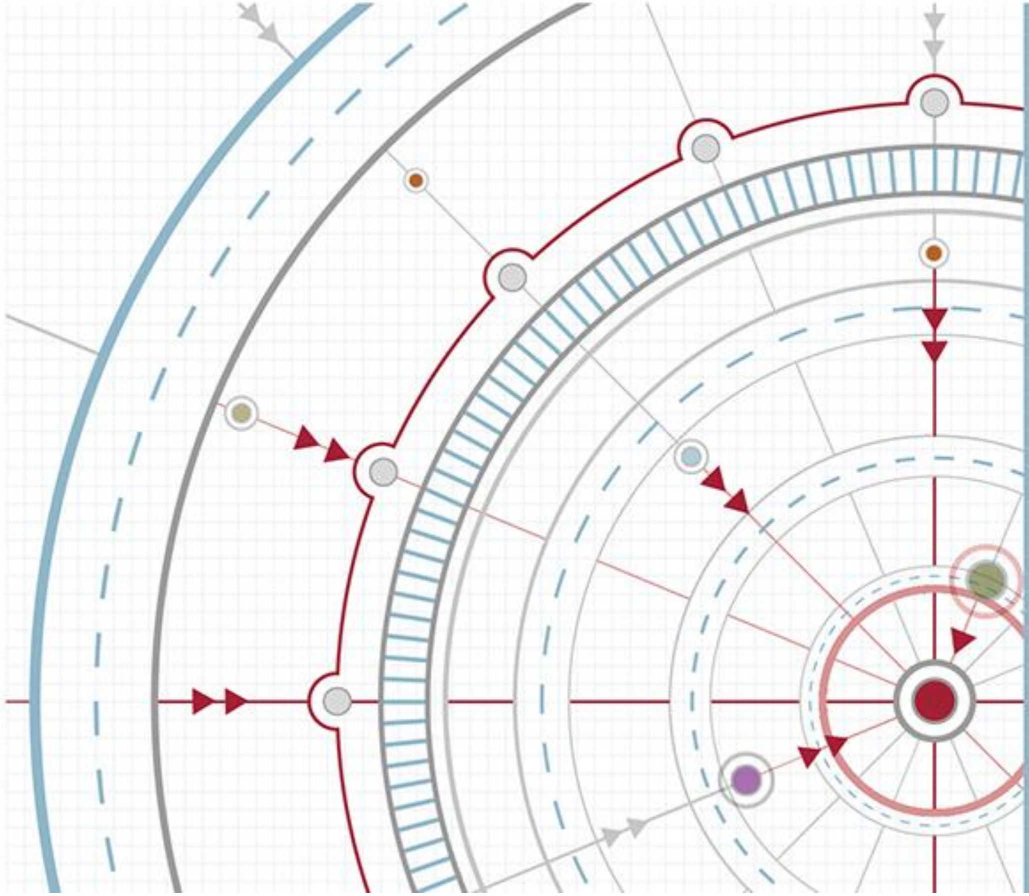

Emerging Economies Group
March 2019

Agenda paper 3

Business Combinations under Common Control

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board or IFRS Foundation.

Content

Purpose of the session

The staff seek EEG members' views on the accounting approaches being developed to business combinations under common control and whether these approaches would meet the information needs of the primary users of the receiving entity's financial statements. 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.

Questions for EEG members (1/3)

BCUCC that affect NCI in the receiving entity

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 20)? In particular:
   a) do you think that a current value approach should be applied to all or some business combinations under common control that affect NCI, and why?
   b) if a current value approach is applied to only some transactions that affect NCI, how do you think the distinction should be made, and why?

Questions for EEG members (2/3)

Lenders and other creditors

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 24)?
3. Do you agree that the Board could pursue different approaches for:
   a) all or some business combinations under common control that affect NCI in the receiving entity; and
   b) those that affect lenders and other creditors in the receiving entity but do not affect NCI?

Questions for EEG members (3/3)

Prospective equity investors

4. 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 29)?

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Project recap and update

Previous EEG discussion—December 2017

Scope of the project (see slide 9)

In October 2017 the Board tentatively decided to include in the scope of the project transactions under common control in which the reporting entity obtains control over one or more businesses, regardless of whether IFRS 3 *Business Combinations* would identify the reporting entity as the acquirer if IFRS 3 were applied.

EEG members welcomed the Board's October 2017 tentative decision.

EEG members supported the staff's December 2017 recommendations for the Board that the project should also consider business combinations under common control that are either preceded by an external acquisition of one or more combining parties; or followed by an external sale of the combining parties; or both.

The Board tentatively agreed the recommendations by the staff.

Scope of the project

focuses on transfers of
Business
(as defined in IFRS 3 *Business Combinations*)
under common control

includes **more** transactions than just **BCUCC**

addresses financial reporting by the **receiving entity**

considers **application questions**

Previous EEG discussion—December 2017

Primary users (see slides 11–12)

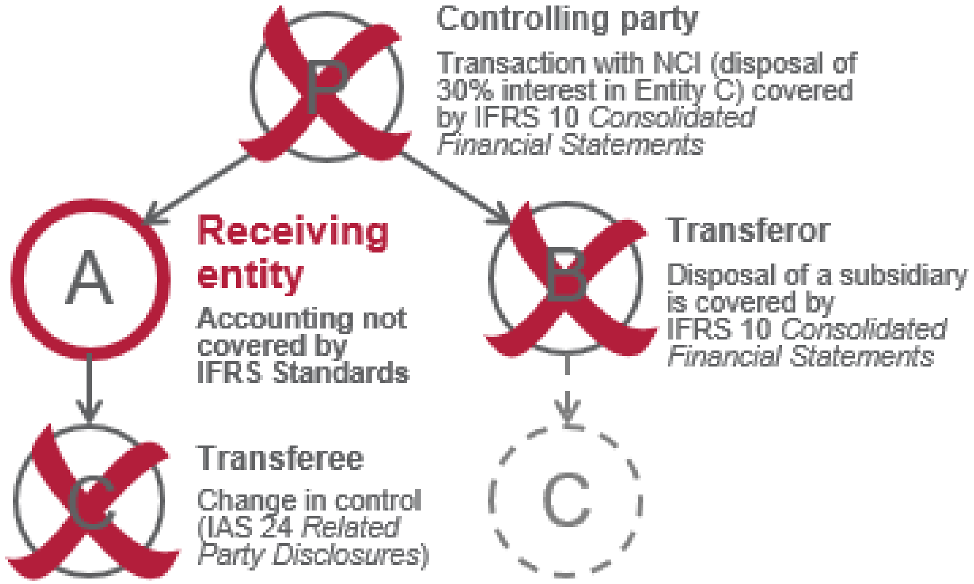
Some EEG members suggested that the Board **focus on the information needs** of external parties (eg NCI or prospective equity investors in an IPO) affected by the transaction.

→

In exploring measurement approaches, the staff is focusing on the information needs of the primary users of the receiving entity's financial statements.

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.

Previous EEG discussion—December 2017

Measurement approaches for BCUCC (see slide 14)

EEG members discussed whether the acquisition method or a predecessor approach should be used as **the starting point** in developing requirements for BCUCC.

Most EEG members stated a predecessor approach is commonly applied in their jurisdictions. One of the reasons is the **cost-benefit considerations**.
The members acknowledged **diversity in practice** in applying predecessor method.

Some EEG members agreed that in some circumstances the **acquisition method can provide useful information** to financial statements users.

In June 2018, 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 **for BCUCC that affect non-controlling shareholders**. *(see slide 17)*

In December 2018, the Board discussed whether such an approach should be applied to **all or only some BCUCC that affect a NCI** in a receiving entity and how any such distinction should be made. No decisions were made. *(see slide 18)*

In March 2019, the Board will discuss which approach or approaches should be applied for BCUCC that affect **lenders and other creditors or prospective equity investors**. The Board will not be asked to make decisions at that meeting.

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

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

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Approach for transactions that affect NCI (1/4)

Acquisition method

Possible modifications to consider

Additional disclosures

Recognise a contribution instead of recognising a gain if fair value of acquired net assets exceeds consideration

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 providing 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).

Approach for transactions that affect NCI (2/4)

Factors considered (see slide 14)	**Require a current value approach based on the acquisition method** For **ALL** transactions that affect NCI	**Require a current value approach based on the acquisition method** 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 Appendix A—*Approach for transactions that affect non-controlling interest.*

Approach for transactions that affect NCI (3/4)

Ways of making a distinction between transactions that affect NCI

Qualitative			**Quantitative**
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 Appendix A—*Approach for transactions that affect non-controlling interest*.

Approach for transactions that affect NCI (4/4)

Staff's observations

- 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 Appendix A—*Approach for transactions that affect non-controlling interest*.

Lenders and other creditors

BCUCC between wholly owned entities

Lenders and other creditors (1/3)

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

Lenders and other creditors (2/3)

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 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 Appendix B—*Lenders and other creditors in BCUCC.*

Lenders and other creditors (3/3)

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, the staff identified a number of common features.

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.

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.

The essence of credit analysis of the entity is the same regardless of whether it relates to an existing or potential debt investment.

Some debt investors and credit analysts have access to private information by virtue of contractual arrangements with the entity and rely on that private information in their analysis.

Implications for BCUCC

- This information and analysis would be largely unaffected by whether a current value approach or a predecessor approach is used for BCUCC.
- Information about the amounts, maturity and seniority of debt and unrecognised commitments acquired in a BCUCC would be essential for credit analysis.

For further information refer to paragraphs 18–30 of Appendix B.

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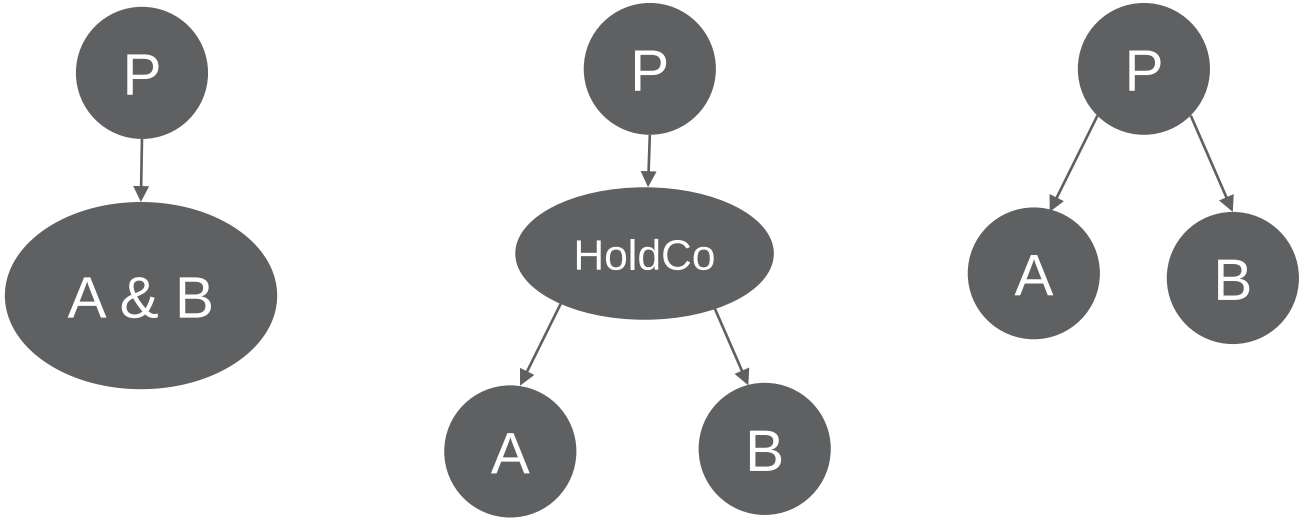
Prospective equity investors

BCUCC between wholly owned entities

Prospective equity investors (1/4)

Group structure before restructuring and subsequent sale

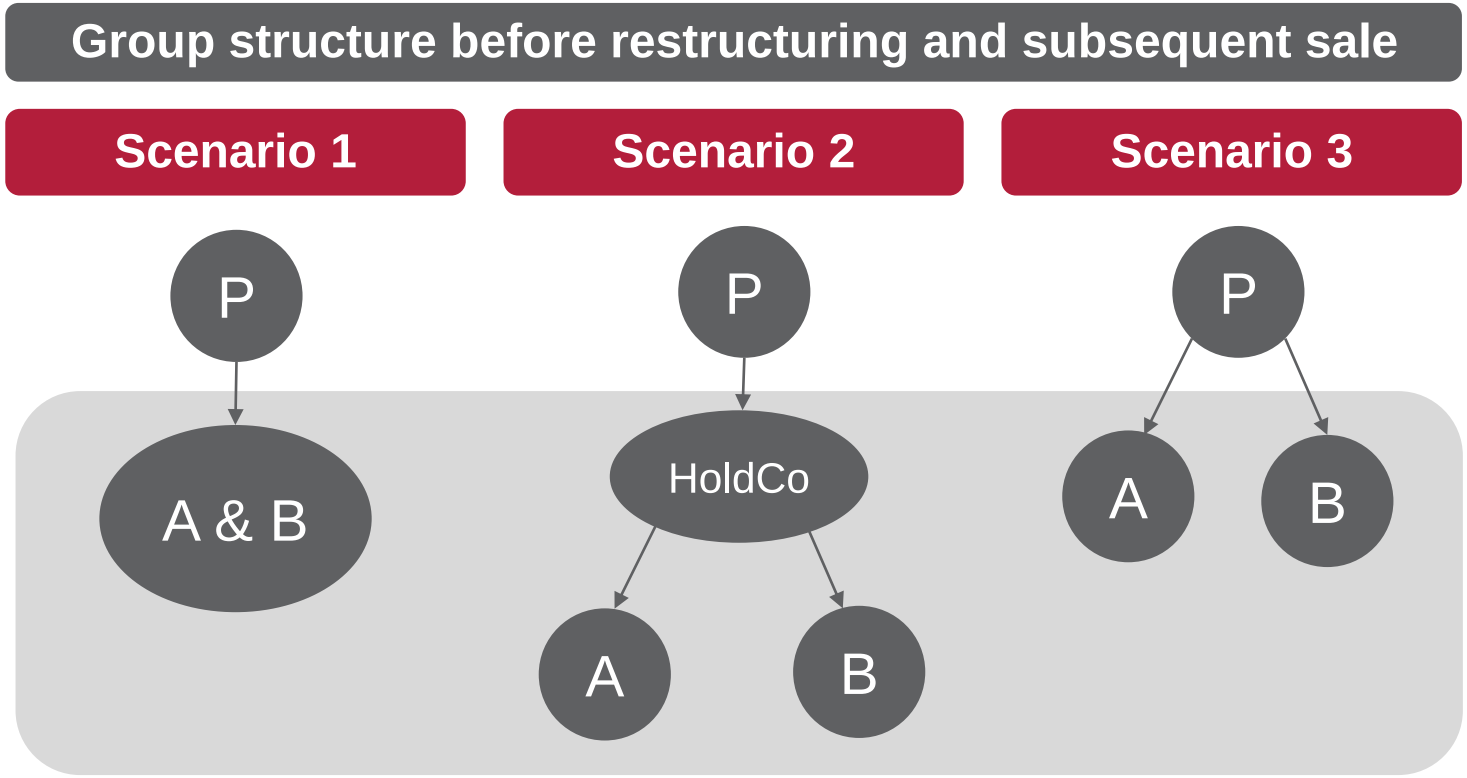
Scenario 1	Scenario 2	Scenario 3



Consider the following scenarios

- Parent P controls and wholly owns businesses A and B.
- In Scenario 1, businesses A and B are contained within a single legal entity.
- In Scenario 2, 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.

Prospective equity investors (2/4)



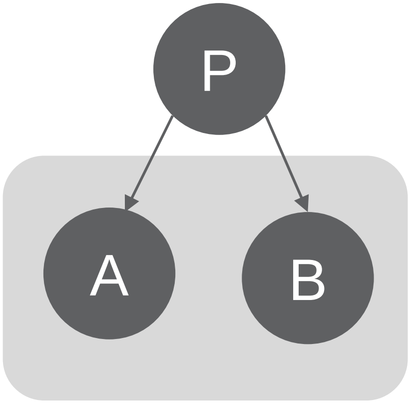
Parent P decides to sell businesses A and B together in an IPO.

- 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.

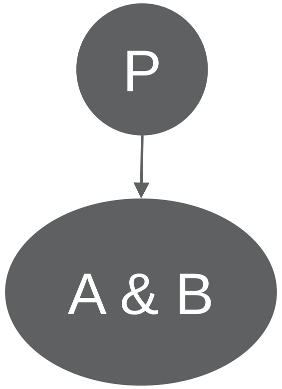
Prospective equity investors (3/4)

Restructuring in preparation for a sale in an IPO

Scenario 3

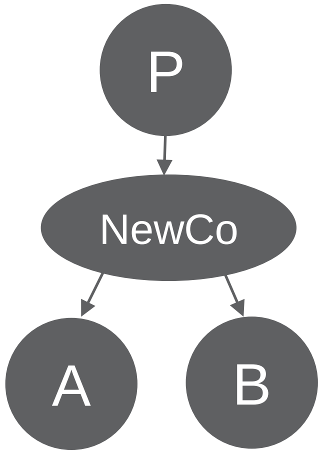


Scenario 3.1



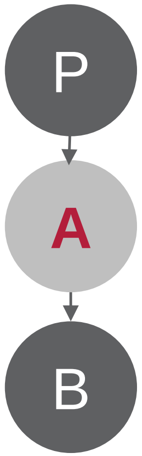
Legal merger of entities A and B in preparation for an IPO

Scenario 3.2



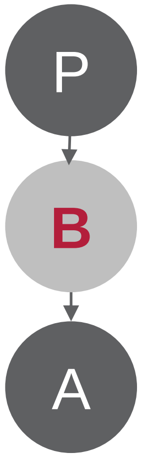
NewCo is formed to acquire A and B in preparation for an IPO

Scenario 3.3



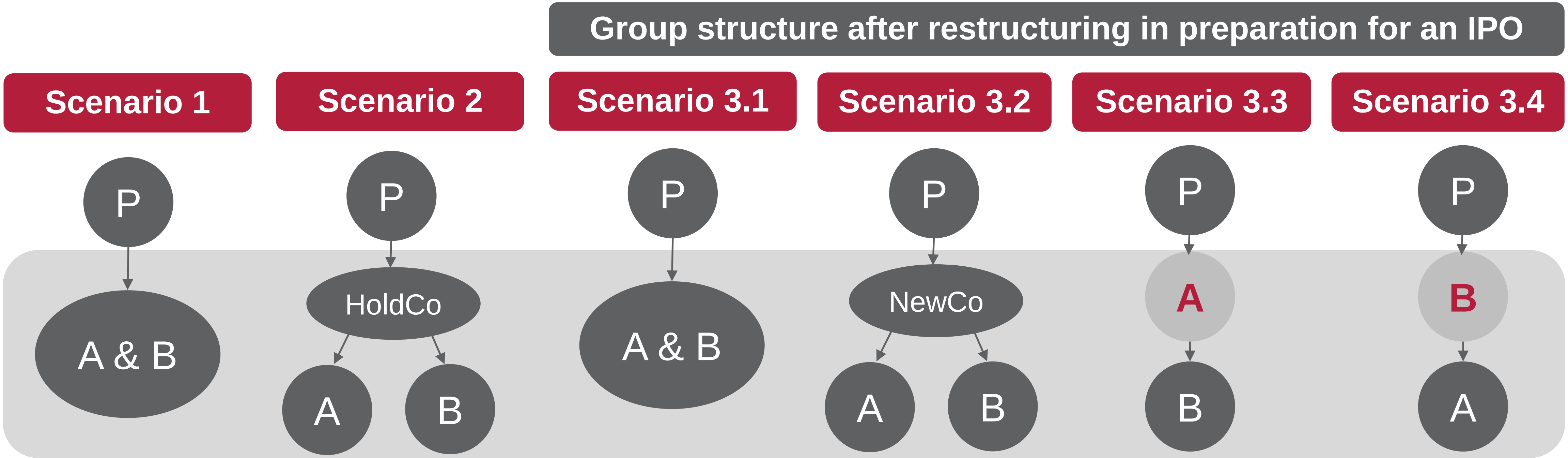
A acquires B in preparation for an IPO

Scenario 3.4



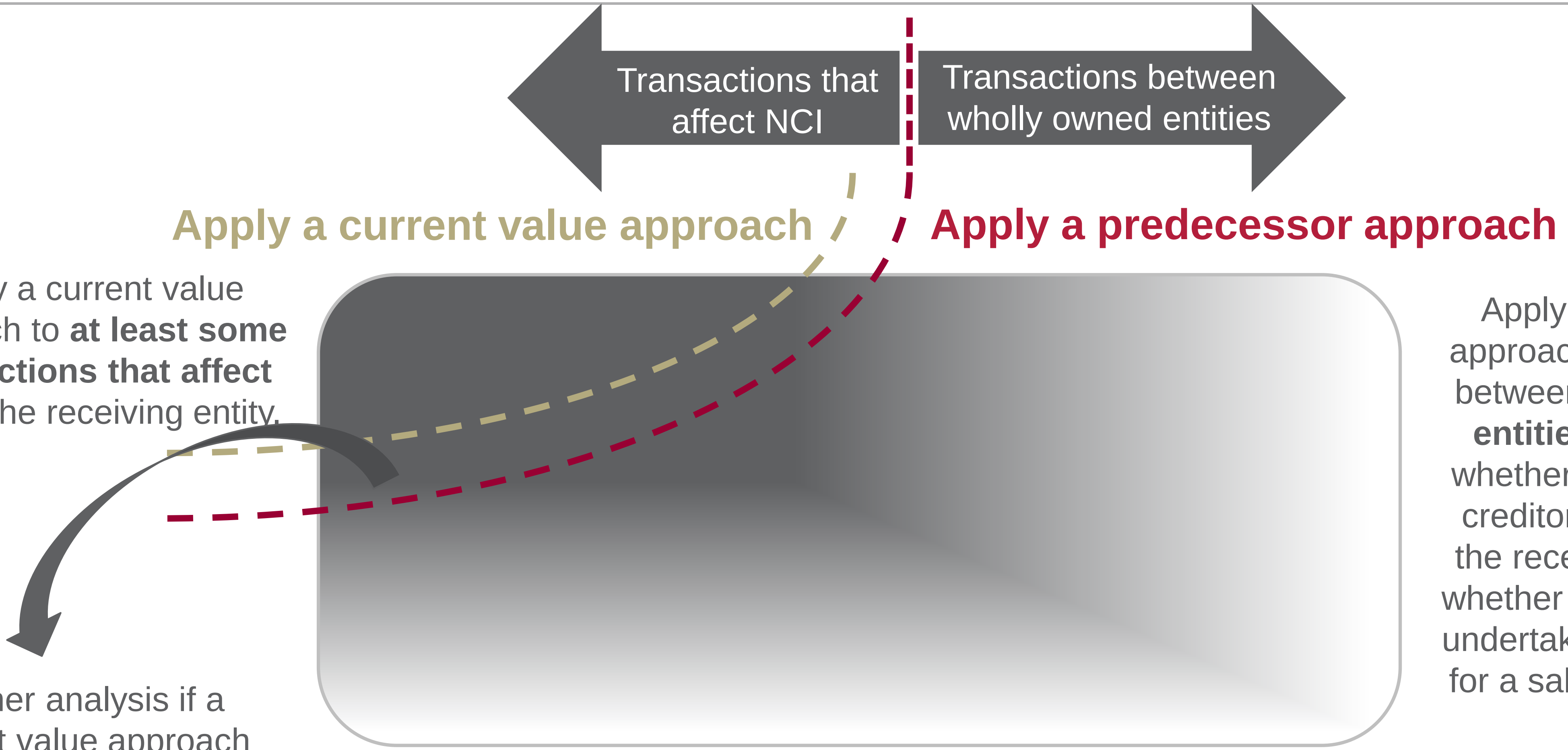
B acquires A in preparation for an IPO

Prospective equity investors (4/4)



The staff note that in all these scenarios the economic substance remains 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.

Bringing it all together
Staff's observations



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

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.

Transactions within the scope of the BCUCC project

Project timeline and next steps

Dec 2017	Scope of the project is finalised
Feb 2018	Direction for transactions within the scope of the project
Jun 2018	Direction for transactions that affect NCI
H2 2018 - 2019	Develop approaches for transactions within the scope of the project
H1 2020	Discussion paper expected to be published

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