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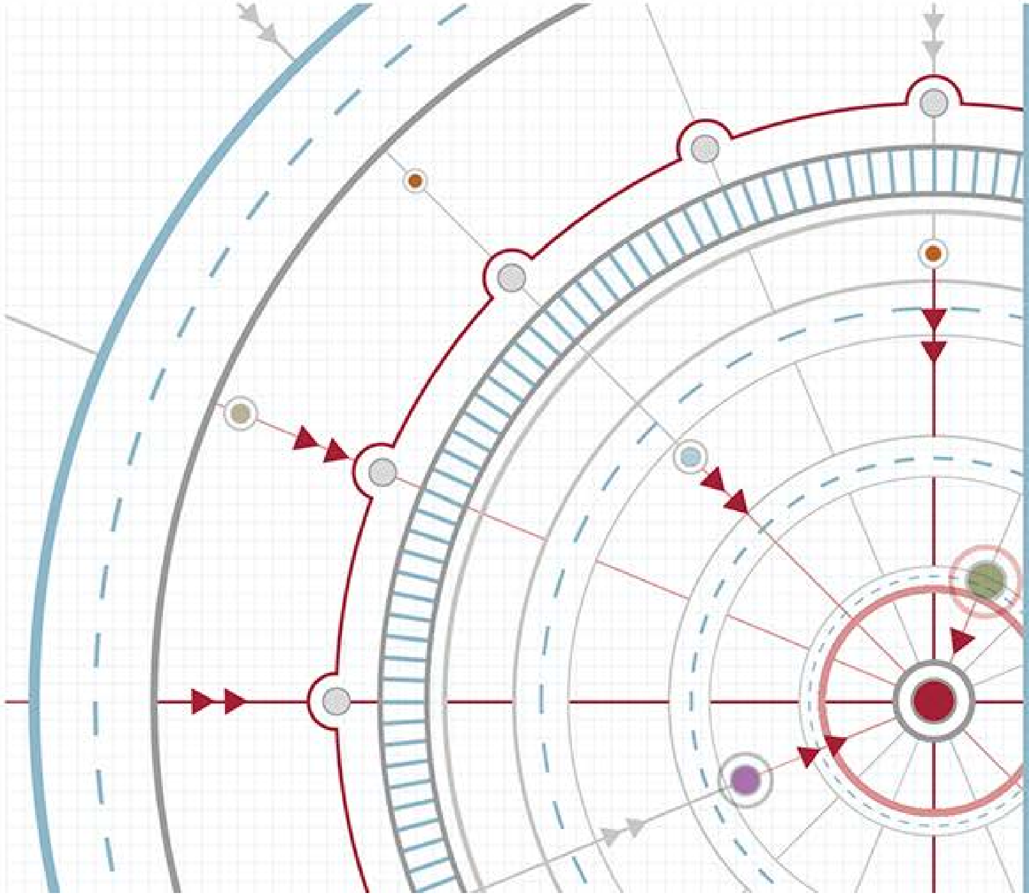
Agenda Paper 5



Business Combinations under Common Control (BCUCC)

Joint CMAC and GPF meeting
June 2019

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Purpose of the session

- At its April 2019 meeting, the Board continued its discussions on when a current value approach and a predecessor approach should be applied to transactions within the scope of the project, including those that affect non-controlling shareholders and those between wholly owned entities. This session focuses on *how* those approaches could be applied.
- The staff seek CMAC and GPF members' views on the benefits and challenges of:
  - identifying and accounting for any distribution from equity when applying a current value approach; and
  - providing comparative information for combining entities when applying a form of a predecessor approach.

Content

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Project recap and update

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About the BCUCC project

The issue

Diversity in practice in the financial reporting of certain types of business combinations: IFRS Standards set out accounting requirements for business combinations (M&As) but do not specify how to account for combinations of companies or businesses controlled by the same party before and after the transaction. As a result, companies report such transactions in different ways. This makes it difficult for investors and regulators to understand and compare the effects of those transactions on companies' financial positions and performances. It also makes it difficult to compare the effects of business combinations and business combinations under common control.

The objective

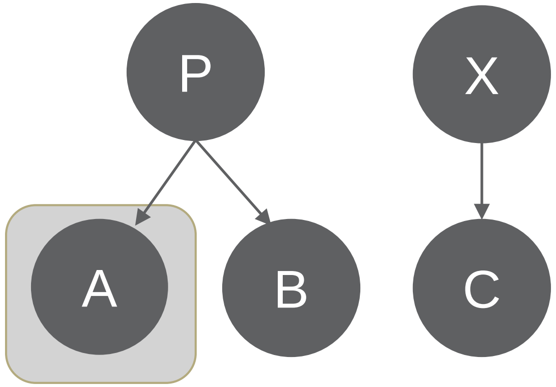
Develop accounting requirements for BCUCC: The Board is looking to develop requirements that would improve comparability and transparency of accounting for business combinations under common control and result in useful information about such transactions at a cost justified by the benefits of that information.

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

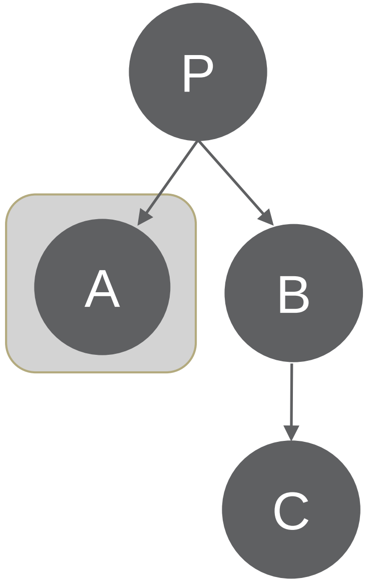
Illustrating the issue

Before

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

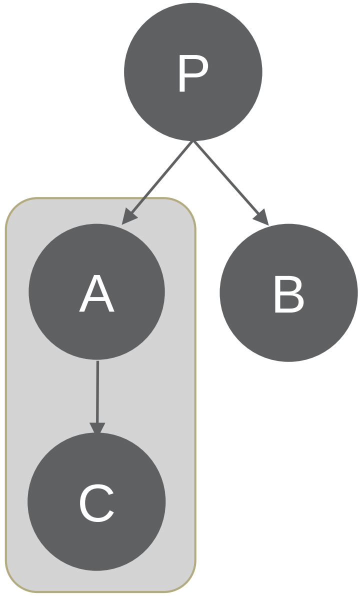


Scenario 2
Entity A and Entity C are controlled by Entity P



After

Entity A acquires Entity C

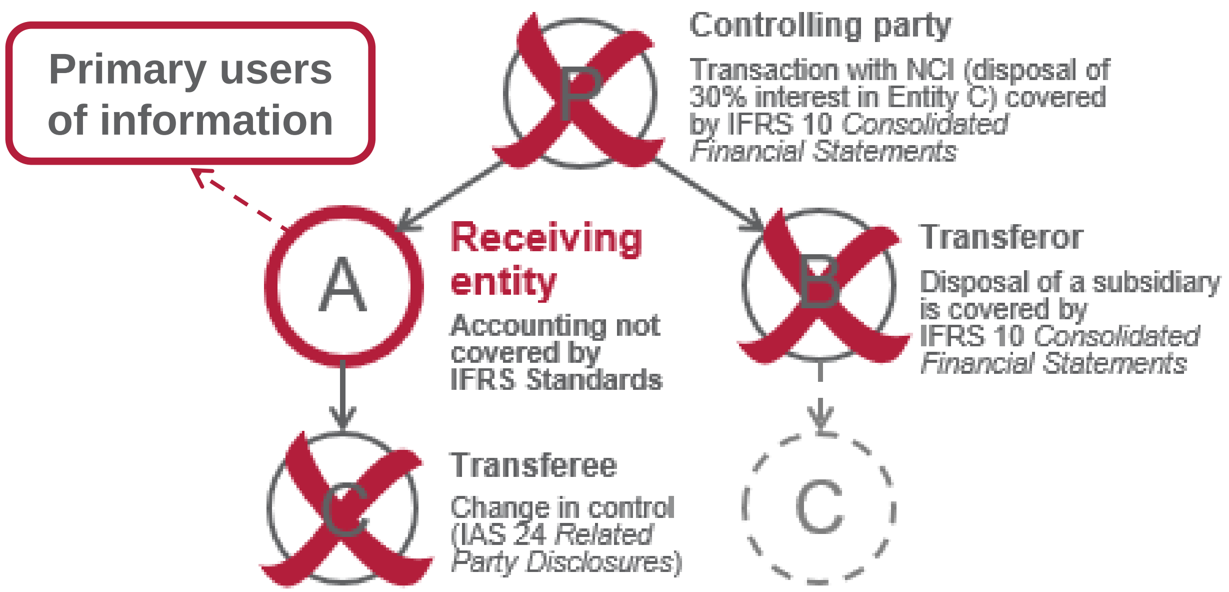


Reporting by Entity A

- 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**

- 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 on the receiving entity



- 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

Input from past discussions with CMAC and GPF

Perspectives on what approach is most appropriate vary for types of primary users

Non-controlling shareholders	A **current value approach** based on the acquisition method would provide useful information to non-controlling shareholders. However, such an approach involves measurement uncertainly and can be costly to apply. Accordingly a current value approach could be appropriate for some but not all transactions that affect non-controlling shareholders and a form of a predecessor approach could be appropriate for other such transactions.
Controlling party	A form of a **predecessor approach** would best meet information needs of the controlling party in BCUCC at a cost justified by the benefits of that information.
Potential equity investors	Prospective equity investors in an IPO need **predecessor historical information** about the combined entity offered to the public to understand trends and assess prospects for cash flows to the entity.
Lenders and other creditors	The result of credit analysis is **largely unaffected** by whether a current value approach or a form of a predecessor approach is applied to transactions that affect lenders and other creditors. Current value information is useful but nevertheless secondary to the focus on cash flows in credit analysis.

Board’s tentative decisions

The Board’s tentative decisions to date reflect input received from CMAC and GPF members, in particular the perspectives on what approach is most appropriate for different types of primary users.

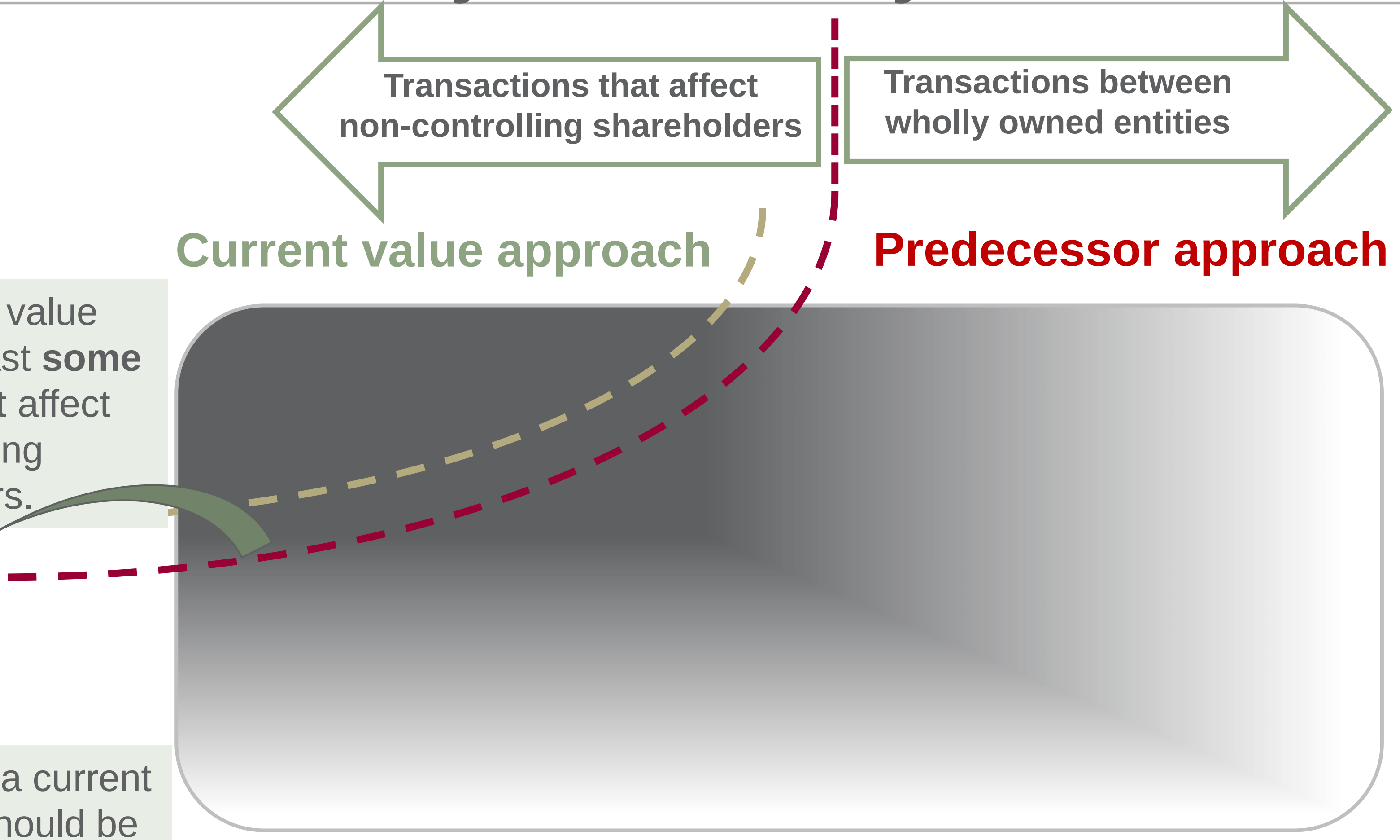
- The Board has tentatively decided to start with the acquisition method for transactions that affect **non-controlling shareholders** and consider whether and how that approach should be modified, for example by requiring:
  (1) additional disclosures;
  (2) recognition of a contribution to equity instead of recognising a gain; or
  (3) recognition of any *excess* consideration as a distribution instead of including that excess in goodwill (see slide 17).

Board’s tentative decisions (cont’d)

The Board’s tentative decisions to date reflect input received from CMAC and GPF members, in particular the perspectives on what approach is most appropriate for different types of primary users.

- The Board has tentatively decided that it need not pursue a single approach for transactions that affect non-controlling shareholders and transactions between wholly owned entities, including those that affect **lenders and other creditors**. Specifically, the Board could pursue:
  (1) a current value approach for all or some transactions that affect non-controlling shareholders in 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 in the analysis



Transactions within the scope of the BCUCC project

Apply a current value approach to at least **some** transactions that affect non-controlling shareholders.

Further analysis if a current value approach should be applied to **all** transactions that affect non-controlling shareholders and if not, how the distinction could be made.

Apply a predecessor approach to transactions between **wholly owned entities**, including those that affect lenders and other creditors and those undertaken in preparation for a sale, for example in an initial public offering.

Breakout session guidelines

- During the 40 minute breakout, we expect the groups to cover the following topics:

20 minutes

- Applying a current value approach (slides 14–19)
  - the staff seek views from CMAC and GPF members on which alternative for reporting a distribution applying a current value approach to develop further

20 minutes

- Applying a predecessor approach (slides 20–31)
  - the staff seek views from CMAC and GPF members on the way forward for reporting comparative information applying a predecessor approach

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Applying a current value approach

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A recap of the acquisition method

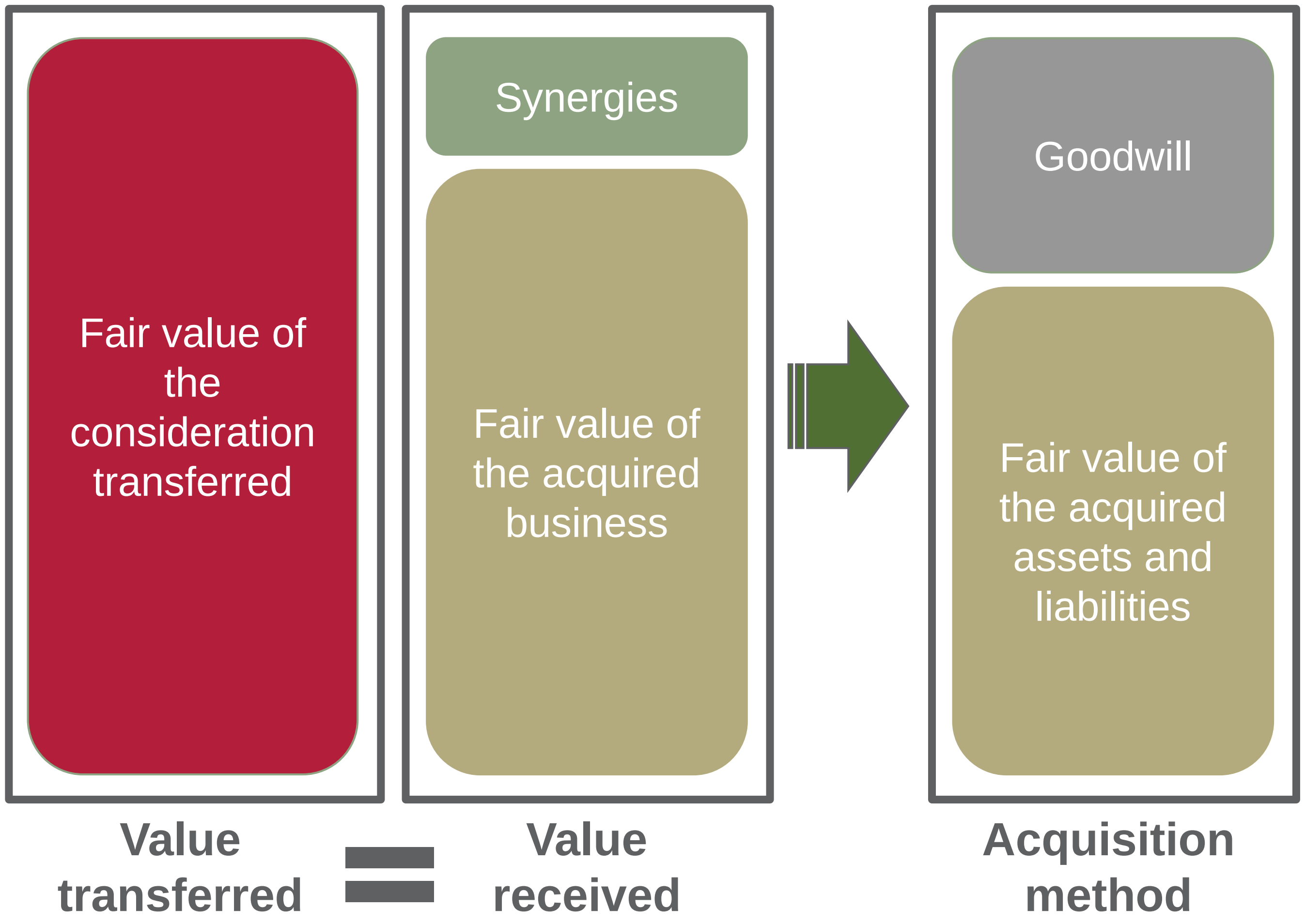
As stated on slide 10, the Board directed the staff to start with the acquisition method set out in IFRS 3 in developing a current value approach for transactions that affect non-controlling shareholders.

Acquisition method

- Assets and liabilities acquired in a business combination are recognised at their acquisition-date fair values.
- Goodwill is measured as the difference between consideration transferred and acquired assets and liabilities.
- In a bargain purchase, consideration is less than fair value of acquired assets and liabilities. In such cases, a gain is recognised.
- Any amounts transferred that are not part of the consideration for the acquired interest (eg payments for employee services) must be identified and accounted for separately.

Illustrating a business combination

Consider a business combination from the perspective of the acquiring entity



Economics of the transaction

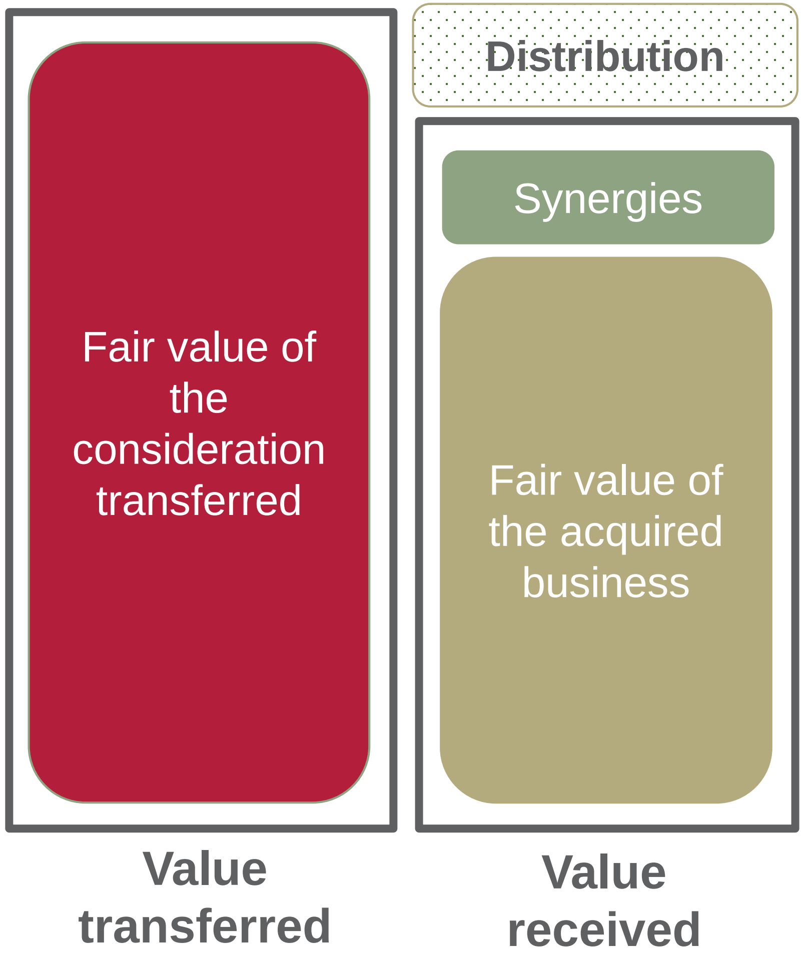
- A business combination between independent parties is the result of **negotiations** and is expected to **benefit the acquiring entity**.
- Fair value of the consideration normally reflects **fair value of the acquired business** and **synergies** expected from the combination.

Financial reporting of the transaction

- Application of the acquisition method results in recognition of goodwill that comprises any goodwill internally generated by the acquired business and expected combination synergies.

Illustrating a BCUCC—distribution

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



Economics of the transaction

- Unlike a business combination illustrated on slide 16, 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.
- Fair value of the consideration in a BCUCC **may not reflect fair value of the acquired business** and **synergies** expected from the combination.

Financial reporting of the transaction

- Economically, any excess of the consideration transferred over the fair value of the acquired business and expected combination synergies represents a **distribution from the receiving entity's equity**.
- We seek views on how to provide information about such a distribution in the receiving entity's financial statements.

Information about a distribution in a BCUCC

- The staff have identified two broad alternatives to providing information about a distribution in a BCUCC in the receiving entity's financial statements.

Recognition

or

Disclosure

- 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.

- Instead of being recognised separately, the distribution is subsumed within goodwill that is subject to subsequent impairment tests.
- Notes to financial statements provide information about the distribution to help users evaluate the transaction.

Question 1 for the breakout session

The staff seek views from CMAC and GPF members on which alternative for reporting a distribution applying a current value approach to develop further (see slide 18).

Fact pattern	The transaction is a business combination under common control that affects non-controlling shareholders for which the consideration transferred exceeds the fair value of the acquired interest (ie it results in a distribution).
Users	Which of the two alternatives would result in more useful information, and why: 1. measuring and recognising the distribution despite the measurement uncertainty involved; or 2. subsuming the distribution within goodwill and providing information about the distribution in the notes?
Preparers	Do you foresee challenges in applying any of the alternatives to reporting a distribution in a business combination under common control that affects non-controlling shareholders set out on slide 18? If so, what are those challenges and how could they be alleviated?

Applying a predecessor approach

Introducing a predecessor approach

The Board decided that it could pursue a current value approach for transactions that affect non-controlling shareholders and a predecessor approach for transactions between wholly owned entities.

Predecessor approach

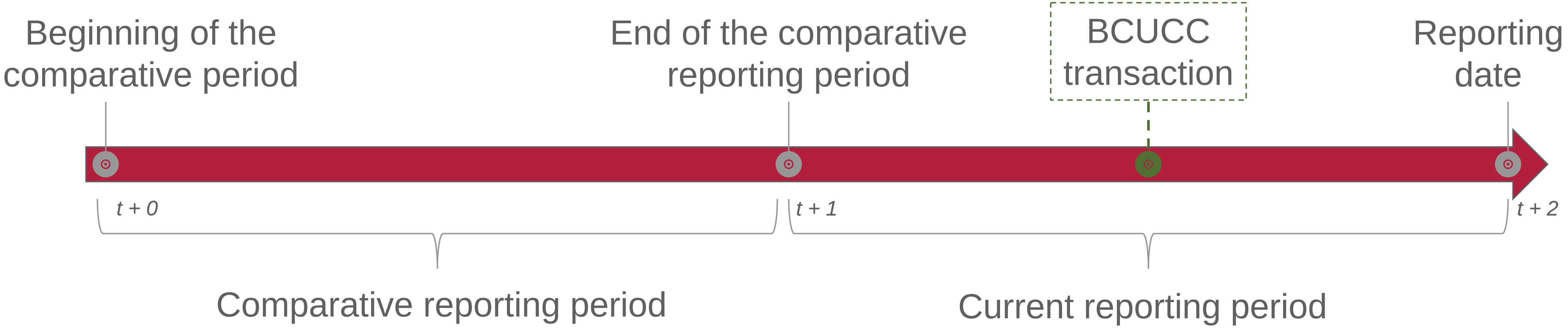
Predecessor approach is a family of approaches. There is diversity in how a predecessor approach is applied in practice, in particular in relation to providing comparative information.

Applying a predecessor approach, the acquired assets and liabilities are recognised at their predecessor carrying amounts.

Any difference between the consideration transferred and the predecessor carrying amounts of the acquired assets and liabilities is recognised in equity. No goodwill or a gain on a bargain purchase is recognised.

In providing comparative information, entities reflect a business combination under common control from the date it occurred or as if the combining entities or businesses have been combined from the beginning of the comparative period (see slide 22).

Illustrating current practice



Diversity in providing comparative information

View A Retrospective accounting	Entities are combined from the beginning of the comparative period. Acquired assets, liabilities and results of operations are recognised from the beginning of the comparative period. **Comparative information is provided for all combining entities**.
View B Prospective accounting	Entities are combined from the date of the transaction (similar to the acquisition method). Acquired assets, liabilities and results of operations are recognised from the date of the transaction. **Comparative information is provided only for the receiving entity**.

Comparative information in a BCUCC

Nature of transactions to which a predecessor approach would apply

- In principle, the Board is considering a predecessor approach for **transactions between wholly owned entities** (see slide 12).
- Arguably, these transactions are different from business combinations under common control that affect non-controlling shareholders.
  - This is because there is **no 'acquisition'** at the level of shareholders of the receiving entity.
  - The transaction changes the legal structure within the group but the economic interest in the underlying assets and liabilities continues unchanged.
  - Accordingly, the staff think that providing comparative information for all combining entities from the beginning of the comparative period (View A) would best reflect the economics of the transaction.
- However, the staff note that providing such information could be difficult in some cases and could involve judgement and estimates (see scenarios on slides 26 and 28–29).

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Comparative information in a BCUCC (cont'd)

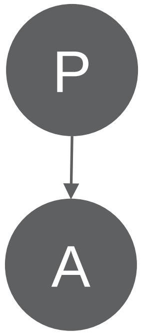
Continuation of a reporting entity vs a new set of assets, liabilities and results of operations

- Some transactions between wholly owned entities can be seen as a **continuation** of a previous reporting entity in a new legal form (see slides 25 and 27).
  - In those cases, comparative information under both View A and View B will be that of the previous reporting entity.
- Other transactions between wholly owned entities result in **a new set** of assets, liabilities and results of operations being reported together for the first time (see slides 26 and 28–29).
  - In those cases, comparative information under View A will be combined (or carveout) information for all combining entities or businesses and under View B it will be that of the receiving entity.

Comparative information Scenario 1a

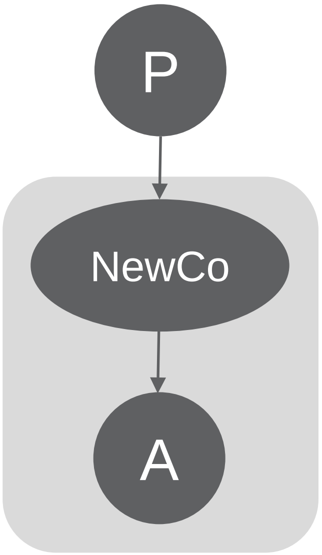
Before BCUCC

- 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

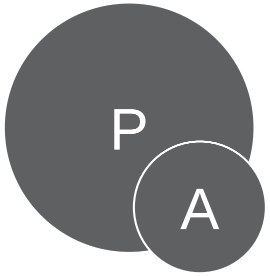
NewCo can be seen as a continuation of Entity A. NewCo reflects the transaction from the beginning of the comparative period.

- **Conclusion:** Comparative information is that of Entity A under both View A and View B.

Comparative information Scenario 1b

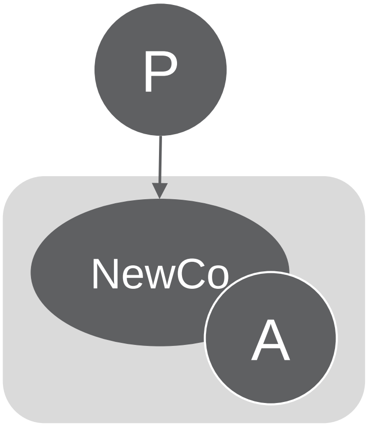
Before BCUCC

- 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

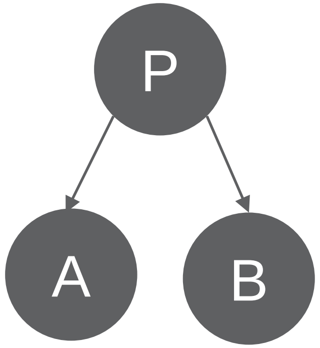
NewCo is NOT a continuation of a previous reporting entity because Business A was not a reporting entity before the combination.

- **Conclusion under View A:** NewCo will reflect the combination from the beginning of the comparative period and will provide carveout historical information about Business A. Providing carveout historical information is currently not addressed in the IFRS Standards and would involve judgements and estimates.
- **Conclusion under View B:** NewCo will reflect the combination prospectively from the date of the transaction. No historical information for Business A will be provided.

Comparative information Scenario 2a

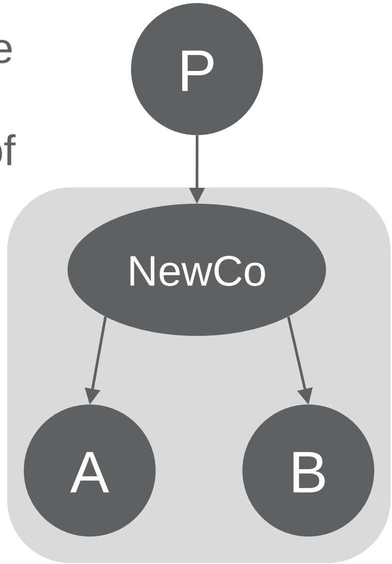
Before BCUCC

- 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

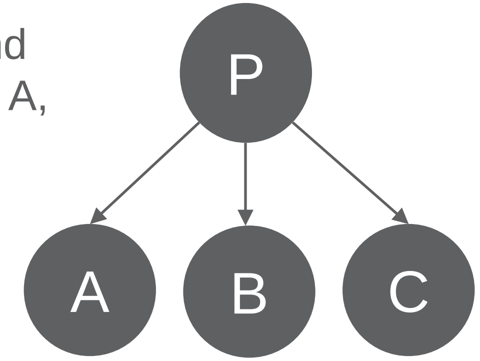
NewCo can be seen as a continuation of Parent P because investments in Entities A and B are Parent P's only assets and Parent P is a reporting entity. NewCo reflects the transaction from the beginning of the comparative period.

- **Conclusion:** Comparative information under both View A and View B is that from Parent P's consolidated financial statements.

Comparative information Scenario 2b

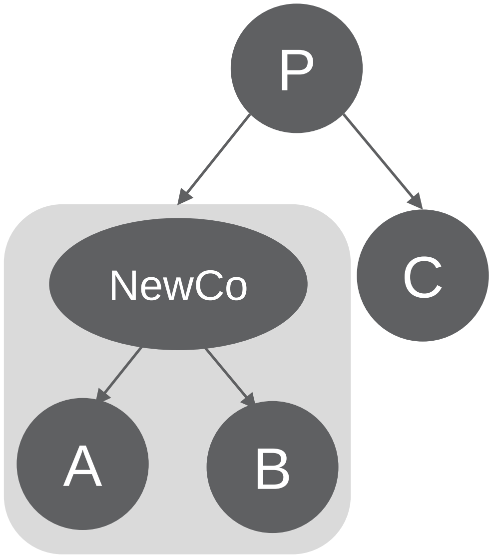
Before BCUCC

- 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

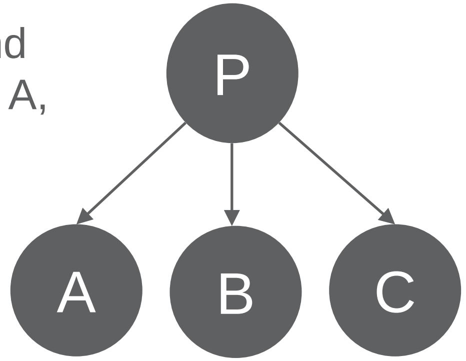
NewCo is NOT a continuation of Parent P because investments in Entities A and B are not Parent P's only assets.

- **Conclusion under View A:** NewCo will reflect the combination from the beginning of the comparative period and will provide combined comparative information for both Entities A and B (the comparative information for both entities can also be seen as carveout information from Parent P's consolidated financial statements similar to Scenario 1b).
- **Conclusion under View B:** NewCo will reflect the combination prospectively from the date of the transaction. It will provide comparative information for one of the combining entities that is identified as the receiving entity but not for the other.

Comparative information Scenario 2c

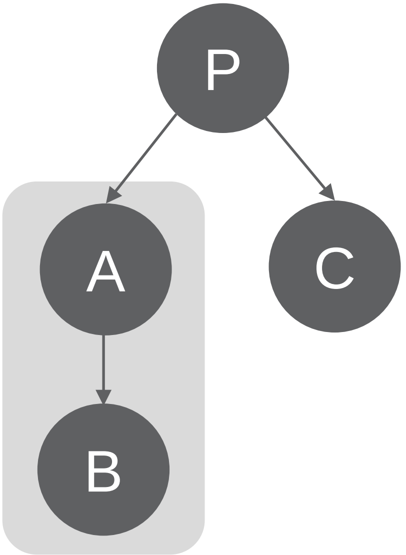
Before BCUCC

- 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, the combination results in a new set of assets, liabilities and results of operations being reported together for the first time.

- **Conclusion under View A:** Entity A will reflect the combination from the beginning of the comparative period and will provide combined comparative information for both Entities A and B (the comparative information for both entities can also be seen as carveout information from Parent P’s consolidated financial statements similar to Scenario 1b).
- **Conclusion under View B:** Entity A, the receiving entity, will reflect the combination prospectively from the date of the transaction. The comparative information will be that of Entity A only and not of Entity B.

Bringing it all together

View A Retrospective accounting for BCUCC applying a predecessor method

Under View A, comparative information for all combining entities is provided regardless of the legal form of the transaction and regardless of whether such information was reported before. If it was, it will be information as reported previously (eg information reported by Entity A in Scenario 1a and consolidated information reported by Parent P in Scenario 2a). If it wasn't, the comparative information will be combined information for the combining entities (Scenarios 2b and 2c) or carveout information (Scenario 1b).

Preparing combined and carveout information can be difficult and involve judgements and estimates. *Conceptual Framework* provides guidance on how to determine what to include in combined financial statements to meet users' needs (see Appendix B).

View B Prospective accounting for BCUCC applying a predecessor method

Under View B, comparative information for all combining entities is only provided if previously reported (eg information reported by Entity A in Scenario 1a and consolidated information reported by Parent P in Scenario 2a). If not, comparative information is only provided for the receiving entity (Scenarios 2b and 2c). Identifying the receiving entity in a meaningful way can be difficult. That could result in different information being provided depending on how the controlling party structures the transaction.

Under View B, selected comparative information for all combining entities could be required in the notes to financial statements.

Question 2 for the breakout session

The staff seek views from CMAC and GPF members on the way forward for reporting comparative information applying a predecessor approach.

Users

What would result in more useful information about a business combination under common control between wholly owned entities, and why:

1. **Applying View A:** reflecting the combination retrospectively and providing comparative information for all combining entities from the beginning of the comparative period, even though producing such information may involve use of judgements and estimates; or

2. **Applying View B:** reporting the combination prospectively and providing comparative information for the receiving entity only. If you prefer View B, would providing selected comparative information for all combining entities in the notes be useful?

What additional information should be required in applying either View A or View B?

Preparers

Do you foresee challenges in providing comparative information for all combining entities from the beginning of the comparative period using the guidance in the *Conceptual Framework* (see Appendix B) when the combination results in a new set of assets, liabilities and results of operations being reported together for the first time (Scenarios 1b, 2b and 2c)?

If so, what are those challenges and how could they be alleviated?

Appendix A

Overview of the staff's research of transactions

- 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 reviews by the staff.

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Appendix B

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Extract from the *Conceptual Framework*

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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