Business Combinations under Common Control

World Standard-setters Conference 2019

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Agenda

Background

When to apply alternative approaches

- Transactions that affect non-controlling shareholders
- Transactions that do not affect non-controlling shareholders

How to apply alternative approaches

- Applying a current value approach
- Applying a predecessor approach

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Background

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Why we are doing the project

Issue

IFRS Standards **do not specify** how to account for business combinations under common control. As a result:

- Transactions are reported in different ways
- Lack of comparability

Objective

Develop **requirements** that would **improve comparability and transparency** of accounting for business combinations under common control and group restructurings by the receiving entity.

Business combinations under common control are common in practice, in particular in emerging economies.

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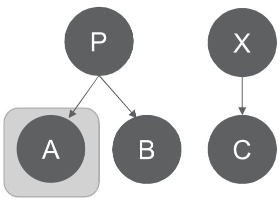
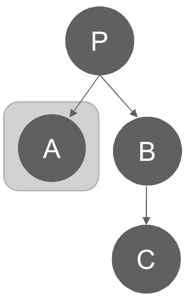
Illustrating the issue

Before

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

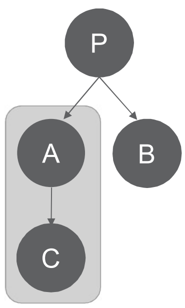


Scenario 2
Entity A and Entity C are controlled by Entity P



After

Entity A acquires Entity C



Reporting by Entity A

Scenario 1:

- The transaction is a **business combination** between third parties
- IFRS 3 *Business Combinations* requires the acquisition method
- Entity A reflects assets and liabilities of Entity C 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
- Entity A reflects assets and liabilities of Entity C at **fair value** or at **predecessor carrying amounts**

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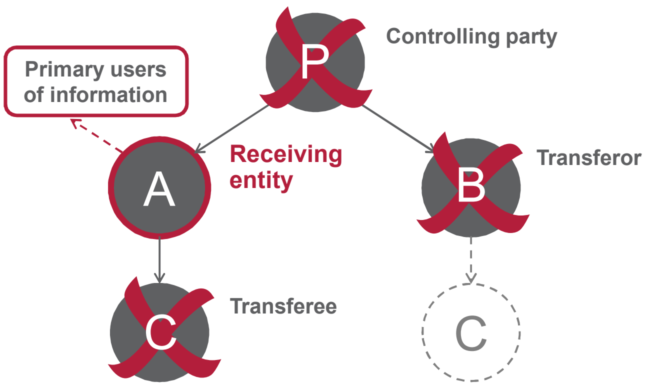
Focus on the receiving entity



- 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.
- The project focuses on information needs of the **primary users** of the receiving entity's financial statements. Primary users are existing and potential investors, lenders and other creditors. Different 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.

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Focus on the primary users of information

Non-controlling shareholders (NCS)	Lenders and other creditors	Potential equity investors	Controlling party
• Typically perpetual claim against receiving entity • Transaction may affect value of claim • Exposed to residual equity risks of receiving entity	• Contractual maturity of the claim against receiving entity • Transaction may affect recoverability of claim • Exposed to credit risk of receiving entity	• No existing claim against the combining entities at the time of transaction • Investment decision is made for combined entity not just receiving entity	• Controls all combining entities before/after transaction • Does not solely rely on receiving entity's financial statements for information

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How we develop measurement approaches

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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*
- *Accounting arbitrage*

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Where we are today

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Transactions that affect non-controlling shareholders of the receiving entity

A current value approach

Transactions that do not affect non-controlling shareholders of the receiving entity

A predecessor approach

A current value approach for at least some transactions that affect NCS

Transactions within the scope of the BCUCC project

A predecessor approach for all other transactions within the scope, including those that affect lenders and other creditors and those undertaken in preparation for a sale.

A current value approach for all or some transactions that affect non-controlling shareholders?

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Transactions that affect non-controlling shareholders

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Are current values always appropriate for NCS?

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Require a current value approach based on the acquisition method

For **ALL** transactions that affect NCS	For **SOME** transactions that affect NCS
All non-controlling shareholders will receive current value information in all scenarios.	Some non-controlling shareholders will not receive current value information.
However, the benefits of providing that information may not justify the costs in all cases.	However, this approach aims to consider whether the benefits of providing that information justify the costs.
In addition, this approach may give rise to opportunities for accounting arbitrage (achieving a particular accounting outcome by issuing a few shares).	In addition, this approach could minimise opportunities for accounting arbitrage by specifying objective conditions for using a particular accounting treatment.

On balance, the staff expect to recommend that a current value approach is not required for all transactions that affect NCS

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Which transactions that affect NCS?

How to make a distinction between transactions that affect NCS

Qualitative factors

- Traded equity instruments vs privately held
- NCS are not related parties (IAS 24)
- NCS discretion

Quantitative factor

- Size of interest held by NCS

Combination of qualitative and quantitative factors

The staff expect to recommend a qualitative distinction. A quantitative distinction would lack a conceptual basis and may give rise to opportunities for accounting arbitrage.

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Alternatives for qualitative distinction for NCS

Transactions that affect non-controlling shareholders of the receiving entity

	Receiving entity's equity instruments are traded in a public market	Privately held receiving entity: NCS discretion	Privately held receiving entity: NCS are related parties
A current value approach only for publicly held receiving entities	Current value approach	Predecessor approach	Predecessor approach
A current value approach for all publicly held and some privately held receiving entities	Current value approach	Current value approach	Predecessor approach

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Polling question 1

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

Do you agree with applying a current value approach to transactions that affect non-controlling shareholders of the receiving entity?

A. Yes—for all transactions that affect NCS of the receiving entity
B. Yes—for publicly traded entities only
C. Yes—for for publicly traded entities and some private entities
D. No—a current value approach should not be applied to such transactions

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Transactions that do not affect non-controlling shareholders

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Are all BCUCC transactions 'acquisitions'?

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Is there a difference between BCUCC transactions that affect non-controlling shareholders of the receiving entity and those that do not?

BCUCC transactions that affect NCS of the receiving entity

Similar to business combinations between third parties, there is an **acquisition** of residual equity interest in the transferred entities for non-controlling shareholders of the receiving entity.

Consider a current value approach based on the acquisition method eg with additional disclosure

BCUCC transactions that do not affect NCS of the receiving entity

Unlike in business combinations between third parties, there is **no acquisition** of residual equity interest in the combining entities for their shareholders. The interest held by the controlling party continues unchanged.

Consider requiring a different approach, such as a form of predecessor approach

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Information needs of lenders and other creditors

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Nature of claims

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

Focus of credit analysis

- Recoverability
- Specific time frames
- Capital structure

Information needs of debt investors and credit analysts

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

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Focus of credit analysis

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Debt investors and credit analysts use a variety of tools and techniques but there are two common areas of focus.

Predominance of cash flow analysis	**Focus on the total gross debt**
Cash flow measures or their proxies such as EBITDA, cash flow projections and cash flow-based ratios are at the heart of credit analysis.	Qualitative and quantitative information about both recognised debt and unrecognised commitments.

This information and credit analysis would be largely unaffected by whether a current value approach or a predecessor approach is used to account for business combinations under common control.

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Information needs of potential equity investors

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	Non-controlling shareholders	**Potential equity investors**
Economic decisions	Hold or sell an existing investment	
	Place a new investment	
Assessing the prospects for future net cash inflows	Use accounting data as input to valuation models. Existing and potential equity investors generally use the same valuation models.	
Assessing management's stewardship of the entity's economic resources	Need information to monitor management's stewardship and decide whether they can trust management with further capital.	

Both existing and potential equity investors focus on valuation in their analysis.

However, their economic position relative to combining entities is different.

Existing NCS acquire residual interest in the transferred entities, or businesses, as a result of the transaction.

Potential equity investors will make their investment decisions relative to the combined entity.

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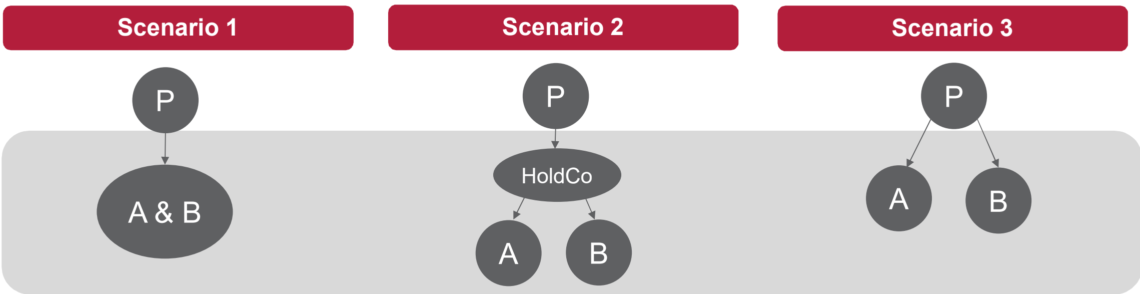
Illustrating transactions that affect PEI
Step 1—group structure before the combination

Parent P controls and wholly owns complementary Businesses A and B. Parent P decides to sell Businesses A and B together in an IPO. The legal structure of the group pre IPO is different.



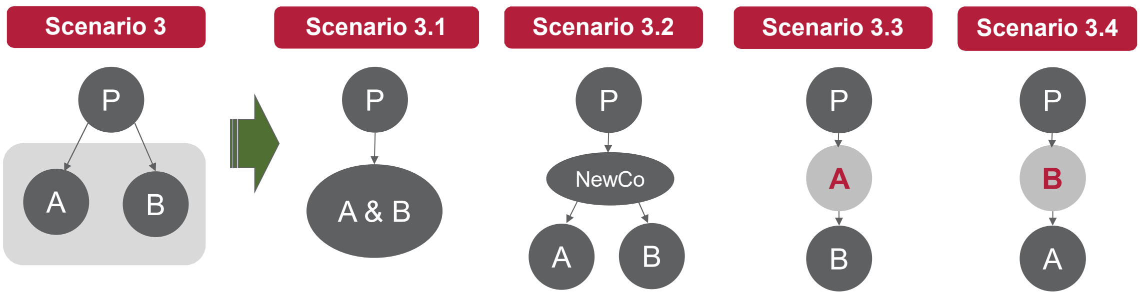
Businesses A and B can be sold together as a single legal entity.

Businesses A and B are held via NewCo and can be sold together by selling HoldCo.

Businesses A and B are separate legal entities directly owned and controlled by Parent P. Parent P must undertake a restructuring to sell Entities A and B.

Illustrating transactions that affect PEI
Step 2—restructuring in preparation for an IPO

In Scenario 3, Parent P could undertake the restructuring in a number of different ways.



Businesses A and B are separate legal entities directly owned and controlled by Parent P

Legal merger of Entities A and B

NewCo is formed to acquire Entities A and B

Entity A acquires Entity B

Entity B acquires Entity A

Illustrating transactions that affect PEI
Step 3—restructuring is complete

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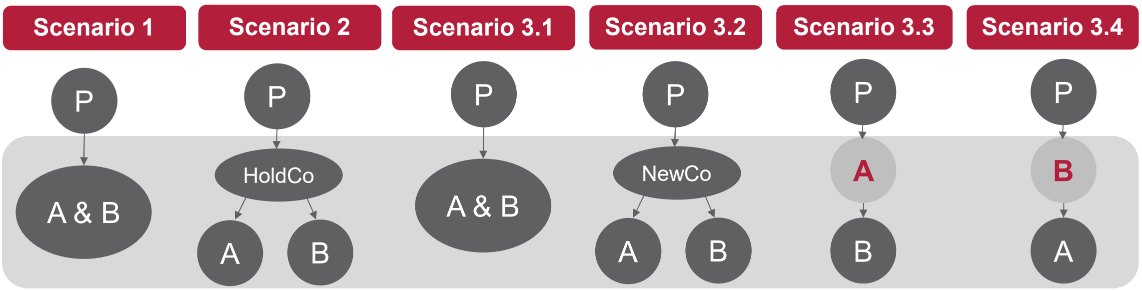
Parent P completes the restructuring in preparation for an IPO of Businesses A and B



- In all scenarios, potential equity investors in an IPO are investing in Businesses A and B
- In Scenarios 1 and 2, potential equity investors will receive historical information about Businesses A and B
- The same information could also be provided in all sub-scenarios of Scenario 3 by applying a form of predecessor approach

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Polling question 2

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The Board tentatively decided that it need not necessarily pursue a single approach for all transactions within the scope of the project and that it could pursue a predecessor approach for transactions that do not affect non-controlling shareholders.

Do you agree with applying a predecessor approach to transactions that do <u>not</u> affect non-controlling shareholders of the receiving entity?

A. Yes
B. No—a current value approach should be applied to all transactions
C. No—a different approach should be applied
D. I do not know

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Applying a current value approach

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Applying a current value approach
Start with the acquisition method

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The Board is developing a current value approach based on the acquisition method for transactions that affect non-controlling shareholders of the receiving entity.

To the extent those transactions are similar to business combinations, similar information should be provided and to the extent they are different, different information should be provided.

Distribution

If the consideration transferred exceeds the fair value of the acquired interest, recognise a distribution from the receiving entity's equity?

Disclosures

Provide additional disclosures to help users of the receiving entity's financial statements understand the effects of the transaction?

Contribution

If the fair value of the acquired net assets exceeds the fair value of the consideration transferred, recognise a contribution to the receiving entity's equity instead of recognising a gain?

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Illustrating a business combination

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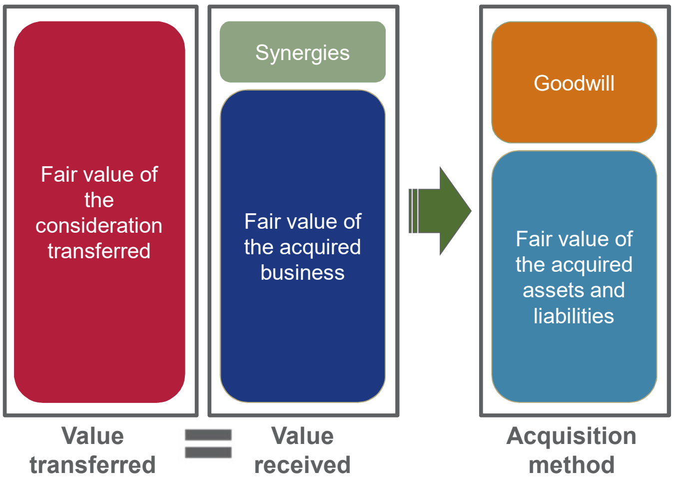
Consider a business combination from the perspective of the acquiring entity



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

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Applying a current value approach
Illustrating a BCUCC

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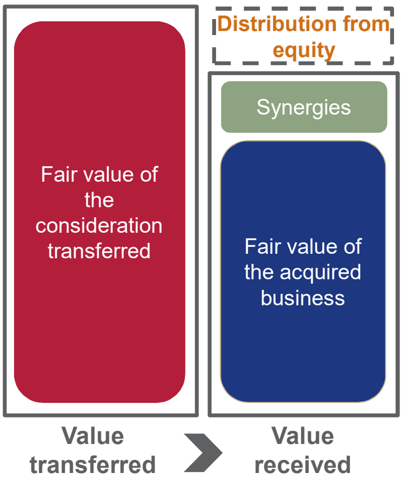
Consider a business combination under common control from the perspective of the receiving entity



- A business combination under common control may be:
  - directed by the controlling party; and
  - undertaken to produce benefits for other entities within the group instead of the receiving entity.
- In some cases, regulations may be in place to require transactions that affect NCS in the receiving entity to be conducted at fair value.
  - *however*, consideration may not always reflect fair value of the acquired business and expected synergies.
- Economically, any excess consideration over the fair value of the acquired business and expected combination synergies represents a distribution from the receiving entity's equity.

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Applying a current value approach
Information about a distribution in a BCUCC

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- The staff have identified two broad alternatives to providing information about a distribution in a business combination under common control in the receiving entity's financial statements.

Recognition or **Disclosure**

Recognition

- 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 would be subject to measurement uncertainty.

Disclosure

- Instead of being recognised separately, any distribution is subsumed within goodwill that is subject to subsequent annual impairment tests.
- Notes to financial statements provide information about the transaction to help users evaluate its effects on the receiving entity's financial position and performance.

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Applying a current value approach
Information about a contribution in a BCUCC

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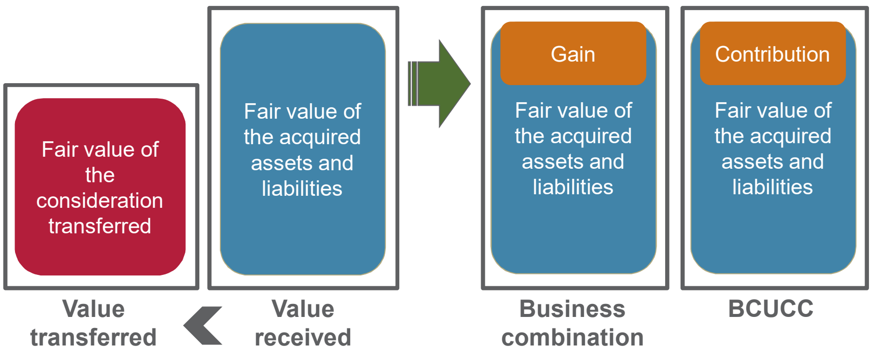
- Occasionally, an acquirer in a business combination will make a bargain purchase in which the fair value of the acquired assets and liabilities exceeds consideration transferred. Applying the acquisition method, the acquirer recognises that excess as a gain.
- In a business combination under common control, any such access represents a contribution to the receiving entity's equity rather than a gain and in the staff's view should be recognised as such.



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Polling question 3

In your view on applying a current value approach, which alternative for reporting a distribution should the Board pursue?

A. Recognising distribution in primary financial statements despite the measurement uncertainty involved
B. Providing information about the distribution in the notes
C. Neither of the above—information about a distribution applying a current value approach is not useful

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Applying a predecessor approach

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Applying a predecessor approach

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The Board decided that it could pursue a predecessor approach for transactions that do not affect non-controlling shareholders of the receiving entity.

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 pre-combination information.

Pre-combination information	Predecessor carrying amounts	Presentation in equity
Entities reflect a business combination under common control from the date it occurred or as if the entities were combined from the beginning of the comparative period—or from a date when entities were first under common control, if later.	Entities recognise acquired assets and liabilities at their predecessor carrying amounts. In some cases, the carrying amounts at the transferred entities are used and in other cases the carrying amounts at the controlling party. Applying the reporting entity concept, the staff expect to recommend the former.	Any difference between the consideration transferred and the predecessor carrying amounts of the acquired assets and liabilities is recognised in equity. Presentation in equity is generally not prescribed by the Board.

Focus of the breakout session

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Providing pre-combination information

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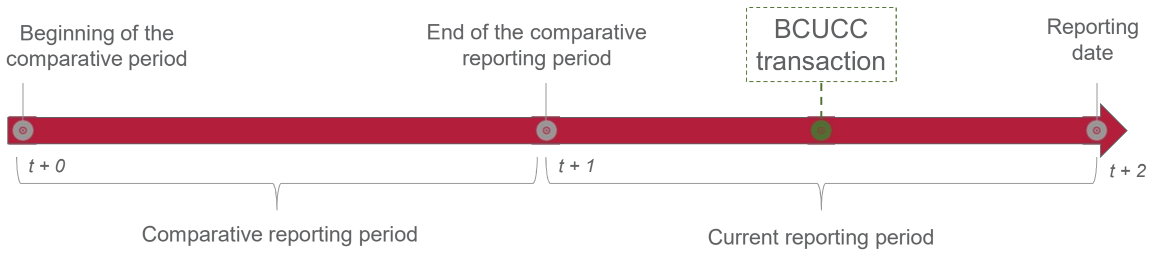

Diversity in practice in providing pre-combination information

Alternative A

- Acquired assets, liabilities and results of operations are recognised from **the beginning of comparative period**.
- Pre-combination information on the face of financial statements is provided for all combining entities.

Alternative B

- Acquired assets, liabilities and results of operations are recognised from **the date of the transaction**.
- Pre-combination information on the face of financial statements is provided only for the receiving entity.

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Does the previous reporting entity continue?

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The staff think that Alternative A and Alternative B could result in the same information depending on whether the transaction results in (1) continuation of a previous reporting entity in a new legal form; or (2) a new set of assets, liabilities and results of operations reported together for the first time.

Providing pre-combination information on the face of financial statements

Continuation of a previous reporting entity		**A new set of net assets put together**	
Alternative A	Alternative B	Alternative A	Alternative B
Previous reporting entity		All combining entities/ businesses	Receiving entity only
Scenarios 1a and 2a		Scenarios 1b, 2b and 2c	

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Pre-combination information Scenario 1a

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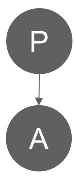
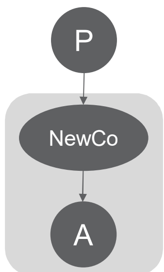
Before BCUCC

- 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 represents a **continuation** of Entity A.

Alternative A
NewCo will provide pre-combination information for Entity A (from Entity A's FS).

Alternative B
NewCo will provide pre-combination information for Entity A (from Entity A's FS).

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Pre-combination information Scenario 1b

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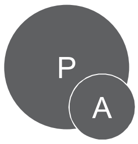
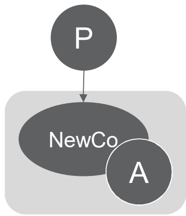
Before BCUCC

- 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

A **new set** of assets, liabilities and results of operations are reported together for the **first time** (because Business A is not a reporting entity).

Alternative A
NewCo will provide carveout pre-combination information about Business A.

Alternative B
NewCo will not provide pre-combination information about Business A.

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Pre-combination information Scenario 2a

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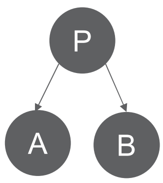
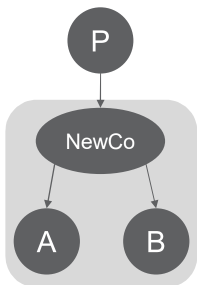
Before BCUCC

- 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 represents a **continuation** of Parent P as investments in Entities A and B are Parent P's only assets and Parent P is a reporting entity that presents consolidated FS.

Alternative A
NewCo will provide pre-combination information for both Entities A and B (from Parent P's consolidated FS).

Alternative B
NewCo will provide pre-combination information for both Entities A and B (from Parent P's consolidated FS).

Pre-combination information Scenario 2b

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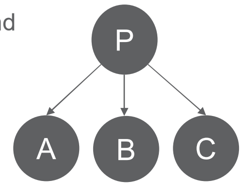
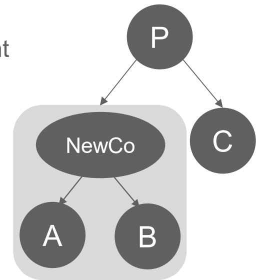
Before BCUCC

- 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

A **new set** of assets, liabilities and results of operations are reported together for the **first time** (as Entities A and B are not Parent P's only assets).

Alternative A
NewCo will provide combined pre-combination information for both Entities A and B.

Alternative B
No pre-combination information for Entities A and B is provided on the face of NewCo financial statements.

Pre-combination information Scenario 2c

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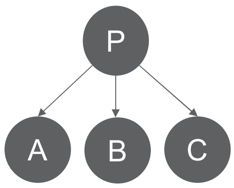
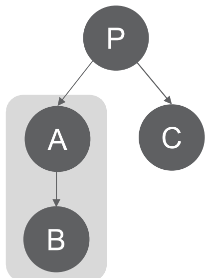
Before BCUCC

- 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.



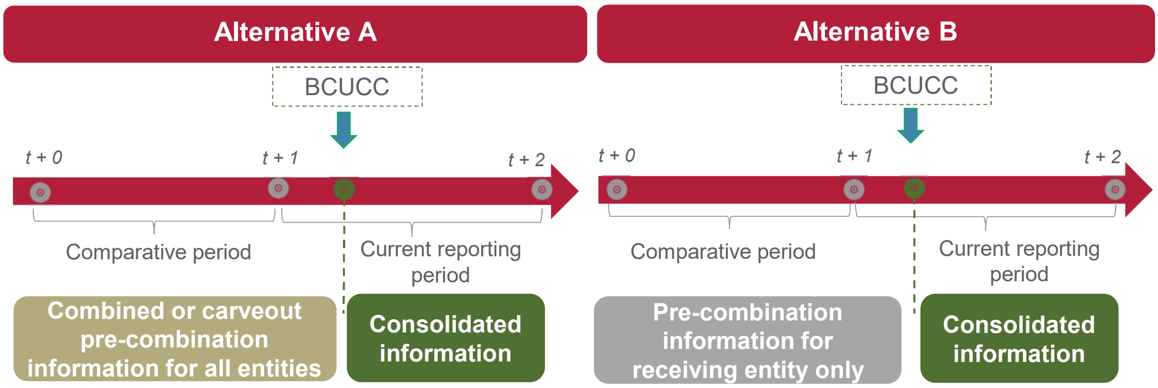
Analysis

Similar to Scenario 2b, a **new set** of assets, liabilities and results of operations are reported together for the **first time**.

Alternative A
Entity A will provide combined pre-combination information for both Entities A and B.

Alternative B
Entity A will not provide pre-combination information for Entity B.

Bringing it all together



Polling question 4

In your view on applying a predecessor approach, what would result in more useful information on the face of financial statements about a transaction that does not affect NCS of the receiving entity?

A. Providing pre-combination information for all combining entities from the beginning of the comparative period
B. Reporting the combination from the date of the transaction and providing pre-combination information for the receiving entity only
C. Neither A or B—pre-combination information should not be provided for any of the combining entities applying a predecessor approach
D. Neither A or B—such transactions should be reported applying a current value approach

Project timeline

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December 2017	June 2018	April 2019	H2 2019	H1 2020
Scope of the project is finalised	Start with a current value approach for transactions that affect NCS	Need not necessarily pursue a single approach to all BCUCC transactions	*When* and *how* to apply a current value approach and a predecessor approach to BCUCC transactions	Discussion paper

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Get involved

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