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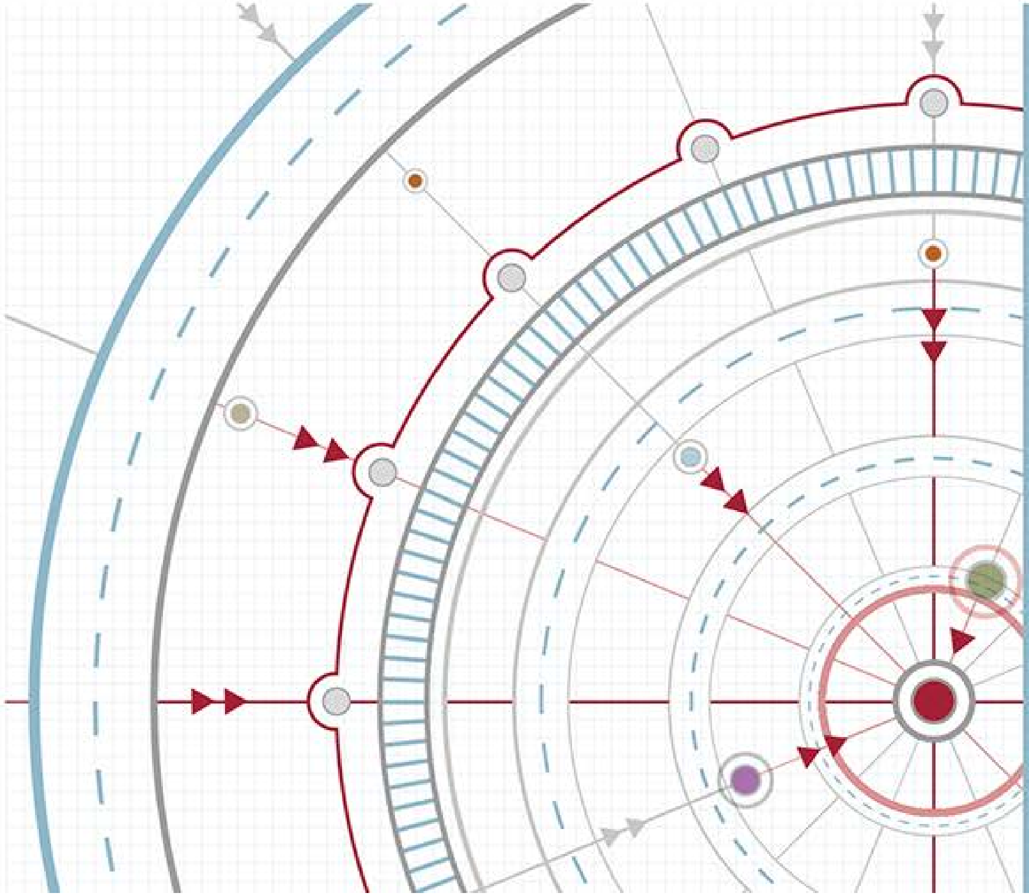

CMAC Meeting March 2019
Agenda paper 7

Business Combinations under Common Control

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Disclaimer

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Purpose of the session

The staff seek CMAC members' views on:

- whether the measurement approaches being developed by the staff for business combinations under common control would meet the information needs of the **receiving entity**'s (see slide 9) investors, lenders and other creditors. Those approaches are
  a) a current value approach based on the acquisition method set out in IFRS 3 *Business Combinations* and
  b) a predecessor approach; and
- how to determine when each of those approaches should be applied to a business combination under common control.

Questions for CMAC members

The staff considered the initial input from past discussions with CMAC (see slide 12) in developing approaches for transactions within the scope of the project. In developing those approaches, the staff explored and analysed information needs of different types of primary users of the receiving entity’s financial statements. Based on this further analysis, the staff seek CMAC members’ views on the following questions:

1. Do you agree with the staff’s observations on requiring a current value approach for BCUCC that affect non-controlling shareholders (NCI) in the receiving entity (slide 18)?
2. Do you agree with the staff’s observations on credit analysis by debt investors and credit analysts, in particular that the result of the credit analysis would be largely unaffected by whether a current value approach or a predecessor approach is used in a BCUCC (slide 22 and paragraphs 29–30 of the Appendix)?
3. Do you agree with the staff’s observations that a predecessor approach would provide useful information to prospective equity investors about BCUCC between wholly owned entities undertaken in preparation for an initial public offering (IPO) (slide 27)?

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Project recap and update

About BCUCC project

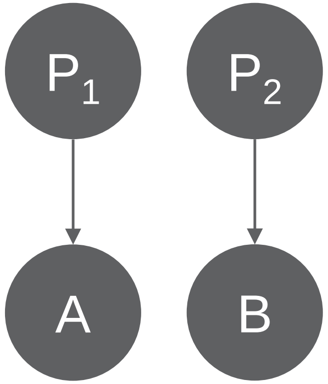
- IFRS Standards do not specify how to account for combinations of companies or businesses controlled by the same party.
- As a result, companies account for such transactions in different ways. This makes it difficult for investors and regulators to compare the effects of those transactions on companies' financial positions and performances (see illustration on slide 8).

The issue: diversity in practice

Before

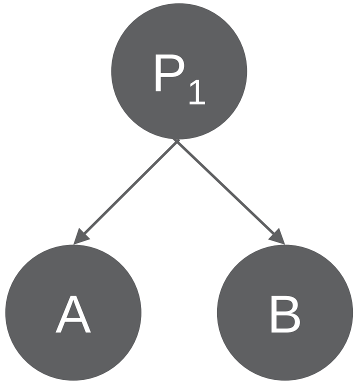
Scenario 1

- Entity A and Entity B are controlled by different parties;
- Entity B is a business.



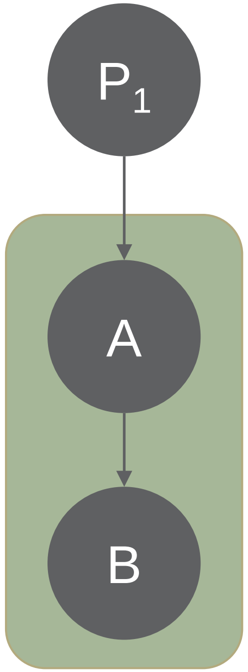
Scenario 2

- Entity A and Entity B are controlled by the same party;
- Entity B is a business.



After

Entity A acquires Entity B



Observations

Scenario 1

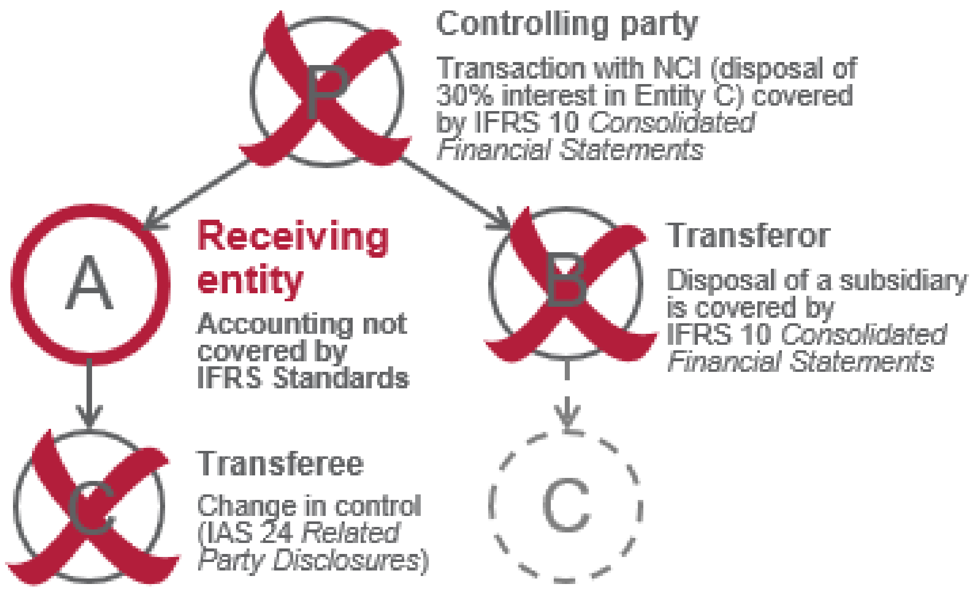
- The transaction is a **business combination** not under common control
- IFRS 3 *Business Combinations* requires the **acquisition method**
- Entity A reflects identifiable assets and liabilities of Entity B at **fair value**

Scenario 2

- The transaction is a **business combination under common control**
- IFRS Standards do not specify how to account for such transactions which leads to **diversity in practice**
- Entity A reflects identifiable net assets of Entity B at **fair value** or at **predecessor carrying amounts**

Focus on the primary users of information (1/2)

The project focuses on the information needs of the primary users of the **receiving entity's** financial statements. Primary users can have different or even conflicting information needs.



Entity A acquires Entity C from Entity B. Entities A, B and C are all controlled by Entity P. Entity C is a business.

The project does not consider accounting by the controlling party, the transferor or the transferee as those parties are already covered by the existing IFRS Standards.

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

Focus on the primary users of information (2/2)

Overview of primary users of the receiving entity's financial statements in a BCUCC

Existing NCI	Controlling party	Lenders and other creditors	Prospective equity investors
Typically perpetual interest in the receiving entity. Transaction may affect the value of their existing interest. Exposed to residual equity risks of the receiving entity.	Controls all combining entities before and after the transaction. Does not solely rely on the receiving entity's financial statements to meet its information needs.	Contractual maturity of the interest in the receiving entity. Transaction may affect recoverability of existing interest. Exposed to the liquidity risk of the receiving entity.	No existing interest in the combining entities at the time of the transaction. Investment decision is made for the combined entity rather than the receiving entity.

The cost-benefit analysis can be different, for example, for business combinations under common control that affect existing NCI and those that do not.

Possible measurement approaches for BCUCC

Measurement approaches being explored

A current value approach based on the acquisition method
Receiving entity will reflect acquired assets and liabilities at their acquisition date fair values.

A predecessor approach
Receiving entity will reflect acquired assets and liabilities at their predecessor carrying amounts.

Factors considered by the staff

Useful information for primary users

Cost-benefit analysis

Complexity

Structuring opportunities

Initial input from past discussions with CMAC

Information needs of the primary users of the receiving entity's financial statements

Existing NCI

- Most members agreed that a current value approach based on the acquisition method would provide the most useful information to NCI in the receiving entity.
- Some members emphasised that a current value approach should be applied only if NCI is 'substantive' but did not discuss what 'substantive' NCI means.
- Some advocated the use of the acquisition method without modifications.

Lenders and other creditors

- Members expressed mixed views on what type of information would be most useful for lenders and other creditors of the receiving entity.
- Some stated that a current value approach would provide the most useful information. Others stated that current value information is not essential for credit analysis.

Controlling party

- Most members agreed with the staff's preliminary view that a predecessor approach would best meet information needs of the controlling party in BCUCC at a cost justified by the benefits of that information.

Prospective equity investors

- Most members expressed a view that 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.

Where we are today

Discussed by the Board in 2018

Only some BCUCC affect NCI in the receiving entity

Most if not all BCUCC could affect lenders and other creditors in the receiving entity and prospective equity investors

Transactions within the scope of the BCUCC project

Next steps

- Transactions between wholly owned entities, including those that affect:
  - lenders and other creditors of the receiving entity; and
  - prospective equity investors.

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BCUCC that affect NCI in the receiving entity

Current value approach for BCUCC that affect NCI

Acquisition method

Possible modifications to consider:

1. Additional disclosures
2. Recognise a contribution instead of recognising a gain if fair value of acquired net assets exceeds consideration
3. Recognise a distribution instead of recognising goodwill if consideration exceeds fair value of the acquired interest.

The Board directed the staff to develop an approach based on **the acquisition method** set out in IFRS 3 and to consider whether and how that method should be modified to provide the most useful information about transactions that affect NCI.

However, applying a current value approach to all transactions that affect NCI (as opposed to only those where NCI is 'substantive') may not be appropriate.

- This is because the benefits of proving current value information in all NCI scenarios may not always justify the costs of providing that information (eg consider a public entity with significant NCI and a private entity where a few stock options are issued to key management personnel).
- In addition, requiring current value approach in all NCI scenarios (but not for transactions between wholly owned entities) could give rise to structuring opportunities (eg an entity could 'choose' to apply a current value approach by issuing a few employee stock options).

Are current values always appropriate for NCI?

Factors considered *(see slide 11)*	Require a current value approach based on the acquisition method	
	For **ALL** transactions that affect NCI	For **SOME** transactions that affect NCI
Useful information for primary users	Provides the most useful information to all NCI	Some NCI will not receive the most useful information
Cost-benefit analysis	The benefits of providing current value information may not always justify the costs	Could better reflect cost-benefit considerations
Complexity	Different approaches for BCUCC depending on whether NCI is present in the receiving entity	Different approaches for BCUCC depending on whether 'substantive' NCI is present in the receiving entity
Structuring opportunities	May give rise to structuring opportunities	Could minimise structuring opportunities depending on how the distinction is made

For further information refer to paragraphs 13–21 of [*AP23 Approach for transactions that affect non-controlling interest*]

How to distinguish when to apply current values

Ways of making a distinction between transactions that affect NCI			
Qualitative factors			**Quantitative factor**
Traded equity instruments vs privately held	NCI held by related or unrelated parties	NCI opt-in or opt-out for current value	Size of NCI
Require a current value approach when equity instruments of the receiving entity are traded in a public market.	Require a current value approach except when NCI is held only by related parties of the receiving entity.	Require a current value approach when NCI opt-in for that approach (or do not opt-out of that approach).	Require a current value approach when the size of the NCI meets or exceeds a specified threshold.
Combination of qualitative and quantitative factors			
Eg require a current value approach for (a) all public and (b) some private entities based on the size of NCI			

For further information refer to paragraphs 22–46 of *AP23 Approach for transactions that affect non-controlling interest*

Staff's observations on BCUCC that affect NCI

- Considering costs and benefits of providing current value information and structuring opportunities, the staff think that requiring a **current value approach for some but not all transactions that affect NCI** may be appropriate.
- If a current value approach is required for some but not all transactions that affect NCI, the staff think that making that distinction based on whether the **receiving entity's equity instruments are traded in a public market** is a viable approach to explore. It is a simple approach that provides the most useful information to NCI in all public entities, it indirectly takes into account the cost-benefit analysis without creating a bright line and it is arguably least open to structuring opportunities.
- The staff do not support a distinction based on whether NCI is held by related parties because such a distinction would fail to take into account the cost-benefit analysis and would be open to structuring. If it is desirable to also provide current value information to NCIs in private entities in some cases, **NCI opt-in for (or opt-out from)** current value information can be explored. However, such an approach could be difficult to operationalise.
- The staff do not think that a distinction that involves a quantitative threshold is appropriate. It lacks a conceptual basis and would be open to structuring.

For further information refer to paragraphs 47–49 of *AP23 Approach for transactions that affect non-controlling interest*

Lenders and other creditors

BCUCC between wholly owned entities

Work performed on lenders and other creditors

Summary of work performed by the staff in understanding information needs of lenders and other creditors of the receiving entity in a BCUCC

- Meetings with credit investment managers and credit analysts
- Review of the corporate credit methodology of two leading credit rating agencies
- Review of academic papers, reports, articles and other literature that consider information needs of lenders and other creditors

Nature of claims and information needs

Nature of claims

- Cash flows are determined by contractual provisions
- Typically finite contractual maturity
- Priority of claims can vary

Focus of credit analysis

- Recoverability rather than valuation
- Specific time frames rather than perpetual terminal values
- Capital structure of the entity rather than overall leverage

Information needs of debt investors and credit analysts

- Information about cash flows to the entity
- Information about recognised debt and unrecognised commitments

For further information refer to paragraphs 10–17 of the Appendix—*Lenders and other creditors in BCUCC*

Key findings in the research and outreach

Our research and outreach indicated that debt investors and credit analysts use a variety of tools and techniques depending, for example, on their level of sophistication or industry focus. However, we identified two common areas of focus.

Predominance of cash flow analysis

Cash flow measures or their proxies such as EBITDA, cash flow projections and cash flow-based ratios are at the heart of credit analysis. Those measures are typically derived from information in the statement of profit or loss, the statement of cash flows and notes to the financial statements. 'Non-cash' items, notably amortisation, depreciation and impairment are not included in the cash flow analysis.

Focus on the total gross debt

Credit analysis doesn't tend to focus on the statement of financial position. Debt investors and credit analysts need qualitative and quantitative information about both recognised debt and unrecognised commitments, including information about redemption amounts, maturity, collateral and seniority.

This information and the analysis would be largely unaffected by whether a current value approach or a predecessor approach is used to account for BCUCC.

For further information refer to paragraphs 18–30 of the Appendix—*Lenders and other creditors in BCUCC*

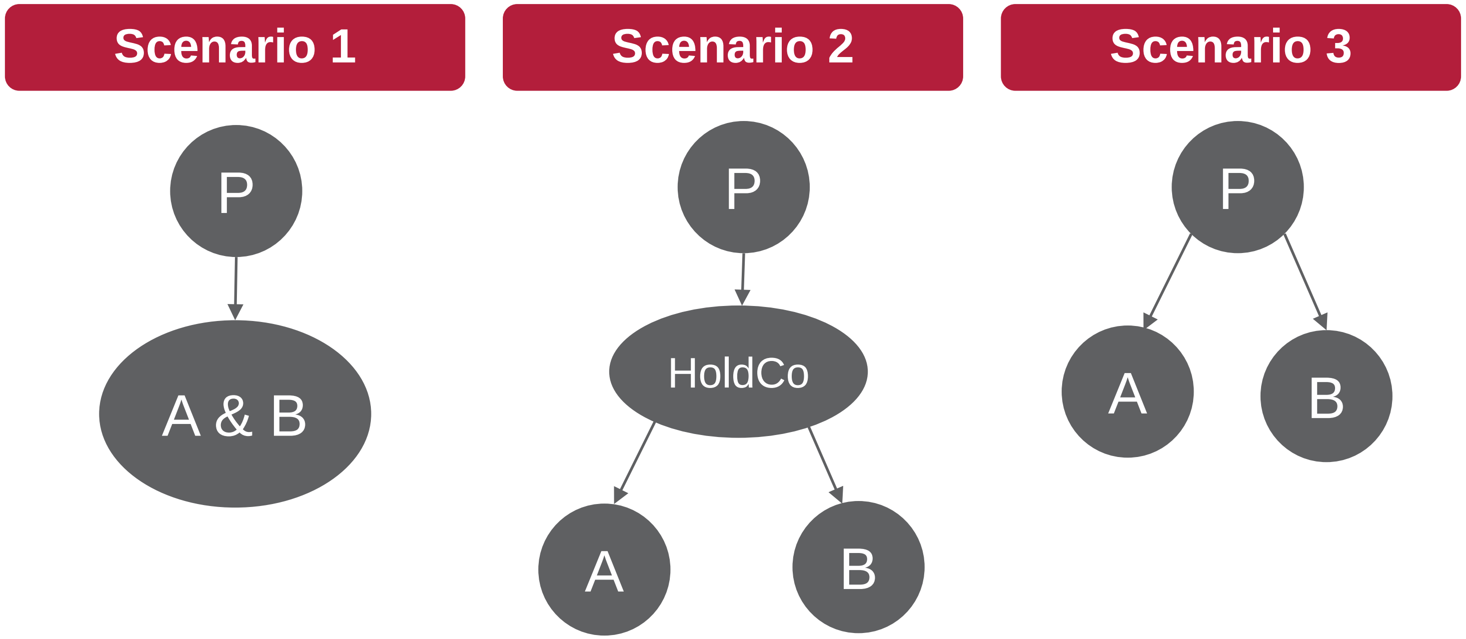
Prospective equity investors

BCUCC between wholly owned entities

Introducing illustrative scenarios

Consider the following illustrative scenarios where Parent P controls and wholly owns businesses A and B but the legal structure of the group is different as outlined below.

Group structure before restructuring and subsequent sale

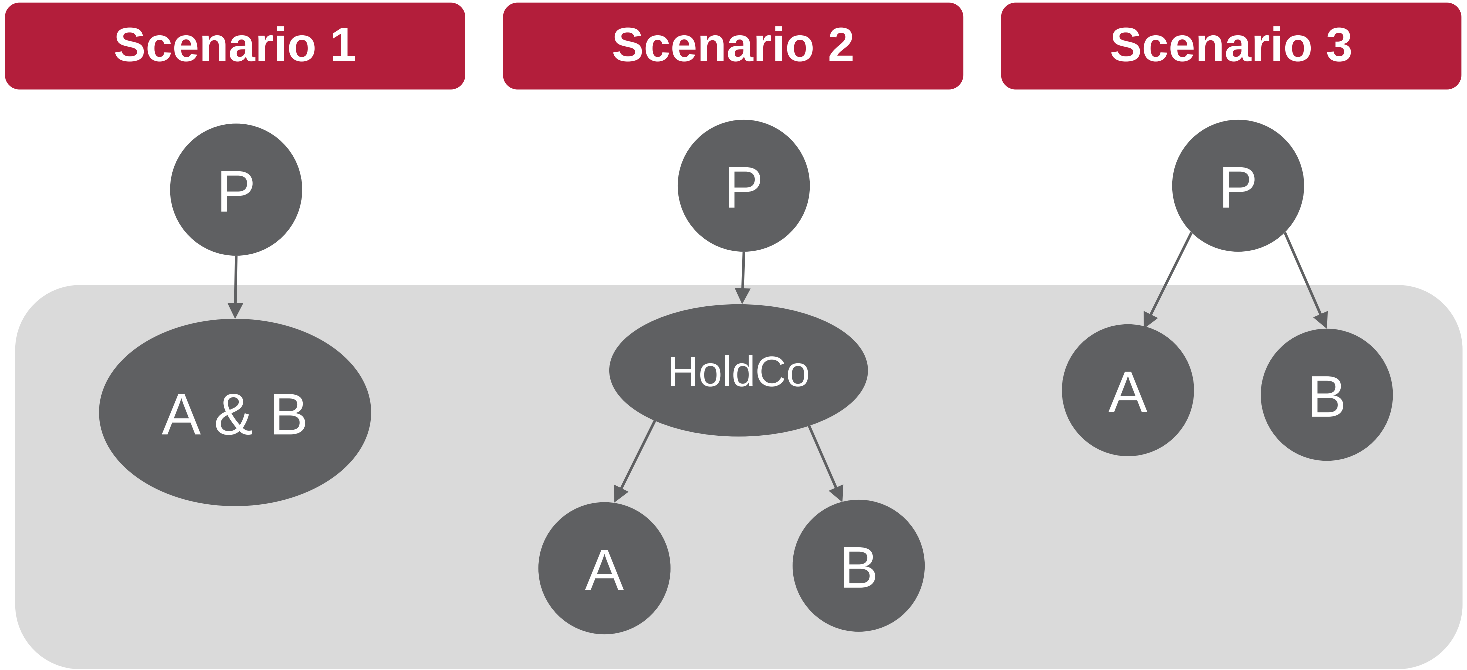


- In Scenario 1, businesses A and B are contained within a single legal entity.
- In Scenario 2, businesses A and B are separate legal entities wholly owned by intermediary HoldCo.
- In Scenario 3, businesses A and B are separate legal entities directly owned by P.

Implications of a decision to do an IPO

Parent P decides to sell its wholly owned and controlled businesses A and B together in an IPO.

Group structure before restructuring and subsequent sale

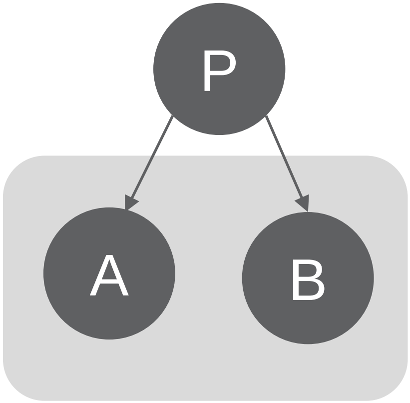


- In Scenario 1, businesses A and B can be sold together as they are contained in single legal entity.
- In Scenario 2, businesses A and B can be sold together by selling HoldCo.
- In Scenario 3, Parent must undertake a legal restructuring in order to sell businesses A and B together (slide 26).

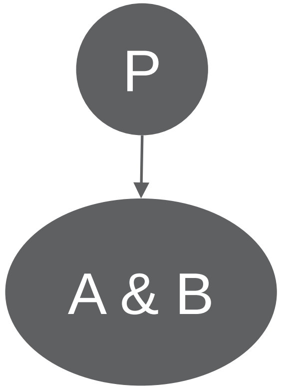
Preparing for an IPO

Restructuring in preparation for a sale in an IPO

Scenario 3

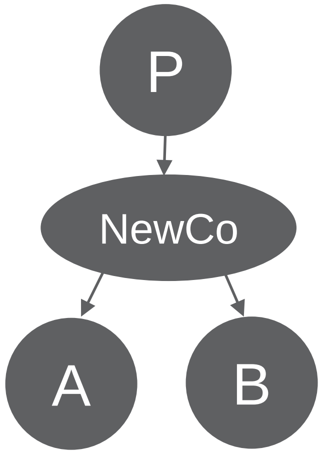


Scenario 3.1



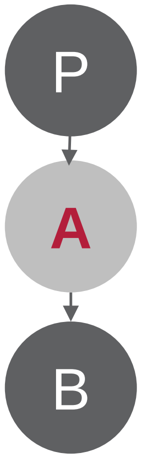
Legal merger of entities A and B in preparation for an IPO

Scenario 3.2



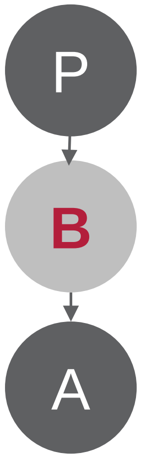
NewCo is formed to acquire A and B in preparation for an IPO

Scenario 3.3



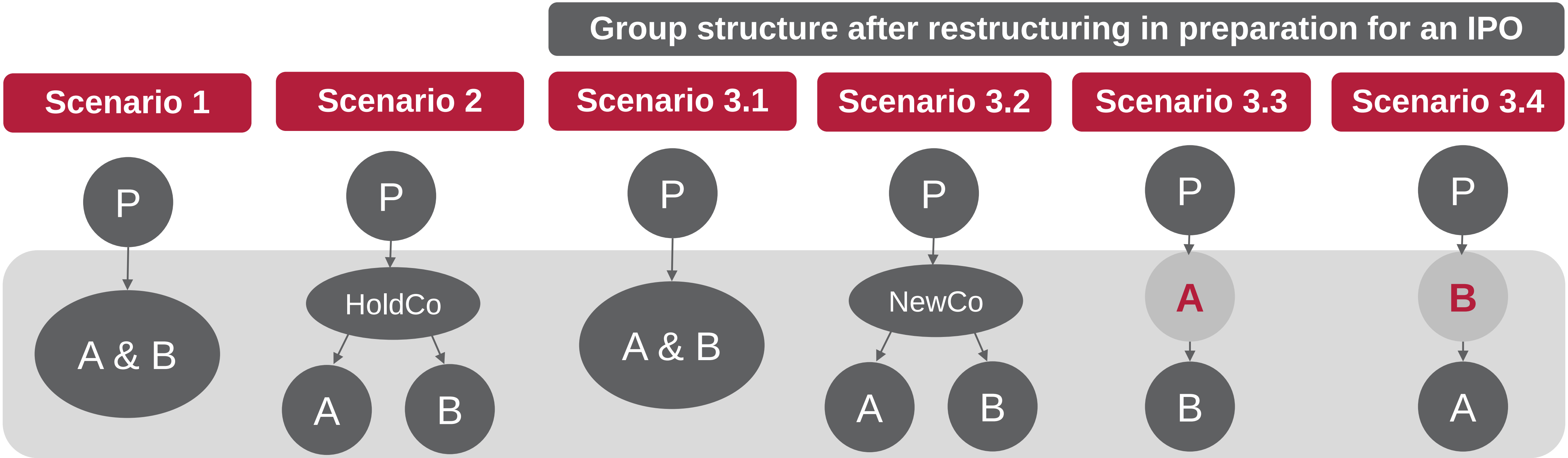
A acquires B in preparation for an IPO

Scenario 3.4



B acquires A in preparation for an IPO

Staff’s observations



- In all scenarios the economic substance is the same – businesses A and B are being sold to new investors.
- In Scenarios 1 and 2, the prospective investors will receive historical information about businesses A and B.
- Accordingly, the staff think that historical information about businesses A and B should also be provided in all sub-scenarios of Scenario 3. That information will be provided by applying a predecessor approach in all sub-scenarios of Scenario 3. This conclusion is consistent with the advice provided by CMAC in the past (see slide 12).

Bringing it all together

Staff's observations

Transactions that affect NCI

Transactions between wholly owned entities

Apply a current value approach

Apply a predecessor approach

Apply a current value approach to **at least some transactions that affect NCI** in the receiving entity.

Further analysis if a current value approach should be applied to all transactions that affect NCI and if not, how the distinction could be made

Transactions within the scope of the BCUCC project

Apply a predecessor approach to transactions between **wholly owned entities** regardless of whether lenders or other creditors are present in the receiving entity or of whether the transaction is undertaken in preparation for a sale, for example in an IPO.

Next steps

- Next milestone—Discussion Paper is expected in H1 2020
- Near term—continue discussions with the Board and consultations with interested parties
  - When to apply a current value approach and when to apply a predecessor approach
  - Whether and how to modify the acquisition method set out in IFRS 3
  - How to apply a predecessor approach

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