IFRS

STAFF PAPER

June 2019

IASB® meeting

Project	**Business Combinations under Common Control**		
Paper topic	Potential equity investors in BCUCC		

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Purpose of this paper

1. At its June 2018 meeting, the International Accounting Standard Board (Board) directed the staff to develop a current value approach based on the acquisition method set out in IFRS 3 *Business Combinations* for transactions that affect non-controlling shareholders of the receiving entity in a business combination under common control.

2. At its March and April 2019 meetings, the Board discussed information needs of lenders and other creditors of the receiving entity, and of potential equity investors in a group restructuring in preparation for a sale of the combining entities in an initial public offering (IPO). The Board noted that the outcome of credit analysis would not depend greatly on whether a current value approach or a form of predecessor approach is applied to account for a business combination under common control and tentatively decided that it does not need to pursue a single measurement approach for all transactions in the scope of the project. Specifically, the Board could pursue:

   (a) a current value approach based on the acquisition method for some or all transactions that affect non-controlling shareholders of the receiving entity; and

   (b) a different approach, such as a form of predecessor approach, for transactions that do not affect such shareholders.

3. This paper considers information needs of potential equity investors of the combining entities about transactions that affect non-controlling shareholders of the receiving entity and about transactions that do not affect such shareholders.

4. This paper is for information only and does not ask the Board for decisions.

Structure of this paper

5. This paper is structured as follows:

   (a) Summary of work performed by the staff (paragraph 6);

   (b) Transactions that affect non-controlling shareholders (paragraphs 7–12);

   (c) Transactions that do *not* affect non-controlling shareholders (paragraphs 13–23); and

   (d) Summary of staff's observations (paragraphs 24–26).

Summary of work performed by the staff

6. In developing the paper, the staff:

   (a) discussed information needs of potential equity investors with the Capital Market Advisory Committee (CMAC) and the Accounting Standards Advisory Forum (ASAF).

   (b) reviewed expert guidance on equity valuation methodology, for example, Koller, T. et al., *Valuation. Measuring and Managing the Value of Companies* published by McKinsey & Company.

   (c) reviewed academic papers, reports, articles and other literature that consider information needs of various types of capital providers, including the following publications that discuss evidence gathered from surveys and outreach activities with users of financial statements:

      (i) European Financial Reporting Advisory Group (EFRAG) and the Institute of Chartered Accountants of Scotland (ICAS)[1], *The*

[1] This academic literature review was presented by the authors at the January 2014 Board meeting

use of information by capital providers, Academic literature review. The paper is based on a comprehensive review of literature on the use of information by capital providers and reflects the input received in outreach activities with users of financial statements.

(ii) Gassen, J. and K. Schwedler, '*The decision usefulness of financial accounting measurement concepts: Evidence from an online survey of professional investors and their advisors*', *European Accounting Review*, 19(3), 2010.

(d) considered the Feedback Statement on the Post-implementation Review (PIR) of IFRS 3 *Business Combinations*.

Transactions that affect non-controlling shareholders

7. The staff's research and outreach indicate that information needs of potential equity investors do not differ from information needs of existing equity investors. This is because all equity investors are, or could be, exposed to risks and benefits arising from claims on the reporting entity's residual net assets and that determines both their information needs and analytical approaches. Moreover, an entity or an individual can simultaneously be both an existing and potential equity investor if that entity or individual is considering whether to increase its existing equity investment in a particular entity.

8. Potential equity investors make decisions about investing resources in the entity. Existing equity investors make decisions about whether to hold, sell or increase their investment in the entity so an existing equity investor can simultaneously be a potential equity investor. In all these decisions, equity investors typically focus on:

(a) assessing the amount, timing and uncertainty of the total return on the investment. The estimated total return on equity investment incorporates estimated future dividend pay-outs and estimated increases in the share price. Potential equity investors would forecast total return to determine whether to invest in the entity and what price to pay. Existing equity

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investors would compare their initial forecasted total return with the actual historic and forecasted future performance in making their decisions to hold or sell the investment.

(b) assessing management's stewardship of the entity's resources. For existing equity investors, management's stewardship affects the value of their existing investment and for potential equity investors, it affects their appetite for providing resources to the entity.[2]

9. The staff's research and outreach further indicate that in estimating total return on the investment, equity investors and analysts employ a variety of equity valuation models, including discounted cash flow-based models, economic profit-based models, adjusted present value models, multiples-based models and real options models[3]. An equity investor can select one or more of those models to price a share that it holds or a potential new share or rely on price target reports prepared by equity analysts based on those valuation models. The output from valuation models can often be combined with qualitative analysis to determine the expected total return for a security. However in all cases, the same information is used in each particular valuation model regardless of whether valuation is performed by a retail investor or a professional institutional investor or an analyst and regardless of whether those parties focus on publicly traded or private equity instruments or on a particular industry.

10. The Board has already decided in developing IFRS 3 that the acquisition method provides most useful information about business combinations that are not under common control. That conclusion was reaffirmed in PIR of IFRS 3 that stated that 'comments received confirm that fair value is the best approach for measuring the assets acquired and the liabilities assumed in a business combination'.

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[2] The evidence that potential equity investors are interested in assessing management's stewardship has been provided by CMAC members as part of the Board's research project on goodwill and impairment in the context of exploring additional disclosures for assessing the subsequent performance of a business combination. That feedback is included in paragraph 28 of Agenda Paper 18A *Better disclosures for business combinations* for the May 2019 Board meeting:

'The majority of CMAC members indicated that information on the subsequent performance of the acquired business is needed to monitor management's stewardship in making acquisition decisions, to help investors decide whether they can trust management with further capital.'

[3] Koller, T. et al., *Valuation. Measuring and Managing the Value of Companies,* McKinsey & Company, Wiley, 2010, pp. 103-132

11. Furthermore, the Board has:

    (a) directed the staff to develop measurement approaches for transactions within the scope of the project by considering, among other factors, whether and how transactions within the scope of the project can be different from business combinations that are not under common control; and

    (b) tentatively decided to pursue a current value approach based on the acquisition method for transactions that affect non-controlling shareholders of the receiving entity.

12. Based on the analysis presented in paragraphs 7–11, it follows that if a current value approach provides most useful information to existing non-controlling shareholders of the receiving entity, such an approach would also provide most useful information to potential equity investors in those circumstances. The staff note that this conclusion is consistent with IFRS 3 that does not distinguish between existing and potential equity investors. Furthermore, it is also consistent with the staff's discussion and analysis of information needs of lenders and other creditors presented in March 2019 AP23B *Lenders and other creditors in BCUCC* that did not distinguish between existing and potential providers of debt.

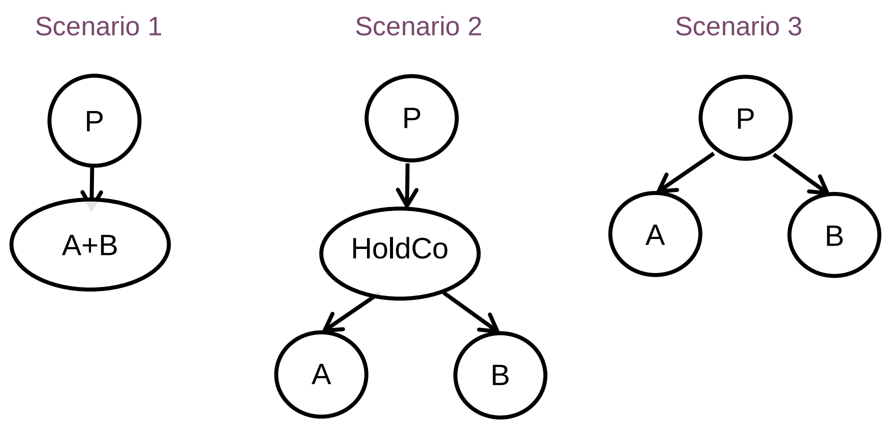
Transactions that do *not* affect non-controlling shareholders

13. The question arises what information would be useful for potential equity investors for transactions within the scope of the project that do *not* affect non-controlling shareholders of the receiving entity.

14. Information needs of potential equity investors in transactions that do not affect non-controlling shareholders were already discussed in March 2019 Agenda Paper 23A *Overview of the staff's approach* (March 2019 Agenda Paper 23A). That paper argued that a form of predecessor approach would provide useful information in the context of a group restructuring between wholly owned entities in preparation for an IPO. The scenarios and fact pattern discussed in that paper are illustrated in Figure 1 and Figure 2 below.

Figure 1

Parent P controls and wholly owns businesses A and B. In Scenario 1, businesses A and B are contained within a single legal entity. In Scenario 2, the businesses are separate legal entities wholly owned by intermediary Holdco. In Scenario 3, the businesses are separate legal entities directly owned by Parent P.



15. March 2019 Agenda Paper 23A considered the interaction between different group structures and the intention of Parent P to undertake a restructuring for the combined sale of businesses A and B. Group structures in Scenarios 1 and 2 in Figure 1 are favourable for a combined sale of the businesses. In Scenario 1, businesses A and B can be sold together as they are contained in a single legal entity. In Scenario 2, businesses A and B can be sold together by selling HoldCo. On the other hand, in Scenario 3, Parent P must undertake a legal restructuring in order to sell businesses A and B together.

16. Figure 2 reproduces the possible restructuring alternatives identified by the staff:

(a) in Scenario 3.1 entities A and B are merged together, the group structure after the transaction is identical to Scenario 1 in Figure 1;

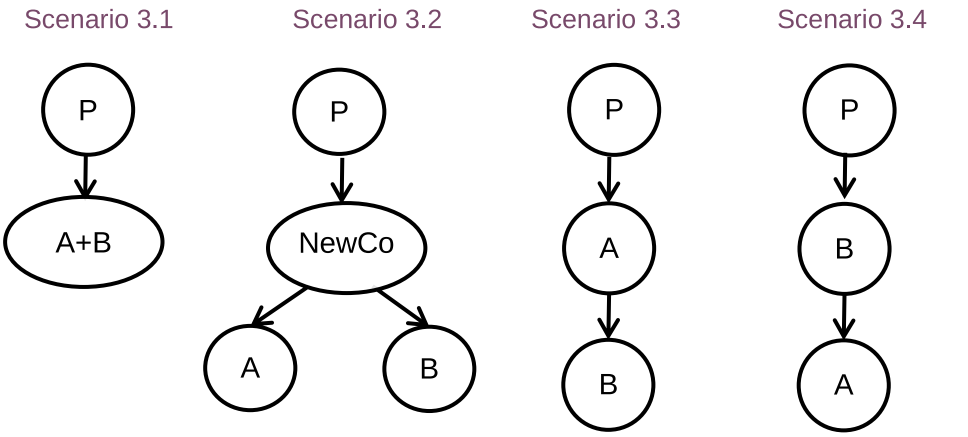
(b) in Scenario 3.2 a NewCo is formed to acquire entities A and B, the group structure after the transaction is identical to Scenario 2 in Figure 1;

(c) in Scenario 3.3 Parent P directs Entity A to acquire Entity B; and

(d) in Scenario 3.4 Parent P directs Entity B to acquire Entity A.

Figure 2

Considering Scenario 3 in Figure 1, the staff identified the following options for parent P for restructuring its group.



17. In March 2019 Agenda Paper 23A, the staff observed that in all scenarios presented the economic substance remains substantially the same, except perhaps for factors such as tax, treasury or capital structure consequences. Furthermore, in all scenarios the controlling party's residual interest in the transferred entities or businesses is retained unchanged. In Scenarios 1 and 2 in Figure 1, a potential equity investor will receive historical information about businesses A and B. Therefore, the staff think that the same information should also be provided in all sub-scenarios in Scenario 3. That would be achieved by applying a form of predecessor approach in all sub-scenarios of Scenario 3.

18. The staff have discussed the above scenarios and the information needs of potential equity investors with both CMAC and ASAF:

   (a) at the March 2019 CMAC meeting, the staff sought input from CMAC members on whether a form of a predecessor approach would provide useful information to potential equity investors about business combinations under common control between wholly owned entities undertaken in preparation for a sale, for example in an IPO. CMAC members who commented on the topic agreed with the staff's observation that various legal forms that such transactions can take do not affect the economic substance of those transactions. They agreed that a form of a predecessor approach would provide useful information about the business being sold in the IPO to potential equity investors. No members objected to that conclusion.

(b) that topic was also discussed at the April 2019 ASAF meeting. All ASAF members who commented on the topics generally agreed with the use of a form of predecessor approach for transactions between wholly owned entities, including transactions undertaken in preparation for a sale. They stated that a predecessor approach would provide useful information to potential equity investors.

19. The staff note that transactions between wholly owned entities in preparation for a sale, for example in an IPO, represent a sub-set of transactions that do not affect non-controlling shareholders of the receiving entity. The staff analysed transactions undertaken in preparation for an IPO as an example to illustrate why a form of predecessor approach would provide useful information to potential equity investors about transactions between wholly owned entities. However, the staff did not suggest that the use of a predecessor approach should be limited to transactions between wholly owned entities undertaken in preparation for an IPO.

20. In June 2019 Agenda Paper 23A *Transactions that do not affect non-controlling shareholders* (June 2019 Agenda Paper 23A), the staff provided further analysis of transactions that do not affect non-controlling shareholders. The staff argued that:

(a) transactions that do not result in non-controlling shareholders of the receiving entity acquiring residual interest (equity claim) in transferred entities or businesses are different from both:

(i) transactions within the scope of the project that result in non-controlling shareholders acquiring such residual interest; and

(ii) business combinations not under common control; and

(b) a current value approach based on the acquisition method may not work well for those transactions.

21. In developing June 2019 Agenda Paper 23A, the staff reviewed national requirements and guidance on business combinations under common control and group

restructurings, guidance published by accounting firms and responses received in recent consultation on the topic. The staff noted that the effect of the transaction on ownership interests or rights of owners was a common condition in determining the appropriate accounting treatment for business combinations under common control and group restructurings. The staff also noted that the concept of ‘looking through’ the combining entities onto the effects on their owners is already adopted in the application guidance in IFRS 3 on identifying the acquirer.

22. Based on the staff’s research and analysis presented in June 2019 Agenda Paper 23A, the staff argued that if non-controlling shareholders do not acquire a residual interest (equity claim) in the transferred entities or businesses, the transaction is not an acquisition. Therefore, if a current value approach based on the acquisition method were applied to such transactions, identifying an acquirer would not always be possible or would not result in useful information. Instead, a form of predecessor approach would provide useful information about those transactions.

23. The staff further note that IFRS 3 generally does not deal with cases where the controlling party is the sole existing shareholder and potential equity investors are the only ‘equity type’ primary users that rely on the information provided in general purpose financial statements. Therefore, applying the requirements of that Standard may be not appropriate in the absence of non-controlling shareholders.

Summary of staff’s observations

24. Based on the discussion in paragraphs 7–12, the staff think that a current value approach based on the acquisition method will provide most useful information to both existing and potential equity investors about transactions that result in non-controlling shareholders of the receiving entity acquiring residual interest (equity claim) in the transferred entities or businesses (for brevity, also referred to as transactions that affect non-controlling shareholders). Those transactions are arguably similar to business combinations not under common control and therefore requiring the same accounting treatment would provide most useful information to both existing and potential equity investors.

25. In contrast, based on the discussion in paragraphs 8–23, the staff think that transactions that do not result in non-controlling shareholders of the receiving entity acquiring residual interest (equity claim) in the transferred entities or businesses (for brevity, also referred to as transactions that do not affect non-controlling shareholders) are different from both:

    (a) transactions within the scope of the project that result in non-controlling shareholders acquiring such a residual interest; and

    (b) business combinations that are not under common control.

26. Consequently, applying a current value approach based on the acquisition method to those transactions would not always be possible or would provide useful information about such transactions to potential equity investors. Instead, a form of predecessor approach would be more appropriate for those transactions.

Question for the Board

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