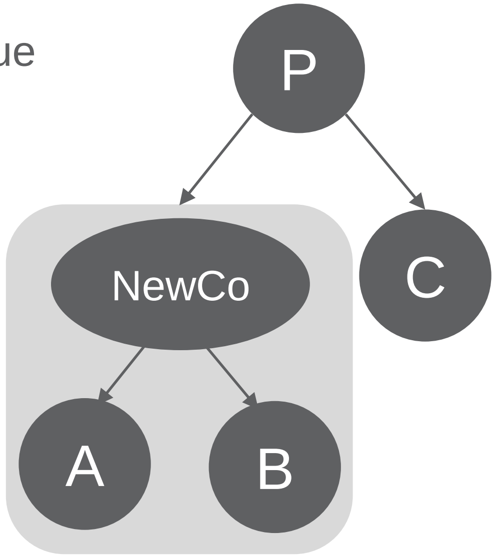
Before BCUCC

- Parent P controls and wholly owns Entities A, B and C.



After BCUCC

- Newco is formed to issue shares to Parent P in exchange for all shares of Entities A and B.
- NewCo is a reporting entity.



Analysis

A **new set** of assets, liabilities and results of operations are reported together for the **first time** (as Entities A and B are not Parent P's only assets).

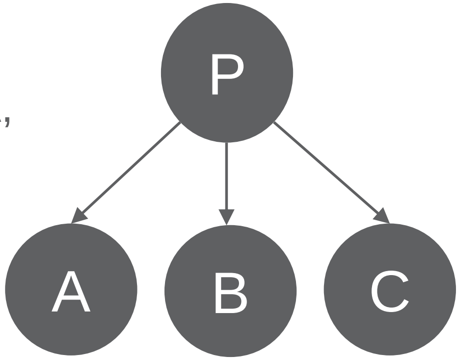
Alternative A
NewCo will provide combined pre-combination information for both Entities A and B.

Alternative B
NewCo will provide pre-combination information only for the receiving entity (NewCo, Entity A or Entity B).

Pre-combination information Scenario 2c

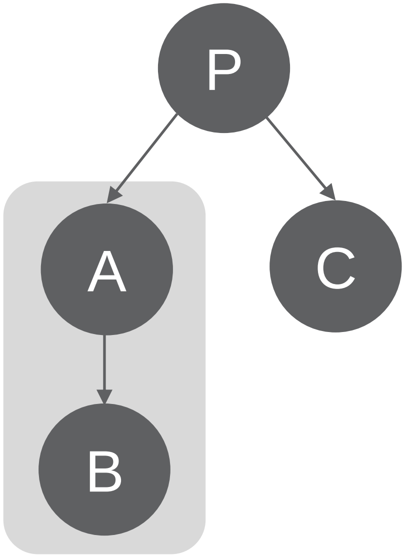
Before BCUCC

- Parent P controls and wholly owns Entities A, B and C.



After BCUCC

- Entity A issues shares to Parent P in exchange for all shares of Entity B.
- Entity A is a reporting entity.



Analysis

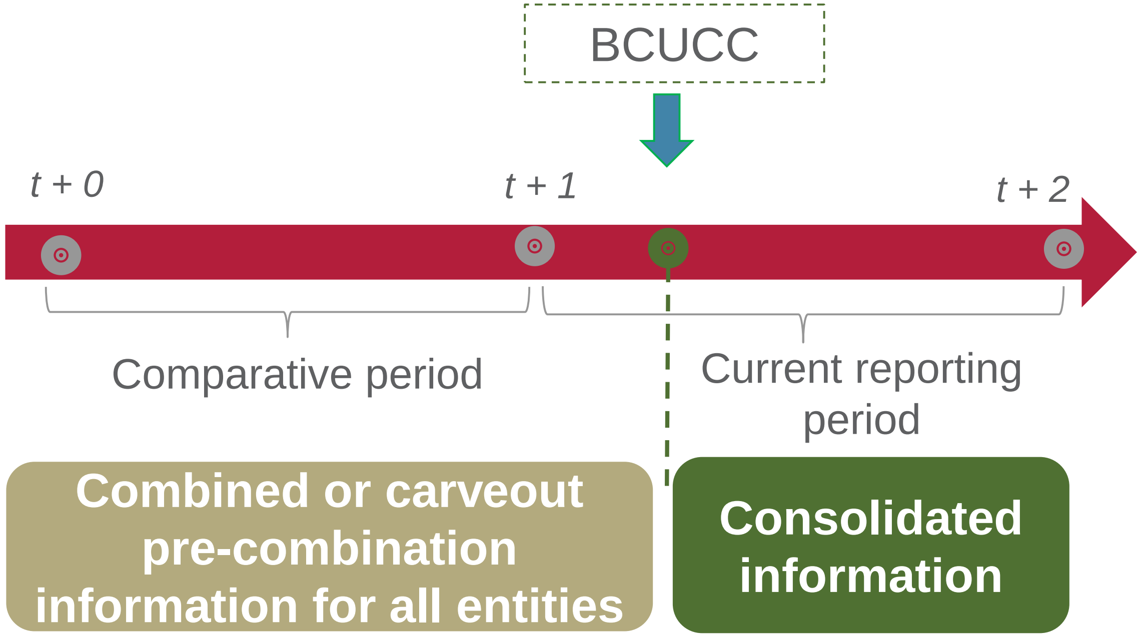
Similar to Scenario 2b, a **new set** of assets, liabilities and results of operations are reported together for the **first time**.

Alternative A
Entity A will provide combined pre-combination information for both Entities A and B.

Alternative B
Entity A will only provide pre-combination information for the receiving entity.

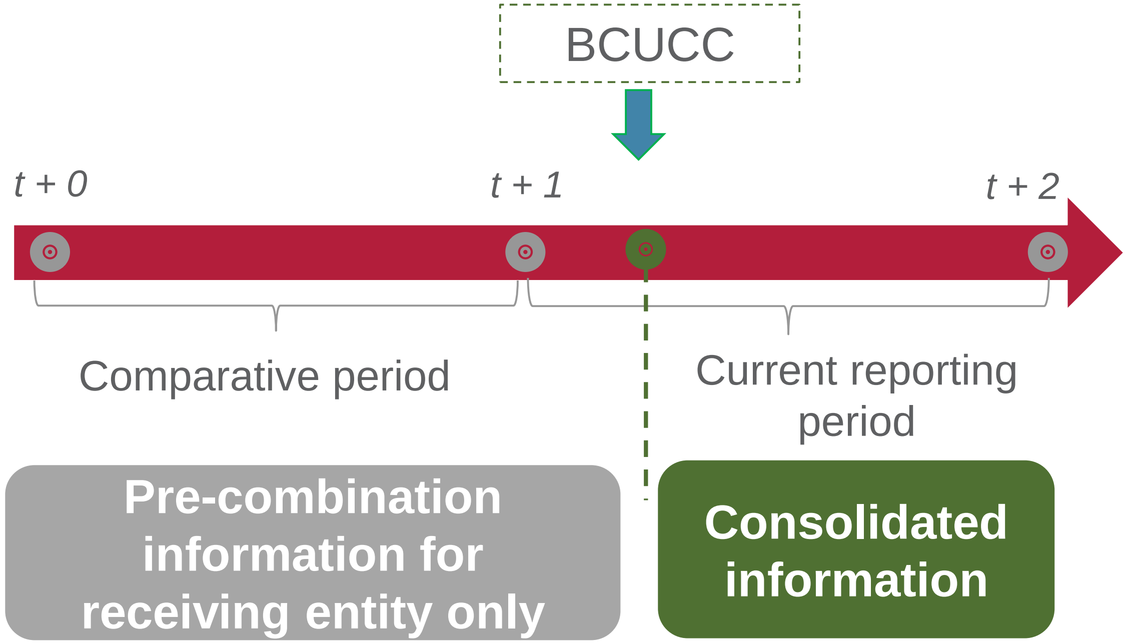
Bringing it all together

Alternative A



- Pre-combination information is always provided for all combining entities.
- Combined financial statements are addressed in para 3.12 of the *Conceptual Framework* (see Appendix B), carveout financial statements are not addressed.
- Preparing combined and particularly carveout information (see Scenario 1b on slide 33) can be difficult and involve judgements and estimates.

Alternative B



- Pre-combination information for all combining entities is only provided if it was previously reported. If not, it is only provided for the entity identified as the receiving entity.
- Identifying the receiving entity in a way that provides useful information can be difficult in some cases.

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How to apply a predecessor approach Questions for ASAF members

A predecessor approach is considered for transactions that do *not* affect NCS

- **Question 6 *Pre-combination information***

Which alternative identified on Slide 37 for providing pre-combination information do you prefer, and why?

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Appendix A

Overview of the staff's desktop review

- The staff performed a desktop review of business combinations under common control.
- We used the financial search engine, AlphaSense, to search for business combinations under common control in entities' annual reports filed between 1 January 2018 – 31 March 2019. The search was limited to annual reports written in English and would identify the existence of business combinations under common control only if presented and/or disclosed separately in annual reports.
- The staff identified more than 250 business combinations under common control. These transactions are most prevalent in emerging economies. Developed markets account approximately for a quarter of the transactions reviewed by the staff.

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Appendix B

Extract from the *Conceptual Framework*

The reporting entity

(…)

3.12 If a reporting entity comprises two or more entities that are not all linked by a parent-subsidiary relationship, the reporting entity's financial statements are referred to as 'combined financial statements'.

3.13 Determining the appropriate boundary of a reporting entity can be difficult if the reporting entity:

(a) is not a legal entity; and

(b) does not comprise only legal entities linked by a parent-subsidiary relationship.

3.14 In such cases, determining the boundary of the reporting entity is driven by the information needs of the primary users of the reporting entity's financial statements. Those users need relevant information that faithfully represents what it purports to represent. Faithful representation requires that:

(a) the boundary of the reporting entity does not contain an arbitrary or incomplete set of economic activities;

(b) including that set of economic activities within the boundary of the reporting entity results in neutral information; and

(c) a description is provided of how the boundary of the reporting entity was determined and of what constitutes the reporting entity.

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