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STAFF PAPER

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Project	**Business Combinations under Common Control**
Paper topic	Update on when each measurement approach would apply

CONTACT(S)	Yulia Feygina	yfeygina@ifrs.org	+44 (0)20 7332 2743
	Jan Carlo Pereras	cpereras@ifrs.org	+44 (0)20 7246 6487
	Paolo Dragone	pdragone@ifrs.org	+44 (0)20 7246 6902

Purpose of this paper

1. At the September 2019 meeting, the International Accounting Standards Board (Board) tentatively decided that a current value approach based on the acquisition method set out in IFRS 3 *Business Combinations* would be applied to transactions that affect non-controlling shareholders of the receiving entity subject to an exception and an exemption for entities whose equity instruments are not traded in a public market[1] (paragraph 23). All other transactions would be reported applying a predecessor approach.

2. The proposed approach for determining when a current value approach and a predecessor approach would be applied has been discussed with various stakeholders, including at the September 2019 meeting with the European Securities and Markets Authority and the World Standard-setters Conference, at the November 2019 meeting of the Asian-Oceanian Standard-Setters Group, and at the December 2019 outreach meeting with Chinese stakeholders.

3. Many stakeholders generally supported that approach. However, some stakeholders disagreed, arguing that a predecessor approach should be applied to all transactions within the scope of the project. In particular, stakeholders from China stated that a predecessor approach is currently applied to all business combinations under common

[1] Public market is described in paragraph 4(a)(ii) of IFRS 10 *Consolidated Financial Statements*, paragraph 2(b)(i) of IFRS 8 *Operating Segments*, paragraph 2(b)(i) of IAS 33 *Earnings per Share*.

control in their jurisdiction and argued that such an approach provides the most useful information about those transactions to non-controlling shareholders of the receiving entity, and does so at a cost justified by the benefits of that information.

4. In addition, some stakeholders raised questions or concerns about the Board's proposed approach, making comments including the following:

   (a) requiring two different measurement approaches would cause more complexity than a single measurement approach for all transactions within the scope of the project and could decrease comparability.

   (b) it is unclear why the Board focuses on non-controlling shareholders in determining the appropriate measurement approach. The *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) states that in developing IFRS Standards the Board should seek to provide information that will meet the needs of the maximum number of the primary users.[2]

   (c) the proposal to require or permit different measurement approaches depending on whether the receiving entity's equity instruments are traded in a public market seems to lack a conceptual basis. The information needs of non-controlling shareholders are the same regardless of whether the entity's equity instruments are traded in a public market or privately held.

5. This paper considers the above feedback. In particular, it explores whether and how the exemption and the exception from applying a current value approach that are proposed for private entities could be extended to public entities.[3]

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

Terminology and structure of this paper

7. At the December 2019 meeting, the Board tentatively decided that the current value approach would be the acquisition method set out in IFRS 3 except that if the fair value of the acquired identifiable net assets exceeds the fair value of the consideration

[2] Paragraph 1.8 of the *Conceptual Framework*.

[3] In this paper, we use the term 'public entities' to refer to entities whose equity instruments are traded in a public market, and the term 'private entities' to refer to all other entities.

transferred, the receiving entity would recognise that excess as an increase in the receiving entity's equity (contribution), not as a gain on a bargain purchase in the statement of profit or loss. Accordingly, this paper uses the specific term 'the acquisition method' instead of the broader term 'a current value approach'.

8. This paper is structured as follows:

   (a) the need for two measurement approaches for transactions within the scope of the project (paragraphs 9–15);

   (b) transactions that affect non-controlling shareholders and those that do not affect such shareholders (paragraphs 16–19);

   (c) why the acquisition method is proposed for all public entities and only for some private entities (paragraphs 20–23); and

   (d) whether to extend the exemption and the exception from applying the acquisition method to public entities (paragraphs 24–39):

      (i) extending the exemption to public entities (paragraphs 26–32); and

      (ii) extending the exception to public entities (paragraphs 33–39).

The need for two measurement approaches for transactions within the scope of the project

9. As stated in paragraph 4(a), some stakeholders questioned the need for two measurement approaches for transactions within the scope of the project and argued that the use of two measurement approaches would increase complexity and could decrease comparability. However, in assessing the effects of the Board's proposed approach, it is important to consider the Board's proposals in the context of the existing requirements in IFRS Standards as well as existing practice.

10. Today, the acquisition method set out in IFRS 3 is required only for business combinations that are not under common control. All such transactions are considered acquisitions. There is no guidance in IFRS Standards on reporting business combinations under common control. Applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, business combinations under common control

are typically reported either applying a form of a predecessor approach[4] or applying the acquisition method, or a variation on it.[5] That results in limited comparability of information provided in financial statements about similar transactions and creates complexity for users of financial statements. In addition, in some cases it gives rise to application questions on determining whether a business combination is under common control, as the answer drives the reporting for the transaction.[6]

11. To address the current diversity in practice and the application questions, the Board could have decided to propose a single measurement approach—the acquisition method—for all business combinations, including all business combinations under common control. However, the Board concluded that would not be appropriate. This is because business combinations under common control are not a homogenous population. Instead, some of those transactions are similar to acquisitions within the scope of IFRS 3 (for example, a business combination under common control that was initiated and negotiated by a public receiving entity in order to benefit that entity). On the other hand, other transactions may not be that similar to acquisitions within the scope of IFRS 3 (for example, a legal restructuring involving wholly owned private group entities initiated and undertaken by the parent entity in order to benefit the entire group rather than the receiving entity). In addition, the Board noted that the conclusion on the costs and benefits of applying the acquisition method to a business combination under common control could also be different in different scenarios.

12. Accordingly, the Board decided that, in principle, business combinations under common control should be reported applying the acquisition method as set out in IFRS 3 only when both the following conditions are met:

    (a) those transactions are similar to acquisitions within the scope of IFRS 3; and

[4] Paragraphs 6–21 of October 2019 Agenda Paper 23A *Predecessor approach—carrying amounts*, paragraphs 6–19 of October 2019 Agenda Paper 23B *Predecessor approach—pre-combination information*, slide 18 of July 2019 Agenda Paper 23B *How measurement approaches could apply*.

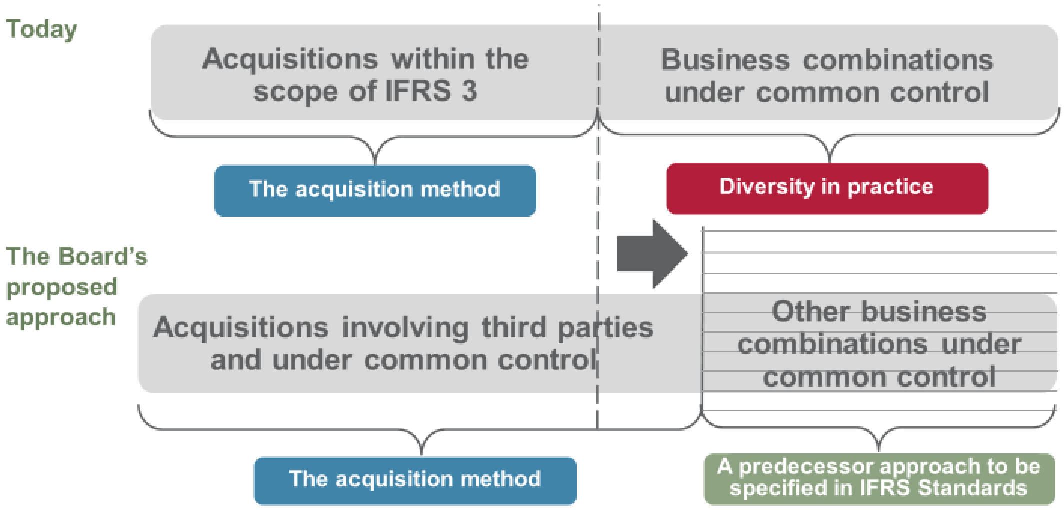
[5] Paragraph 13 of December 2019 Agenda Paper 23A *Applying a current value approach to BCUCC*.

[6] Paragraphs 7–21 of December 2017 Agenda Paper 23B *Scope of the project*.

(b) the benefits of information provided by the acquisition method justify the costs of applying that method.[7]

13. In all other cases, a specified form of a predecessor approach would be applied.

14. The effect of the Board's proposed approach is illustrated in the following diagram.



15. As illustrated by the diagram, the Board's proposed approach is designed to improve comparability and reduce complexity by requiring that similar information is provided about similar transactions and, when transactions are dissimilar, different information is provided about them if that is necessary.

Transactions that affect non-controlling shareholders and those that do not affect such shareholders

16. As stated in paragraph 4(b), some stakeholders commented that it is unclear why the Board focuses on non-controlling shareholders in developing the appropriate measurement approach. They noted that the *Conceptual Framework* states that in developing IFRS Standards the Board should seek to provide information that will meet the needs of the maximum number of primary users.

17. The Board indeed considered information needs of all types of primary users identified in the *Conceptual Framework* in developing the proposed measurement

[7] Paragraph 21 of April 2019 Agenda Paper 23A *Update on the staff's approach.*

approaches.[8] In addition, as stated in paragraph 11, the Board also considered whether and when transactions within the scope of the project are similar to acquisitions within the scope of IFRS 3. The Board noted that in transactions involving wholly owned entities there is no acquisition by non-controlling shareholders of a residual ownership interest (equity claim) in any of the combining entities. In those circumstances, identifying the acquirer may not always be possible or may not result in the most useful information.

18. In contrast, if the transaction results in non-controlling shareholders acquiring a residual ownership interest in the combining entities, that transaction is similar to acquisitions in the scope of IFRS 3. Considering the effect of the transaction on the ownership interest held by non-controlling shareholders in the combining entities would help identify the acquirer and applying the acquisition method would provide the most useful information to such shareholders about that transaction.

19. In addition, as staff's research indicated, transactions that affect non-controlling shareholders are typically subject to laws and regulations that are designed to protect the interests of those shareholders.[9] As a result, the terms of such transactions, notably the transaction price, are likely to be similar to the terms of transactions between independent parties, particularly if the transaction is undertaken by a public entity. Consequently, the acquisition method as set out in IFRS 3 would not require any modifications in order to provide the most useful information in those circumstances.

Why the acquisition method is proposed for all public entities and only for some private entities

20. As stated in paragraph 4(c) in relation to the proposal to require or permit different measurement approaches depending on whether the receiving entity's equity instruments are traded in a public market, some stakeholders suggested that this proposal seems to lack a conceptual basis. In particular, they argued that the

[8] September 2019 Agenda Paper 23A *When to apply which measurement* approach, March 2019 Agenda paper 23B *Lenders and other creditors in BCUCC,* April 2019 Agenda Paper 23B *Update on lenders and other creditors in BCUCC* and July 2019 Agenda Paper 23A *Potential equity investors in BCUCC*.

[9] Paragraphs 21–26 of December 2019 Agenda Paper 23A *Applying a current value approach to BCUCC*.

information needs of non-controlling shareholders are the same regardless of whether the entity's equity instruments are traded or privately held.

21. The staff agree that information needs of non-controlling shareholders generally do not depend on whether the entity's equity instruments are traded or privately held. However, the proposed distinction does not relate to differences in information needs of those non-controlling shareholders. Rather, it is intended to address those circumstances when the benefits of information provided by the acquisition method are not sufficient to justify the costs of providing that information, for example, when the non-controlling interest is not 'substantive'. In addition, the proposed distinction helps to reduce opportunities for accounting arbitrage. Those opportunities might arise if the acquisition method were required in circumstances when an entity might be able to choose whether to create or buy back non-controlling interest, and so, in effect, choose which measurement approach to apply so as to depict the transaction in the most favourable light.

22. The Board concluded that when the receiving entity's equity instruments are traded in a public market the non-controlling interest in the receiving entity is likely to be 'substantive' because of listing requirements on many stock exchanges; when that interest is 'substantive', the benefits of applying the acquisition method would justify the costs. In addition, the Board noted that a distinction based on whether an entity's equity instruments are traded in a public market does not generally create opportunities for accounting arbitrage because listing and de-listing are significant actions that an entity is unlikely to undertake just in order to be able to use the desired measurement approach for a business combination under common control.

23. In contrast, if the receiving entity's equity instruments are privately held, non-controlling interest may be insignificant, it may entirely be held by the entity's related parties or it may be concentrated and held by few investors. In some such cases, it could be easy for the entity to buy back the existing non-controlling interest. It would also generally be easy to create non-controlling interest in a private entity by issuing shares to related parties. In those cases, information provided in the entity's financial statements, including information about business combinations under common control, would be of limited usefulness for those non-controlling shareholders. In addition, in some cases non-controlling shareholders in a private entity may have

access to information about the transaction without having to rely on the entity's general purpose financial statements. Accordingly, to take into consideration the cost constraint and to limit opportunities for accounting arbitrage that could otherwise arise, the Board decided to propose that a privately held receiving entity would be:

(a) permitted to apply a predecessor approach if all its non-controlling shareholders have been informed about and not objected to the receiving entity applying that approach (the exemption); and

(b) required to apply a predecessor approach if all non-controlling shareholders are the receiving entity's related parties[10] (the exception).

Whether to extend the exemption and the exception from applying the acquisition method to public entities

24. As noted in paragraph 3, some stakeholders, notably stakeholders from China, suggested that a predecessor approach should be applied to all business combinations under common control and argued that such an approach would provide the most useful information about those transactions to non-controlling shareholders of the receiving entity. Accordingly, the staff considered whether the exemption from applying the acquisition method should be extended to public entities to accommodate any cases when non-controlling shareholders in a public entity do not object to the entity applying a predecessor approach (paragraphs 26–32).

25. In addition, some stakeholders also suggested that the Board could consider extending the exception from applying the acquisition method to public entities, noting that in environments where government control is pervasive such an exception could alleviate the burden on reporting entities without creating significant disadvantages for investors. The staff analysed that suggestion in paragraphs 33–39.

Extending the exemption to public entities

26. In principle, the staff can see the argument for extending the exemption from applying the acquisition method to public entities on the same grounds on which the exemption

[10] As defined by IAS 24 *Related Party Disclosures*.

is proposed for private entities. That is, if non-controlling shareholders in a public receiving entity do not object to the entity applying a predecessor approach, the Board could conclude that permitting the entity to apply that approach would be an appropriate application of the guidance in the *Conceptual Framework* on the cost constraint. However, the Board could also conclude that applying the cost constraint results in a different conclusion for public receiving entities. That is because non-controlling shareholders in a public entity are likely to change over time and the choice made by those shareholders as of the end of the reporting period may not result in the most useful information provided to the shareholders at the time financial statements are issued. In contrast, private entities are likely to have a more stable and more concentrated ownership structure.

27. Furthermore, the staff think that if the Board were to propose extending the exemption to public entities, the Board would need to consider how such an exemption should be applied both from the conceptual and operational perspectives and whether there are any considerations that are unique or more prevalent for public entities than for private entities.

28. The exemption proposed for private entities is based on the existing requirements in IFRS 10 *Consolidated Financial Statements*. Accordingly, a private entity would be exempt from applying the acquisition method if all its non-controlling shareholders 'have been informed about, and not objected' to the receiving entity applying that approach. Effectively, such an exemption would place the burden of action on non-controlling shareholders if they are to benefit from information prepared using the acquisition method. If the non-controlling shareholders do not raise objections, the entity would be eligible to apply a predecessor approach.

29. Such an exemption can arguably be justified for private entities on cost-benefit grounds. In addition, it can generally be feasible for private entities to apply this exemption from the operational standpoint at least in some cases—the existing exemption from preparing consolidated financial statements in IFRS 10 also applies only to private entities. In contrast, the staff do not think an identical exemption from applying the acquisition method would be appropriate for public entities. This is because, as noted in paragraph 28, such an exemption would place the burden of action on non-controlling shareholders if they are to benefit from information

prepared using the acquisition method. Thus, the staff think that public entities should apply the acquisition method by default—unless non-controlling shareholders express explicit consent to the entity applying a predecessor approach.

30. In addition, from the practical standpoint, the question arises of how likely a public entity would be able to secure such explicit consent in practice, especially from all its non-controlling shareholders, and whether and how such an approach could be made operational for public entities. The staff reviewed the attendance of annual general shareholders' meetings held in 2019 by the top 20 Fortune 500 companies[11] that are publicly traded and noted that none of those companies achieved full attendance. This might indicate that public entities may not be able to secure consent to applying a predecessor approach from all their non-controlling shareholders in practice. In turn, that may raise a question of whether such consent should be required from all non-controlling shareholders of a public entity, or whether a particular quantitative threshold would need to be introduced.

31. The staff think that introducing an exemption for public entities that is different to that for private entities would make the proposed model more complex. On the other hand, modifying the exemption proposed for private entities by requiring explicit consent from non-controlling shareholders for the use of a predecessor approach in the same manner as discussed for public entities in paragraph 29 would make the exemption for private entities less operational. That would increase the costs of applying the model proposed for private entities, without necessarily increasing the benefits of the resulting information. In addition, modifying the exemption for private entities would make it different from the existing requirements in IFRS 10. That would result in losing the benefit of having established practice and would make it more difficult for the Board to assess whether such an exemption would work well in practice.

32. On the basis of the analysis in this section, the staff do not think that the Board should modify the proposed model to extend the exemption from applying the acquisition method to public entities. However, the staff think that the discussion paper could discuss this alternative and seek feedback from stakeholders, including feedback on

[11] https://fortune.com/global500/2019/search/

the practical aspects of how such an exemption could work for public entities if stakeholders are supportive of it.

Extending the exception to public entities

33. As noted in paragraph 23, the Board has tentatively decided to propose an exception from applying the acquisition method for private entities to take into consideration the cost constraint and to limit opportunities for accounting arbitrage by private entities. In addition, the Board noted it is possible for a private entity to have non-controlling shareholders who are all the entity's related parties, and that such shareholders may have access to information from sources other than the entity's financial statements.

34. In principle, the staff can see a benefit of extending the exception from applying the acquisition method to public entities—so that, a public entity would be required to apply a predecessor approach if all its non-controlling shareholders are the entity's related parties. Generally, the staff do not think that such an extension to the exception would commonly apply in practice. This is because regulators often have requirements for a specified volume of shares of public entities to be held by parties referred to as 'public shareholders'—or referred to using a similar term—that is, parties that are not considered 'related' to the entity for the purposes of capital market regulations. Although the requirements related to 'non-public shareholders' differ across capital markets and the notion of 'non-public shareholders' may not align with the definition of related parties in IAS 24, such requirements make it unlikely in most cases that all non-controlling shareholders in a public entity are the entity's related parties as defined in IAS 24.

35. However, one case when an extension to the exception might sometimes apply is when both the public entity and all its non-controlling shareholders are controlled by the government as defined in IAS 24. The staff's research suggests that this could sometimes arise in, for example, China. In such scenarios, the public entity would fall into the scope of the extended exception from applying the acquisition method.

36. Accordingly, the staff think that extending the exception to public entities could alleviate the burden for reporting entities of applying the acquisition method in environments where government control is pervasive, but without depriving investors

of the most useful information in other circumstances. The staff note that special requirements for government-controlled entities already exist in IAS 24.

37. On the other hand, the staff think that non-controlling shareholders who are the entity's related parties would generally have the same information needs as unrelated shareholders and may not always have access to information about the entity from sources other than the entity's financial statements. This is even more likely to be the case when the non-controlling shareholders are related to a public entity only because both are under the government control. That is, such shareholders may not have any privileged access to information about the entity.

38. A similar concern also arises for non-controlling shareholders who are all related parties of a private entity. That is, those shareholders may not always have access to information about the entity from sources other than the entity's financial statements. Indeed, some stakeholders raised a concern about such scenarios. However, as discussed in paragraph 23, in the case of private entities, the additional argument for proposing the exception relates to minimising opportunities for accounting arbitrage. As discussed in paragraph 22, that consideration does not apply to public entities because capital market regulations would result in 'substantive' non-controlling interest in public entities.

39. Accordingly, on balance, the staff do not think that the Board should modify the proposed model to extend the exception from applying the acquisition method to public entities. However, the staff think that the discussion paper could discuss this alternative and seek feedback from stakeholders.

Question for the Board

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