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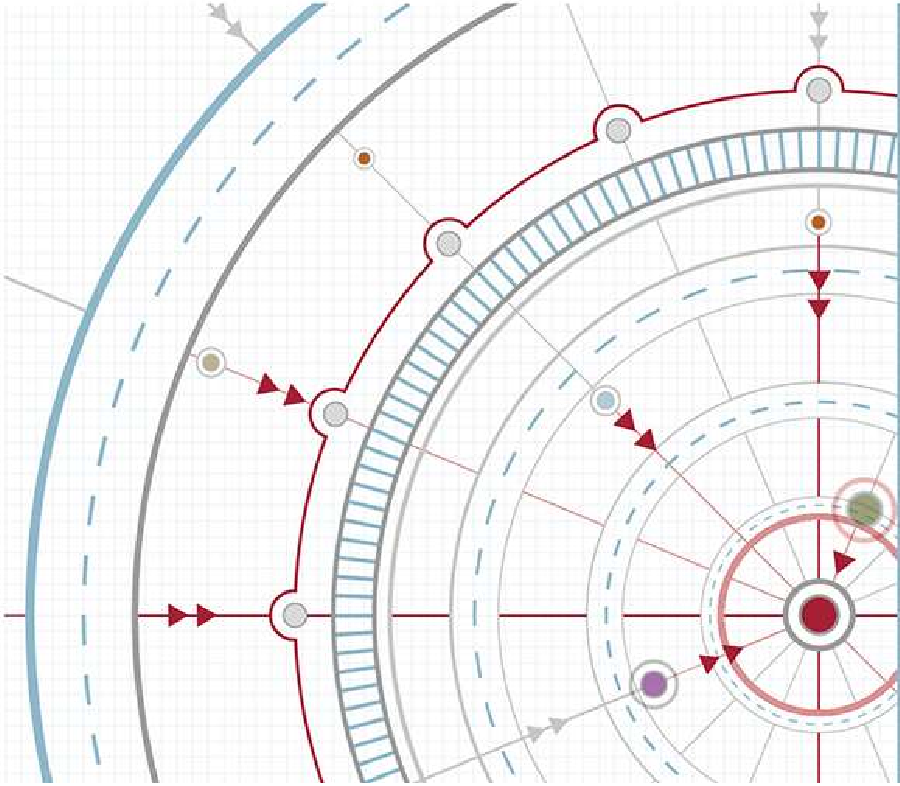

Business Combinations under Common Control

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International Accounting Standards Board

EFRAG Board, July 2020

Agenda

- Introduction
- When to apply which measurement method
- How to apply the acquisition method
- How to apply a book-value method
- Disclosures
- Conclusion
- Appendix

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Introduction

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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 inconsistently
- Lack of comparability and transparency

Objective

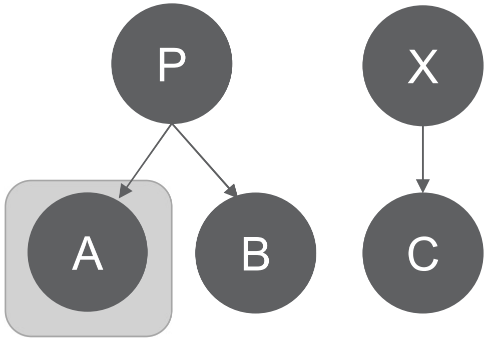
Develop **requirements** that would **improve comparability and transparency** of accounting for business combinations under common control and group restructurings by the receiving entity.

Business combinations under common control are common in practice

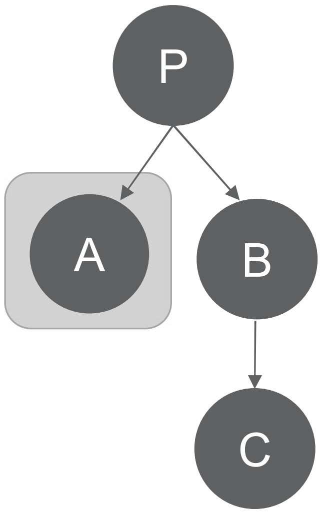
Illustrating the issue

Before

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

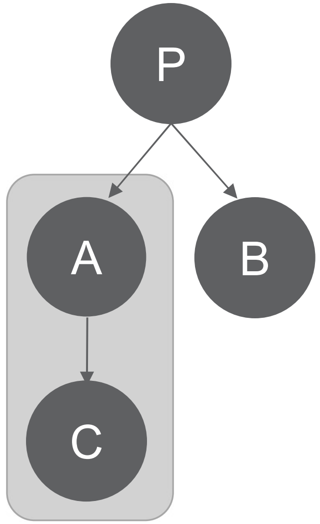


Scenario 2
Entity A and Entity C are controlled by Entity P



After

Entity A acquires Entity C



Reporting by Entity A

- This is a **business combination** between third parties
- IFRS 3 *Business Combinations* requires **the acquisition method**
- Acquired assets and liabilities measured at **fair value**

- This is a **business combination under common control**
- IFRS 3 does not apply
- Entities apply **the acquisition method** or a **book-value method***
- Diversity in how a book-value method is applied

*A book-value method is also referred to as a predecessor approach, merger accounting or pooling of interests.

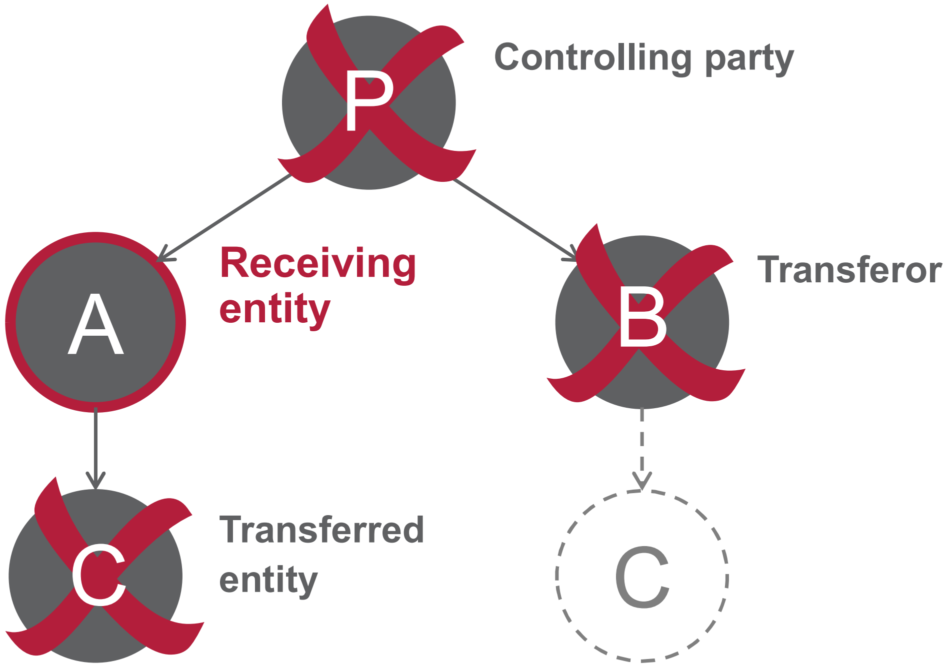
Scope of the project

In scope

- Reporting a business combination under common control by the **receiving entity**.
- Typically the receiving entity's **consolidated financial statements** and in some cases, its **separate** or **individual financial statements**.

Already covered by IFRS Standards

- Reporting by other parties affected by a business combination under common control.
- Reporting of investment in the transferred entity in the receiving entity's separate financial statements.



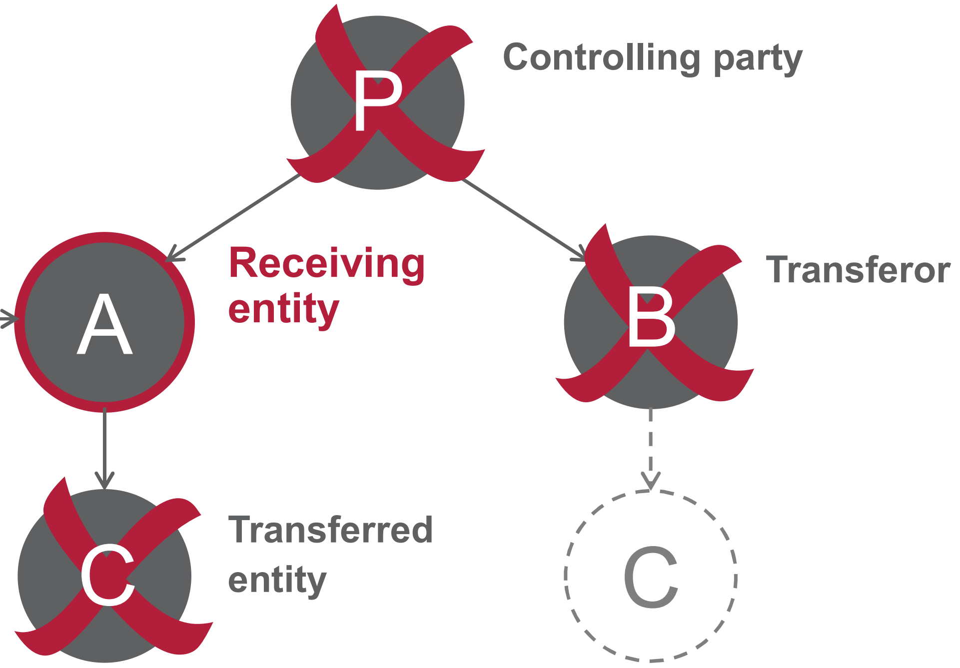
Our focus

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

Non-controlling shareholders (NCS)

Potential shareholders

Lenders and other creditors



- Primary users can have different economic exposure to the receiving entity and **different information needs**
- **Cost-benefit considerations** can also be different for different primary users

Our approach

Conceptual Framework for Financial Reporting

Existing requirements, practice and consultations

Starting point in the analysis

Acquisition method

Recognise acquired assets and liabilities at their **fair values**.

Book-value method

Recognise acquired assets and liabilities at their **book values**.

Considerations in the analysis

- Nature of transactions
- Information needs
- Cost-benefit
- Accounting arbitrage
- Complexity

Work performed

Summary of work performed by the staff in exploring measurement methods for transactions within the scope of the project

Review of national requirements and guidance, guidance published by accounting firms, recent consultation documents issued by national standard-setters, academic papers, reports, articles and other relevant literature

Outreach with national standard-setters, regulators, users and preparers, including meetings with members of the Capital Markets Advisory Committee who specialise in credit analysis

Review of corporate credit rating methodology of two leading credit rating agencies

Desktop review of current reporting practice using financial search engine AlphaSense

Summary of input received in consultations

The acquisition method

- Many (including users) support the acquisition method for transactions that affect NCS:
  - provides useful information to non-controlling shareholders;
  - in most cases cost justified by benefits;
  - presence of non-controlling shareholders indicates a transaction similar to those covered IFRS 3.
- Some suggest that fair value information is also useful for lenders and other creditors.
- Some support the acquisition method for all transactions within the scope of the project, subject to cost-benefit considerations.

A book-value method

- Most (including users) support a book-value method for transactions that do not affect NCS, even if lenders/creditors or potential shareholders are affected:
  - credit analysis does not depend greatly on which approach is applied;
  - information about all combining entities offered to public should be provided on same basis.
- Some support a book-value method for all transactions within the scope of the project.

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When to apply which measurement method

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Why not a single method in all cases?

What is the nature of BCUCC transactions?	• All BCUCC have <u>economic substance</u> for the receiving entity. • Some BCUCC are <u>similar to business combinations</u> covered by IFRS 3 and others may not be similar.
What are the information needs of primary users?	• <u>Depend on how similar</u> the BCUCC is to a business combination covered by IFRS 3 and on the <u>composition of primary users</u>. • Any BCUCC could affect lenders and other creditors and potential shareholders. <u>Only some BCUCC affect non-controlling shareholders</u>.
Are the costs justified by the benefits?	• The costs of providing information <u>may not always be justified</u> by the benefits of that information.

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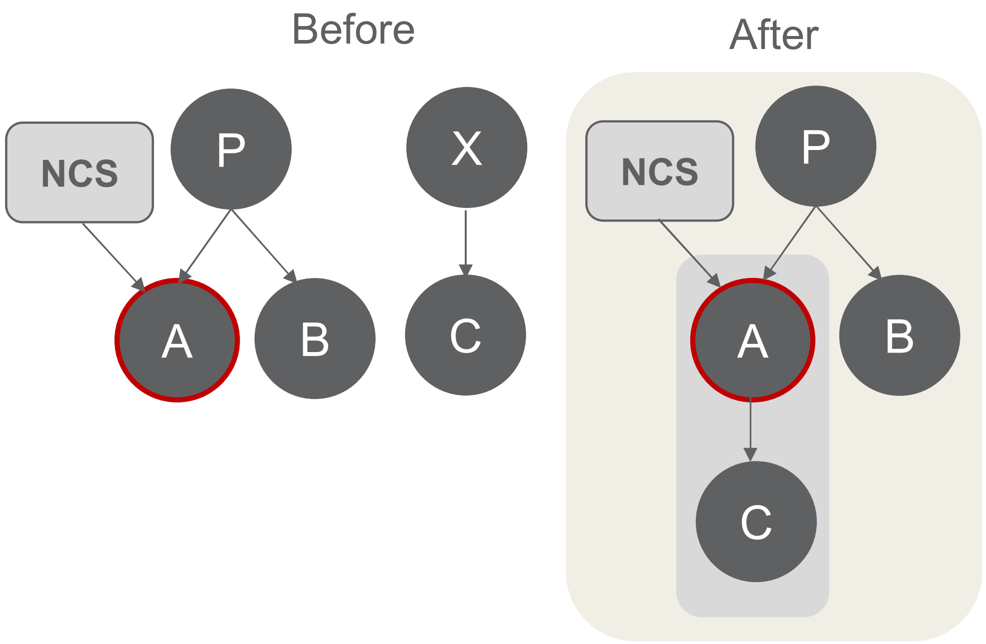
How to 'draw the line'?

Transactions that affect non-controlling shareholders of the receiving entity	**Transactions that do not affect non-controlling shareholders of the receiving entity**
Non-controlling shareholders acquire residual economic interest in the transferred entity.	Ultimately no acquisition of the residual economic interest in the transferred entity.
Transactions are likely to occur at fair value similar to acquisitions within the scope of IFRS 3.	Transaction may not be an equal exchange of values unlike acquisitions in the scope of IFRS 3.
Fair value information about the combination is useful for non-controlling shareholders.	Book value information is useful for lenders and other creditors and potential shareholders.*
↓	↓
Require the acquisition method subject to the cost-benefit considerations.	Require a book-value method.

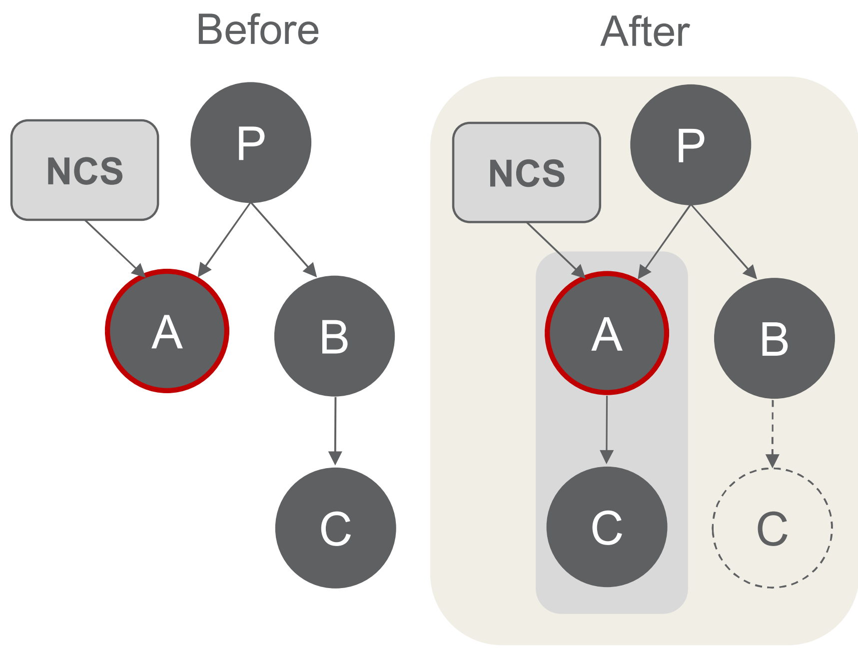
* See Appendix.

Illustrating BCUCC that affect NCS

Business combination covered by IFRS 3



Business combination under common control



Both combinations, regardless of whether ultimate control over the transferred entity changes, result in a substantive change of residual economic interest in that entity. In both cases, non-controlling shareholders acquire residual economic interest in the transferred entity. Accordingly, in principle, the same information should be provided to those shareholders.

All or some combinations that affect NCS?

The benefits of applying the acquisition method may not always justify the costs for BCUCC that affect non-controlling shareholders

Qualitative factors			Quantitative factor
Are the receiving entity's equity instruments traded or privately held?	Are non-controlling shareholders the receiving entity's related parties?	Do non-controlling shareholders wish to receive fair value information?	Does non-controlling interest reach a specified threshold?

Combination of qualitative and quantitative factors

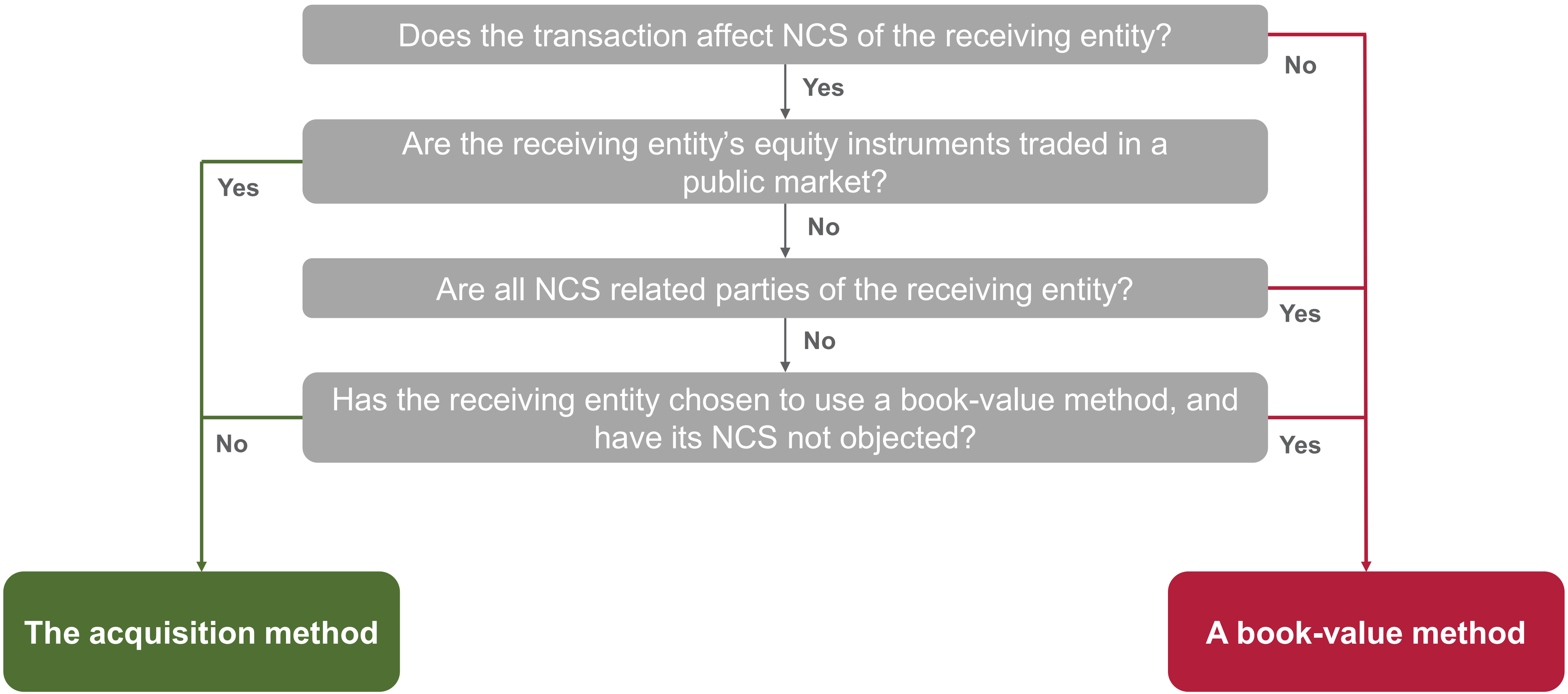
A distinction solely based on quantitative factors would lack a conceptual basis and was not supported by stakeholders.

Explaining a qualitative distinction

Receiving entity's equity instruments are publicly traded*	Receiving entity's equity instruments are privately held	
Costs presumed to be justified due to minimum listing requirements	Costs may or may not be justified	
Many stakeholders support the acquisition method for public entities	Some stakeholders support the acquisition method for private entities	
Require the acquisition method	Permit a book-value method	Require a book-value method
	If non-controlling shareholders are not all the entity's related parties and do not object to book value information.	If all non-controlling shareholders are the entity's related parties

* Equity instruments are traded in a public market as described in IFRS Standards.

The Board's preliminary views



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How to apply the acquisition method

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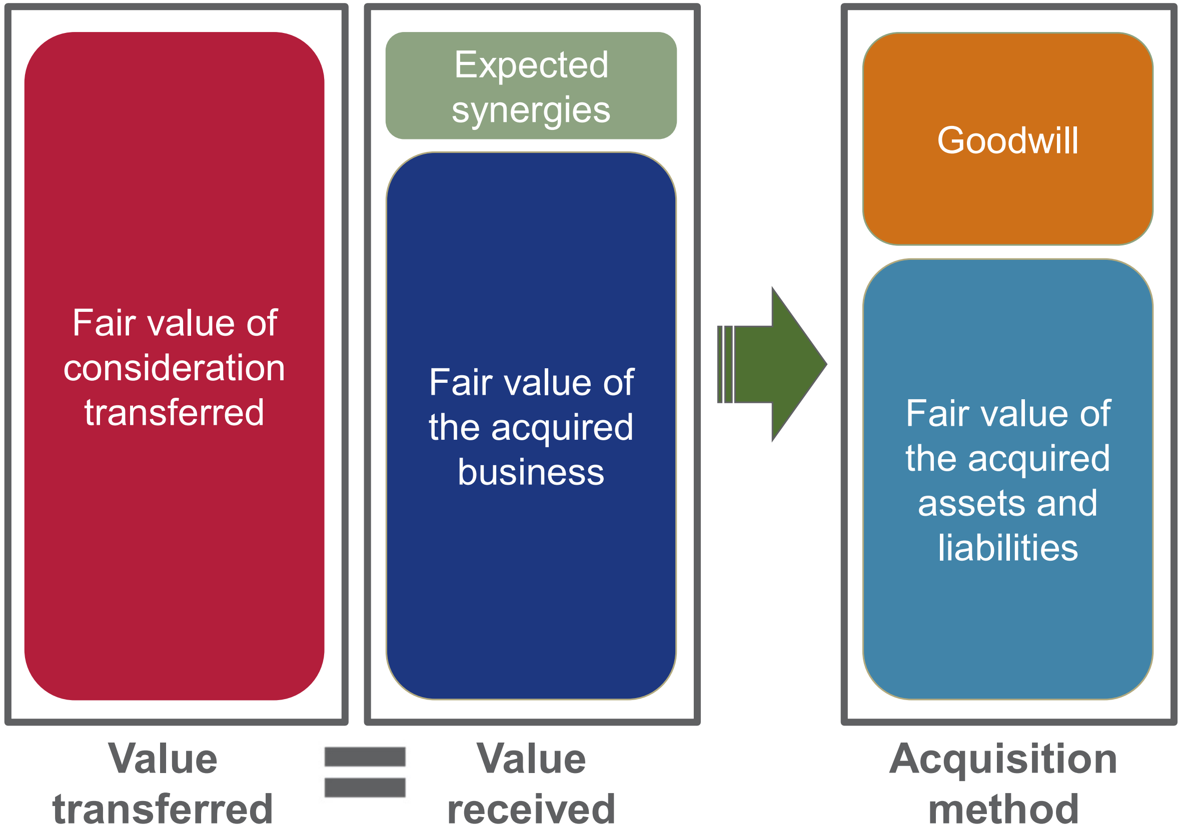
How to apply the acquisition method

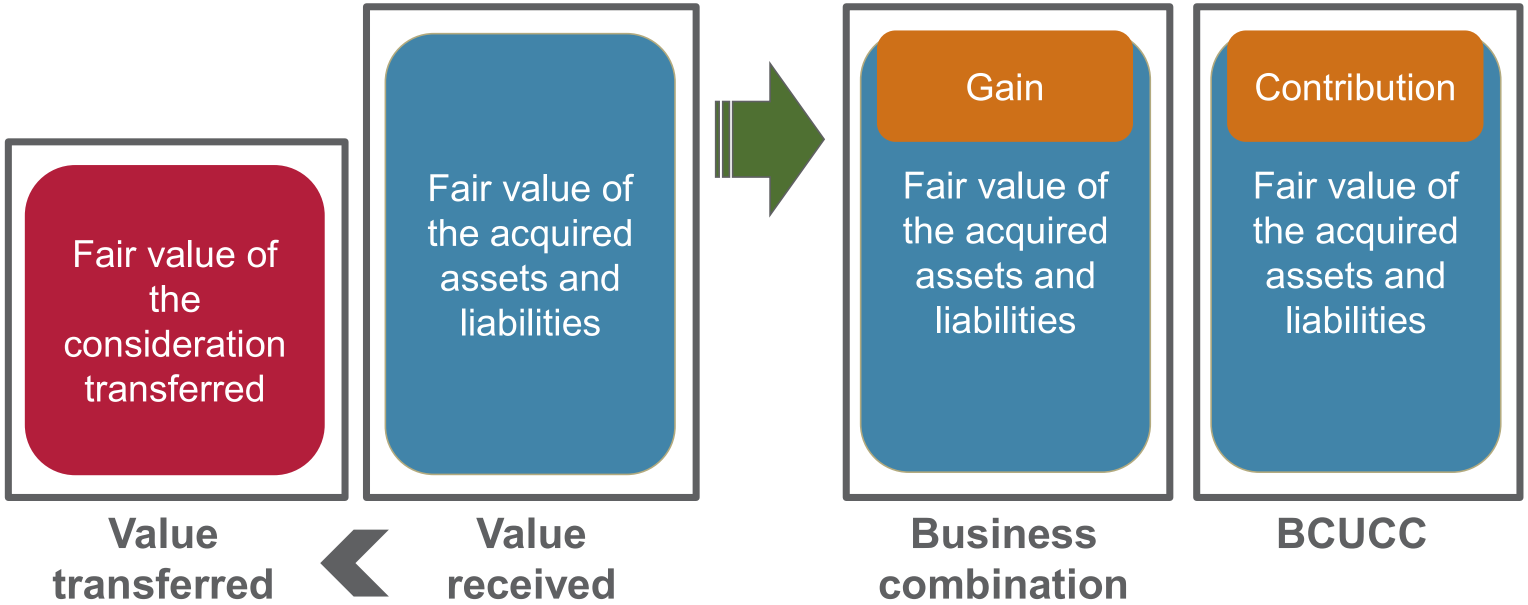
The Board has reached the view that the acquisition method should not be modified for BCUCC



- IFRS 3 assumes an arms' length price negotiation and an equal exchange
- Feedback suggests BCUCC that affect NCS are typically conducted at fair price
- Many stakeholders, including users, support applying the acquisition method to BCUCC with no modifications
- However, additional disclosures about transaction price need to be provided

Reporting underpayment in a BCUCC

- In rare cases, consideration transferred may be below the fair value of the acquired assets and liabilities.
- In a business combination, that difference is recognised in profit or loss as a gain on a bargain purchase.
- In a BCUCC, economically that difference represents a contribution to equity by the controlling party.



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How to apply a book-value method

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How to apply a book-value method

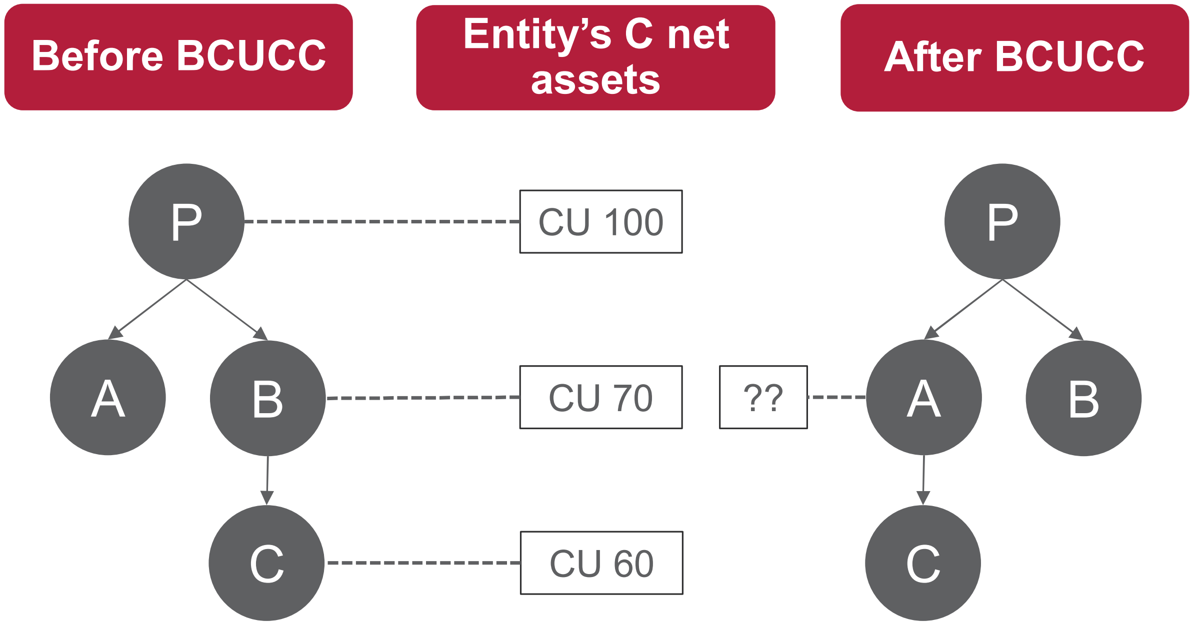
A book-value method would apply to all transactions that do not affect non-controlling shareholders and some transactions that affect such shareholders.

There is a variety of book-value methods applied in practice.

Book values	Consideration	Difference	Pre-combination information
At which book values to measure assets and liabilities received?	How to measure consideration?	Where to recognise the difference between book values and consideration?	How to present pre-combination information?

Why book values can be different?

Book values of the assets and liabilities of the transferred entity may or may not be different at different levels within the group depending on the history of the group



If the controlling party acquired the transferred entity from third party, it would have applied the acquisition method and measured acquired assets and liabilities at fair value, and recognised goodwill arising on that acquisition.

Which book values to use?

Book values in the transferred entity's financial statements

Provides combined financial information that is consistent with the *Conceptual Framework* and reflects the perspective of the combined entity

Book values in the controlling party's financial statements

Can provide a recent valuation for some, but not all, combining entities and reflects the perspective of the controlling party which is not consistent with the *Conceptual Framework*

If necessary, book values must be adjusted to align accounting policies and to eliminate the effects of intercompany transactions

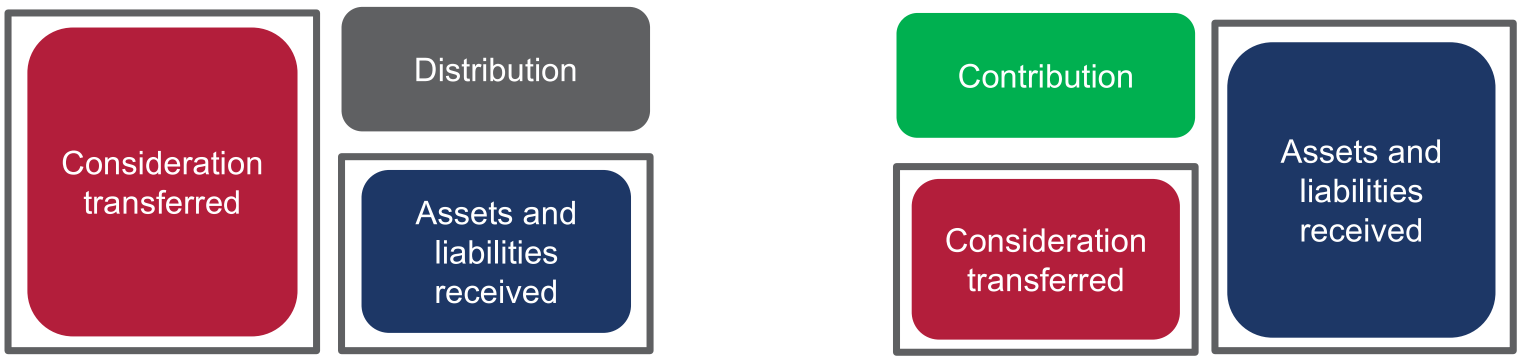
The Board has reached the view that book values in the transferred entity's financial statements should be used.

How to measure consideration?

Consideration transferred can take different forms

Assets	Liabilities	Own shares
Measure at book values at the date of the combination.	Measure at carrying amounts determined in accordance with applicable IFRS Standards.	The Board did <u>not</u> prescribe how to measure such consideration.

How to recognise the difference?

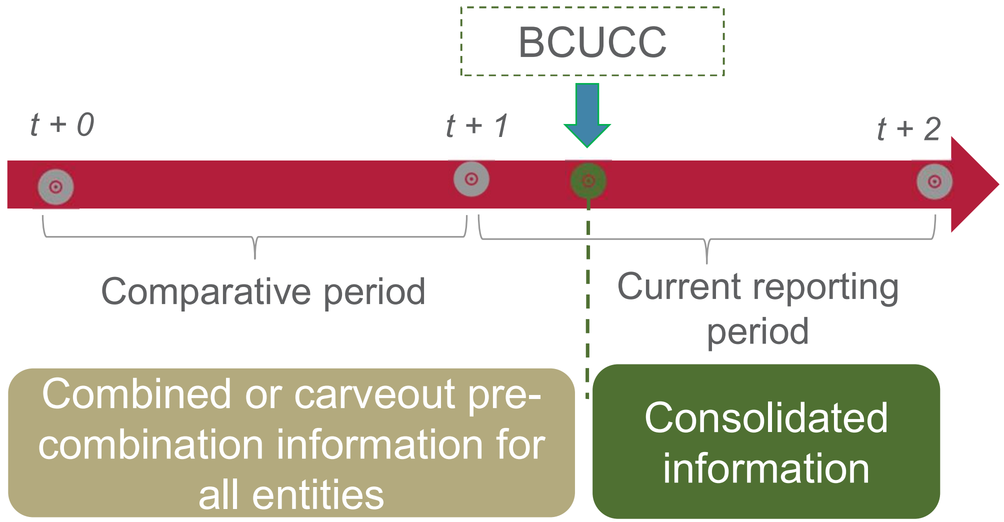


- In a BCUCC reported applying a book-value approach, a difference between consideration transferred and assets and liabilities received is recognised in equity.
- The Board did not prescribe how that difference should be presented within equity.

Which pre-combination information to provide?

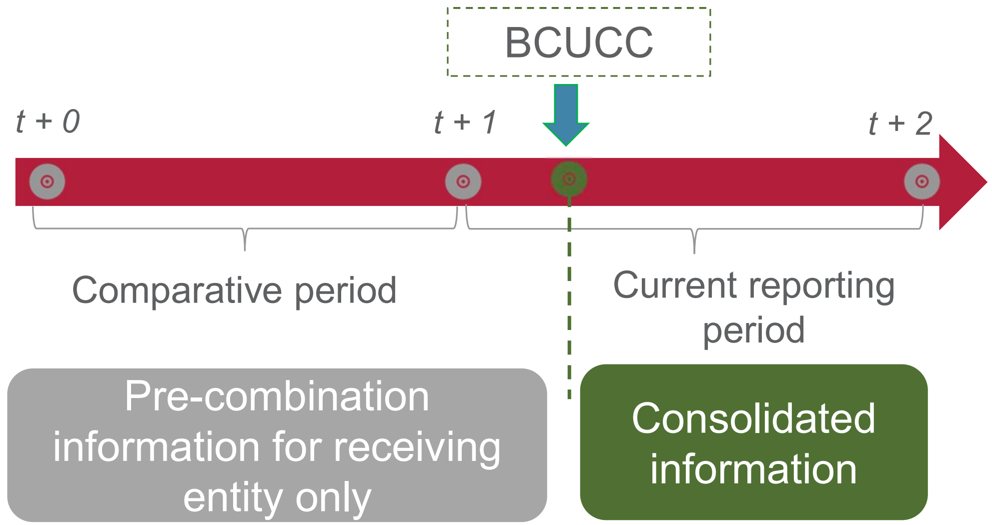
Alternative A

- Assets and liabilities received and results of operations recognised from the beginning of earliest period presented.
- Pre-combination information in primary financial statements for all combining entities.



Alternative B

- Assets and liabilities received and results of operations recognised from the date of combination.
- Pre-combination information in the PFS provided only for the receiving entity.



Pre-combination information—pros and cons

Pre-combination information is provided for all combining entities	Pre-combination information is provided only for the receiving entity
Provides combined financial information that reflects the perspective of the combined entity but presents the legal structure that did not previously exist	Pre-combination information provided in PFS depends on how the combination has been structured and follows the legal form of the transaction
Many stakeholders agree that pre-combination information for all combining entities is useful but support providing such information in the notes	Particular pre-combination information for all combining entities can be provided in the notes

The Board decided that pre-combination information in the PFS should be provided only for the receiving entity.

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Disclosures

Disclosures

Applying the acquisition method

Apply <u>all</u> disclosure requirements in IFRS 3 and preliminary views on disclosure in the Goodwill and Impairment project

Disclose additional information about the transaction price

Applying a book-value method

Apply <u>particular</u> disclosure requirements in IFRS 3 and preliminary views on disclosure in the Goodwill and Impairment project

Disclose the amount of the difference recognised in equity and the component of equity in which that difference is recognised

Conclusion

Reducing diversity

Today

Acquisition method

Business combinations covered by IFRS 3

Acquisition method or a variety of book-value methods

Business combinations under common control

The Board's preliminary views

Acquisition method

Business combinations covered by IFRS 3 and similar combinations under common control

A specified form of book-value method

Other business combinations under common control

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Appendix

Information needs of lenders and other creditors and potential shareholders

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Information needs of lenders and other creditors

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

Focus of credit analysis

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

Cash flow measures or their proxies such as EBITDA, cash flow projections and cash flow-based ratios are at the heart of credit analysis.

Focus on the total gross debt

Qualitative and quantitative information about both recognised debt and unrecognised commitments.

This information and credit analysis would be largely unaffected by whether the acquisition method or a book-value method is used to account for business combinations under common control.

Information needs of potential shareholders

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

Both existing and potential shareholders focus on valuation in their analysis.

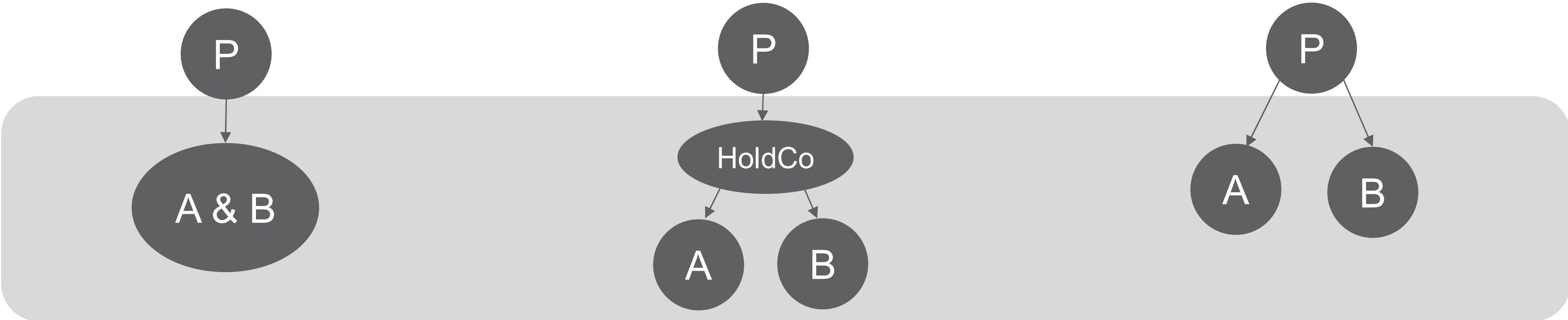
However, their economic position relative to combining entities is different.

Existing NCS acquire residual economic interest in the transferred entity as a result of the transaction.

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

Illustrating transactions that affect potential shareholders 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.



Scenario 1

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

Scenario 2

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

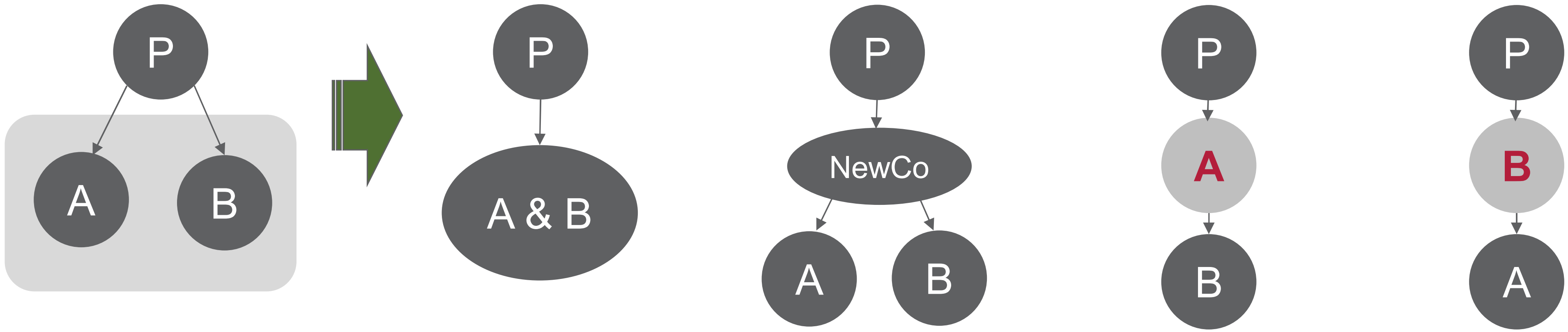
Scenario 3

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 potential shareholders Step 2—restructuring in preparation for an IPO

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

Scenario 3 | **Scenario 3.1** | **Scenario 3.2** | **Scenario 3.3** | **Scenario 3.4**



Scenario 3: Businesses A and B are separate legal entities directly owned and controlled by Parent P

Scenario 3.1: Legal merger of Entities A and B

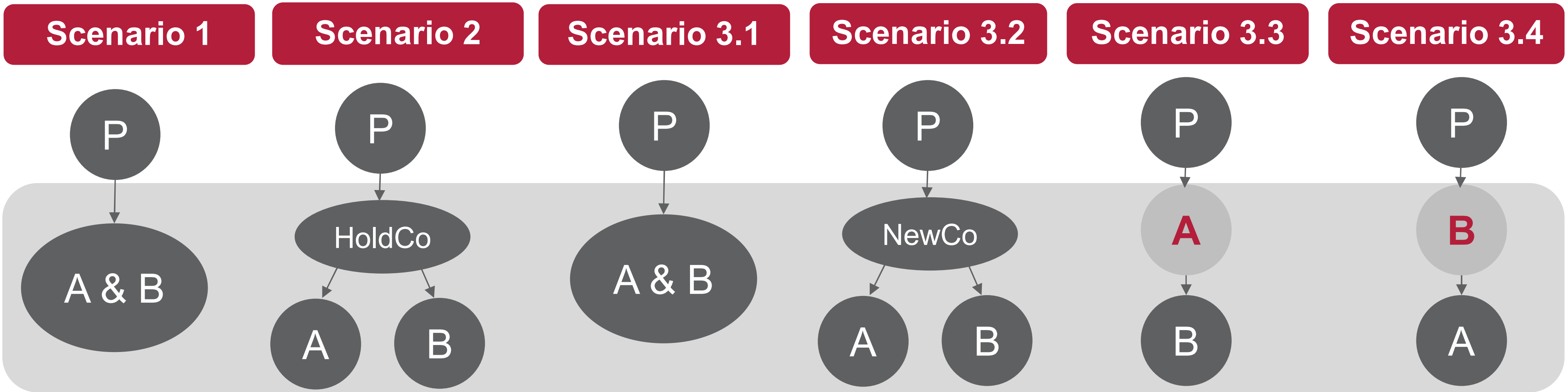
Scenario 3.2: Entities A and B are transferred to a NewCo

Scenario 3.3: Entity B is transferred to Entity A

Scenario 3.4: Entity A is transferred to Entity B

Illustrating transactions that affect potential shareholders Step 3—restructuring is complete

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



- In all scenarios, potential shareholders in an IPO are investing in Businesses A and B
- In Scenarios 1 and 2, potential shareholders will receive historical information about Businesses A and B
- Such historical information could also be provided in PFS or in the notes to financial statements in all sub-scenarios of Scenario 3 by applying a form of book-value method

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