Staff paper

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Project	**Business Combinations under Common Control**
Topic	**The cost-benefit trade-off**
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Introduction and purpose

1. This paper analyses whether the cost constraint on useful financial reporting should affect the selection of the measurement method(s) to apply to business combinations under common control (BCUCCs). Paragraphs 2.39–2.43 of the *Conceptual Framework for Financial Reporting (Conceptual Framework)* say it is important the costs of reporting financial information are justified by the benefits of reporting that information (see Appendix A). For simplicity, we refer to this as the 'cost-benefit trade-off'. This paper only considers the cost-benefit-trade-off as part of reaching overall decisions on selecting the measurement method. Deciding which measurement method to apply will involve considering all factors collectively including, for example, structuring opportunities (Agenda Paper 23G).

2. As noted in paragraph 15 of Agenda Paper 23A, this paper is a supporting paper included for reference—it does not contain questions for the International Accounting Standards Board (IASB). IASB members can raise any particular questions or comments on our analysis in this paper when discussing Agenda Papers 23B and 23C or when answering question (c) on page 8 of Agenda Paper 23A.

Background and structure of this paper

Observations/conclusions in the Discussion Paper

3. As Agenda Paper 23B explains, the IASB's preliminary views in the Discussion Paper *Business Combinations under Common Control* (Discussion Paper) about selecting the measurement method were:

   (a) neither the acquisition method nor a book-value method should apply to all BCUCCs;

   (b) in principle, the acquisition method should apply if a BCUCC affects non-controlling shareholders of the receiving entity (NCS), subject to the cost-benefit trade-off and other practical considerations; and

(c) a book-value method should apply to all other BCUCCs, including all combinations between wholly-owned entities.

4. In reaching its preliminary views the IASB considered, amongst other things, the cost-benefit trade-off (that is, whether the costs of applying the acquisition method or a book-value method to a BCUCC are justified by the benefits of information reported applying those methods).

BCUCCs that affect NCS

5. The IASB's preliminary view that, in principle, the acquisition method should apply to BCUCCs that affect NCS implies that the benefits of applying the acquisition method to such BCUCCs generally justifies the costs of doing so.

6. The IASB also considered whether the acquisition method should apply to all BCUCCs that affect NCS, or whether a book-value method should apply to some such BCUCCs to reflect the cost-benefit trade-off and other practical considerations. As a result, the IASB developed exceptions from applying the acquisition method (for example, the optional exemption)—Agenda Paper 23C analyses those exceptions separately.

BCUCCs that do not affect NCS

7. The IASB's preliminary view is that a book-value method should apply to all BCUCCs that do not affect NCS. This implies that the costs of applying the acquisition method to such BCUCCs would outweigh the benefits of doing so. The IASB did not develop any exceptions from applying a book-value method—respondents suggested some exceptions (for example, for BCUCCs by receiving entities with publicly traded debt) which Agenda Paper 23C analyses separately.

Structure of this paper

8. This paper analyses and sets out our initial views on feedback on the cost-benefit trade-off. Some respondents commented on the costs and benefits of applying the acquisition method and/or a book-value method to all BCUCCs while others commented on the costs and benefits of applying the measurement methods specifically to BCUCCs that affect NCS and/or to BCUCCs that do not affect NCS. Accordingly, our analysis considers separately relevant feedback on:

   (a) the relative costs of applying each method (paragraphs 11–16);

   (b) the cost-benefit trade-off—general considerations (paragraphs 17–21);

   (c) the cost-benefit trade-off for BCUCCs that affect NCS (paragraphs 22–27); and

   (d) the cost-benefit trade-off for BCUCCs that do not affect NCS (paragraphs 28–32).

9. Paragraph 33 summarise our initial views and Appendix A includes excerpts from the Conceptual Framework.

10. This paper does not analyse comments on the exceptions referred to in paragraphs 25 and 31—Agenda Paper 23C analyses feedback on the exceptions.

Staff analysis

The relative costs of applying each method

Observations/conclusions in the Discussion Paper

11. Feedback from stakeholders in developing the Discussion Paper indicated that a book-value method is typically less costly to apply than the acquisition method (see paragraph 2.8 of the Discussion Paper). As paragraph 4.17 of the Discussion Paper notes, the costs of applying a book-value method would be affected by whether the transferred business has prepared financial statements applying IFRS Accounting Standards.[1]

Feedback

12. Many respondents who said a book-value method should apply to all BCUCCs said a book-value method would be less costly to apply than the acquisition method, and provided the following additional feedback:

    (a) some of these said the receiving entity would incur not only the initial costs of the purchase price allocation but also ongoing additional costs of subsequent measurement (for example, impairment tests) if it applies the acquisition method; and

    (b) some of these said the controlling party would incur additional costs to reverse fair value adjustments when preparing its own financial statements if the receiving entity applies the acquisition method.

13. Other respondents did not specifically comment on whether a book-value method is less costly to apply than the acquisition method. However, various respondents said a book-value method should apply to some BCUCCs because the costs of applying the acquisition method to such BCUCCs would outweigh the benefits—this could imply that they think applying a book-value method to those BCUCCs would be less costly than applying the acquisition method.

Analysis and staff initial views

14. We expect the costs of applying the acquisition method to a BCUCC applying the IASB's preliminary views to be comparable to the costs of applying the acquisition method to a business combination covered by IFRS 3 *Business Combinations* (IFRS 3 BC). Although the controlling party may incur additional costs to reverse fair value adjustments when preparing its own financial statements, such

[1] The IASB has not yet deliberated how to apply a book-value method if the transferred business has not prepared financial statements applying IFRS Accounting Standards. The Discussion Paper only considered simple situations and did not address this situation.

consolidation adjustments are commonly required for intercompany transactions and would not, in our view, significantly affect the cost-benefit trade-off.

15. The costs of applying a book-value method, and how that compares to the costs of applying the acquisition method, will depend on:

    (a) the IASB's approach to designing a book-value method—for example, if the IASB designs a book-value method as a simplification of the acquisition method to avoid undue costs;

    (b) the IASB's decisions on how to apply a book-value method—for example, how to measure assets and liabilities received in a BCUCC when the transferred business has not prepared financial statements applying IFRS Accounting Standards; and

    (c) the facts and circumstances of each BCUCC—for example, whether or not the transferred business has prepared financial statements applying IFRS Accounting Standards.

16. The costs of applying a book-value method to a BCUCC will depend on various factors but, assuming the IASB designs a book-value method as a simplification of the acquisition method to avoid undue costs, we expect applying a book-value method to BCUCCs to be, on average, less costly than applying the acquisition method.

The cost-benefit trade-off—general considerations

Observations/conclusions in the Discussion Paper

17. As paragraphs 3–4 note, the IASB concluded that neither the acquisition method nor a book-value method should apply to all BCUCCs. This implies that the cost-benefit trade-off is not the same for all BCUCCs.

Feedback

18. Most respondents did not provide feedback on the cost-benefit trade-off for all BCUCCs. Some respondents said the costs of applying the acquisition method always outweigh the benefits and therefore a book-value method should apply to all BCUCCs.

19. A few respondents said the benefits of applying the acquisition method should be considered separately for each BCUCC. These respondents suggested allowing entities a policy choice between applying the acquisition method or a book-value method to BCUCCs.

Analysis and staff initial views

20. We disagree with respondents who say the costs of applying the acquisition method always outweigh the benefits. As explained in paragraph 5, we think the principle of applying the acquisition method to BCUCCs that affect NCS would meet the cost-benefit trade-off better than applying a book-value method.

21. We agree with respondents that allowing entities a policy choice of which measurement method to apply could allow the receiving entity to assess whether the benefits for its users justify the costs of applying each method, based on the facts and circumstances. However, the resulting lack of comparability (see paragraphs 25–28 of Agenda Paper 23B) would increase the costs of analysis for users.

The cost-benefit trade-off for BCUCCs that affect NCS

22. Paragraph 22–27 analyse feedback on the cost-benefit trade-off for the principle of which measurement method to apply to BCUCCs that affect NCS. Agenda Paper 23C analyses costs-benefit considerations for exceptions (for example, the optional exemption).

Observations/conclusions in the Discussion Paper

23. As paragraph 3 notes, the IASB's preliminary view is that, in principle, the acquisition method should apply to BCUCCs that affect NCS. This implies that the benefits of applying the acquisition method to such BCUCCs justifies the costs of doing so.

Feedback

24. Most respondents who agreed or mostly agreed with the IASB's preliminary view (see Agenda Paper 23B of the IASB's December 2021 meeting) did not specifically comment on the cost-benefit trade-off. However, agreeing with the IASB's preliminary view implies that they think the benefits of applying the acquisition method to BCUCCs that affect NCS would generally justify the costs.

25. As explained in paragraph 12, some respondents said the costs of applying the acquisition method outweigh the benefits for all BCUCCs, regardless of whether they affect NCS. Some respondents said the benefits of applying the acquisition method to BCUCCs that affect NCS generally justify the costs, of which:

    (a) some agreed with the IASB's preliminary view (for example, one user representative group said by raising external capital the receiving entity has accountability to NCS to provide such information); and

    (b) most said the benefits sometimes, but not always, justify the costs—they suggested, for example, applying a book-value method if affected NCS are insignificant or allowing the receiving entity a choice of which method to apply.

Analysis and staff initial views

26. In our initial view, applying the acquisition method to BCUCCs that affect NCS would generally meet the cost-benefit trade-off better than applying a book-value method because we think:

(a) users' common information needs are similar to those in an IFRS 3 BC (see Agenda Paper 23E);

(b) the costs of applying the acquisition method to a BCUCC will be comparable to applying it to an IFRS 3 BC (see paragraph 14); and

(c) therefore, the cost-benefit trade-off will be comparable to IFRS 3 BCs—IFRS 3 requires applying the acquisition method to IFRS 3 BCs, implying that the IASB concluded it meets the cost-benefit trade-off better than applying a book-value method.

27. Regarding feedback from respondents who said the benefits of applying the acquisition method to BCUCCs that affect NCS sometimes, but not always, justify the costs:

(a) paragraphs 25–28 of Agenda Paper 23B analyse whether to allow entities a policy choice of which method to apply; and

(b) Agenda Paper 23C considers possible exceptions whereby book-value method would apply to some BCUCCs that affect NCS.

The cost-benefit trade-off for BCUCCs that do not affect NCS

28. Paragraphs 28–32 analyse feedback on the cost-benefit trade-off for the principle of which measurement method to apply to BCUCCs that do not affect NCS. Agenda Paper 23C analyses costs-benefit considerations for exceptions (for example, applying the acquisition method if the receiving entity has publicly traded debt).

Observations/conclusions in the Discussion Paper

29. As paragraph 3 notes, the IASB's preliminary view is that a book-value method should apply to all BCUCCs that do not affect NCS. This implies that the costs of applying the acquisition method to such BCUCCs outweigh the benefits of doing so.

Feedback

30. Most respondents who agreed with the IASB's preliminary view (see Agenda Paper 23B of the IASB's December 2021 meeting) did not specifically comment on the cost-benefit trade-off. However, agreeing with the IASB's preliminary view implies that they think the costs of applying the acquisition method to BCUCCs that do not affect NCS outweigh the benefits. Some respondents who agreed with the IASB's preliminary view said the costs of applying the acquisition method to BCUCCs that do not affect NCS would outweigh the benefits.

31. Almost all respondents who disagreed with the IASB's preliminary view did not specifically comment on the cost-benefit trade-off. However, disagreeing with the IASB's preliminary view implies that they think the benefits of applying the acquisition method to some BCUCCs that do not affect NCS would justify the costs. A few respondents said the benefits of applying the acquisition method to BCUCCs

that do not affect NCS would justify the costs in some cases (for example, if the receiving entity has publicly traded debt).

Analysis and staff initial views

32. In our initial view, applying a book-value method to BCUCCs that do not affect NCS would generally meet the cost-benefit trade-off better than applying the acquisition method because:

(a) the information provided by either the acquisition method or a book-value method could meet the common information needs of potential investors, lenders and other creditors for a BCUCC that does not affect NCS (see Agenda Paper 23F); and

(b) the costs of applying a book-value method to a BCUCC will depend on various factors but, assuming the IASB designs a book-value method as a simplification of the acquisition method to avoid undue costs (see paragraphs 15–16), we expect applying a book-value method to BCUCCs to be, on average, less costly than applying the acquisition method.

Summary of staff initial views

33. Our initial views, with the assumptions explained in the relevant paragraphs, are:

(a) the costs of applying the acquisition method to a BCUCC will be comparable to the costs of applying the acquisition method to an IFRS 3 BC (paragraph 14);

(b) the costs of applying a book-value method to a BCUCC will depend on various factors but we expect applying a book-value method to BCUCCs to be, on average, less costly than applying the acquisition method (paragraph 16);

(c) applying the acquisition method to BCUCCs that affect NCS would generally meet the cost-benefit trade-off better than applying a book-value method (paragraph 26); and

(d) applying a book-value method to BCUCCs that do not affect NCS would generally meet the cost-benefit trade-off better than applying the acquisition method (paragraph 32).

Appendix A—Extracts from the Conceptual Framework

A1. The following extracts from the Conceptual Framework for Financial Reporting explain the cost constraint on useful financial reporting.

> 2.39 Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. There are several types of costs and benefits to consider.
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> 2.40 Providers of financial information expend most of the effort involved in collecting, processing, verifying and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur costs of analysing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.
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> 2.41 Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence. This results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual investor, lender or other creditor also receives benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all the information that every user finds relevant.
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> 2.42 In applying the cost constraint, the [IASB] assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. When applying the cost constraint in developing a proposed Standard, the [IASB] seeks information from providers of financial information, users, auditors, academics and others about the expected nature and quantity of the benefits and costs of that Standard. In most situations, assessments are based on a combination of quantitative and qualitative information.
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> 2.43 Because of the inherent subjectivity, different individuals' assessments of the costs and benefits of reporting particular items of financial information will vary. Therefore, the [IASB] seeks to consider costs and benefits in relation to financial reporting generally, and not just in relation to individual reporting entities. That does not mean that assessments of costs and benefits always justify the same reporting requirements for all entities. Differences may be appropriate because of different sizes of entities, different ways of raising capital (publicly or privately), different users' needs or other factors.