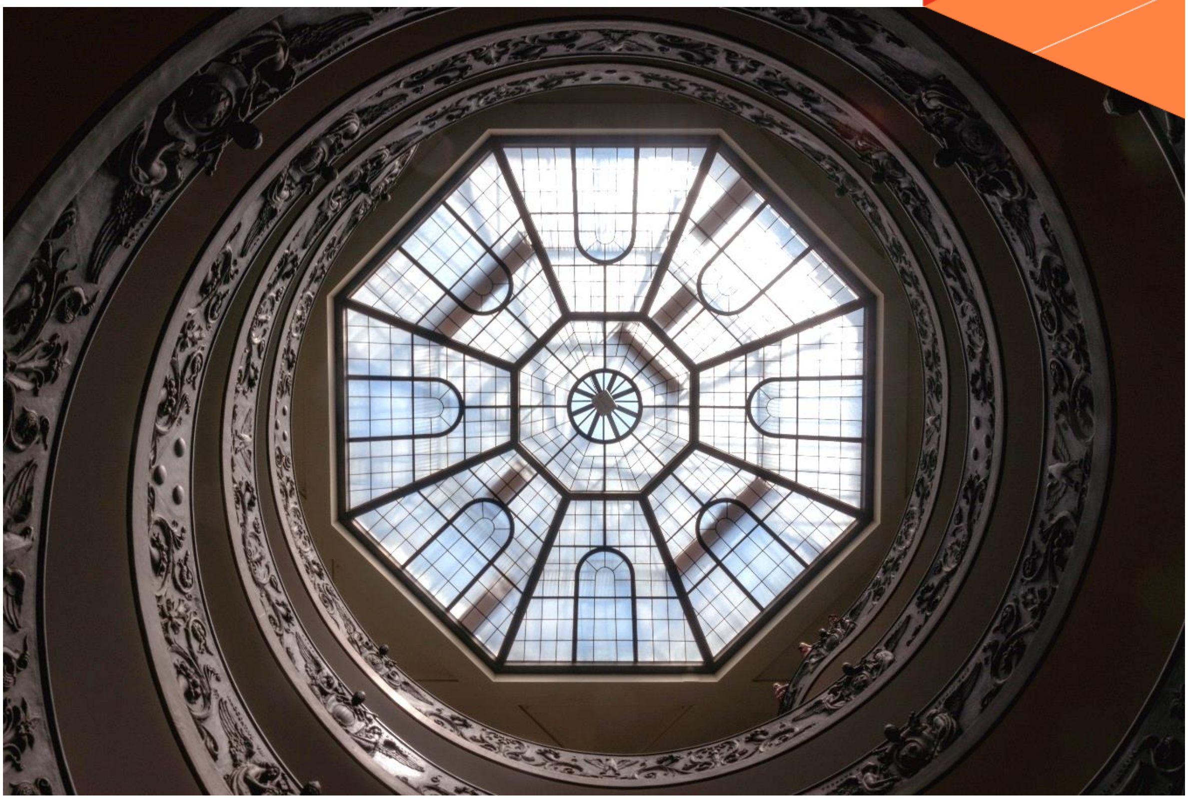
BUSINESS COMBINATIONS UNDER COMMON CONTROL:

ITALIAN PERSPECTIVES

SUMMARY REPORT

14 June 2021



This report has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review by either the EFRAG Board or the EFRAG Technical Expert Group. The views expressed in this presentation are those of the presenter, except where indicated otherwise.

Introduction

In order to receive input from Italian constituents and to stimulate the discussion around the IASB® Discussion Paper on *Business Combinations under Common Controls* (‘the DP’), EFRAG organised a joint outreach event with the Organismo Italiano Contabilita (OIC), and the IFRS Foundation on 14 June 2021. This report has been prepared for the convenience of European constituents to summarise the event and will be further considered by the involved organisations in the respective due process on the IASB proposal.

The program of the event can be consulted here.

The speakers were:

Angelo Casò, OIC Executive Board Chairman, EFRAG Board Member

Chiara Del Prete, EFRAG TEG Chairwoman

Carmine Di Noia, CONSOB Commissioner

Françoise Flores, IASB Board Member

Marcello Bianchi, (ASSONIME Vice-Directors General, Area Head - Capital Markets and Listed Companies)

Luca Cencioni, (ENI Responsible for Group Accounting Policy, OIC Board Member, former EFRAG Board member)

Emanuele Flappini, (MEDIOBANCA Group Chief Financial Officer)

Alessandro Turris, (PwC Italy Partner, Responsible Technical Accounting & Methodology, OIC Executive Board Member)

Participants and panellists were welcomed to the meeting by **Angelo Casò.**

Françoise Flores introduced the proposals, the EFRAG representatives presented EFRAG preliminary position and the panellists participated in the discussion and provided their views on the discussed areas of the DP.

Riccardo Sabbatini moderated the panel discussion.

Presentations by speakers

Angelo Casò, welcomed participants, introduced the panellists, and provided an overview of the importance of the IASB’s project on business combinations under common control (BCUCC) from the Italian perspective. The focus of the BCUCC project is how to report BCUCC transactions in the consolidated financial statements of the receiving company (the buyer) and does not cover how to deal with the purchase of a subsidiary under common control in the separate financial statements. In Italy, both listed and unlisted companies (such as banks) directly apply IFRS Standards both in their consolidated and separate financial statements. Therefore, significant consideration should be given to the impact of the project for Italian companies and in general the IASB should be more active to solve the issues in separate financial statements.

Françoise Flores, IASB Board Member, presented the IASB's preliminary views on how to account for BCUCC transactions included in the proposals of the IASB's discussion paper (the DP).

Chiara Del Prete, EFRAG TEG Chairwoman, presented EFRAG's tentative position on the IASB's proposed requirements for BCUCC included on its draft comment letter.

Carmine di Noia, CONSOB Commissioner, further elaborated that there needs to be guidance for BCUCC as these transactions are frequent and performed for various reasons e.g., tax efficiency. Often newco or spin-offs are created before listing equity instruments and there are various reporting practices that may lead to an incomplete, non-uniform presentation with negative impacts on information provided to the market. In Italy, the association of audit firms (ASSIREVI) has issued guidelines ('OPI 1') to identify when to apply book values and when to apply fair values and recognise goodwill.

Regarding the IASB's proposed approach for BCUCC, the Commissioner pointed out that:

- *criteria for selecting a measurement method* - the approach of not applying the same measurement method to all BCUCC is considered acceptable. However, the differentiating criterion 'affecting the non-controlling shareholders (NCS)' to select a measurement method could be ambiguous and subject to different interpretations. It might be appropriate to consider adding a significance aspect to the criterion so that there were no structuring opportunities, for example a minimum threshold of impact on NCS;
- *definition of a public market* – the definition of a public market may be insufficient to regulate precisely when to apply each measurement method with the practical risk of divergence. For example, an over-the-counter market is a public market where the two participants traded publicly on a bilateral basis, but it is not regulated. The IASB should consider refining this definition;
- *structuring opportunities* – for a privately-held companies, the related-party exception and the optional exemption provide a cost-benefit relief from applying the acquisition method. However, it could be possible that NCS were introduced only for the purpose of avoiding a particular accounting outcome and result in structuring opportunities. A materiality criterion might be needed to avoid such distorting behaviours;
- *transitory control* –the notion of transitory control as included in IFRS 3 need to be clarified in this project;
- *pre-combination information* - some pre-combination information should also be provided in the case of the application of a book-value method (e.g., the revenue and profit or loss of the of the receiving entity as if the combination had been made at the beginning of the reporting period);
- *when applying the acquisition method* – the proposed disclosure requirements in the DP is considered acceptable.

In addition, the Commissioner welcomed the IASB DP "BCUCC" and highlighted the relevance of this project after many years of debate, as stimulated by the OIC and EFRAG.

This topic is very important for the Italy because, in accordance with the opinions of the supervisory authorities, users, auditors, preparers, it was decided to apply the international accounting standards also to the separate and individual financial statements of listed companies except for insurance companies.

When the Legislative Decree 38/2005 was published, the differences between the international accounting standards and the requirements of the Fourth Council Directive (78/660/CEE) and Seventh Council Directive (83/349/EEC) was important, but it has narrowed with the issue of the Accounting Directive 2013/34/EU.

The latest available Commission transpositions show how the EU Member States with the most developed stock markets have taken a different decision from Italy.

In July 2022, it will be 20 years since the IAS regulation 1606/2002 was issued and it could be useful to reflect on the reasons for these very different choices by the markets - especially in the context of the growing integration of the Italian stock market with the main EU markets.

Roundtable

Question 1 – Does the DP solve the problems that large groups have when reporting BCUCC?

Luca Cencioni commented that before the issuance of the OPI 1 guidance in Italy, there were no guidelines on how to report BCUCC transactions. In the past, ENI had conducted some complex BCUCC transactions. To account for these transactions ENI applied the requirement in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and used the US GAAP's predecessor approach. At that time, there was no useful reference in the civil law.

Furthermore, he mentioned that transactions with related parties were complex from a governance point of view. In the absence of guidance, ENI looked at the economic substance of the transaction, such as whether the transaction shifted the dividend capacity from one entity to the other. In the statutory accounts, current values were applied. Therefore, the transaction was accounted using current values in the statutory accounts and book values in the consolidated accounts.

He welcomed the IASB's efforts to develop an adequate set of principles for BCUCC, but he highlighted that it is important that the IASB also regulates the accounting methods for the separate financial statements.

Emanuele Flappini added that MEDIOBANCA participated in this process with a dual role: as a preparer of financial statements, and as a user, being an advisor in M&A transactions. He explained that the market did not like the absence of common rules and the market trends of the last few months showed that often the listing of a company was preceded by a restructuring activity. The existence of a clear and common set of standards for all market participants facilitates the execution of the transaction and their role as advisor. He welcomed the DP's proposal not to apply a single measurement method to all BCUCC transactions. In his experience, the book value method is easier to apply though it may seem less transparent. The concept of fair value in practice has changed a lot recently, in fact the fair value is not always easy to determine and it is not always equivalent to transparency. Often when conducting impairment test, MEDIOBANCA reconciled the book value of equity with the stock market price. Book values are often associated with the concept of cost, but the book value is not the cost. A transaction within a group that created discontinuity of values could also provide evidence of a pre-existing valuation of assets. The fact that there was a negative fair value in a group questioned the recoverable value reported at group level.

Question 2 – Will the proposed requirements for BCUCC favour IPOs?

Emanuele Flappini explained that MEDIOBANCA saw an interesting trend of possible IPO transactions. In order for the market to work efficiently and provide relevant prices, it is important to have clear rules and principles for BCUCC. The IASB's proposal that in the context of an IPO the acquisition method is not mandatory to apply is important, because the determination of the price in an IPO is the result of a strong negotiation and the ability to meet market expectations. Disclosing the fair value of a business line could give rise to problems such as reconciliation with very sensitive IPO prices which is a market driven process.

Question 3 – How will the DP impact the current practice?

Alessandro Turris noted that the DP's proposals would significantly change the current practice. He explained that in the absence of a guidance in IFRS Standards, the audit profession in Italy developed OPI 1 guidance. The OPI, preliminary guidelines on IFRS, is not a mandatory standard and it has no binding power, however, OPI1 has been helpful for Italian companies since it defines a principle to differentiate between the use of the acquisition method and other methods. He pointed out to the following implications of the DP's proposals for Italian companies:

- *differentiating criterion* - the basic principle of OPI 1 is that IFRS 3 should be applied if the transaction has commercial substance, i.e., a significant influence on the cash flows of the net assets transferred. This condition is difficult to demonstrate and as a result, IFRS 3 has almost never been applied in practice. However, the DP does not look at the change in cash flows, but instead considers whether the receiving company is listed and if the transaction affects its NCS;
- *measurement of assets and liabilities under a book-value method* - the DP proposes that assets and liabilities received under a book-value method will be recorded at the transferred company's book values, while OPI 1 grants a policy choice, similar to US GAAP, which allows for the possibility of looking also at the values in the financial statements of the ultimate controlling parent. The DP approach should result in a more homogeneous application, but it may lead to greater complexity in cases where, for example, the transferred company is not an IFRS adopter;
- *pre-combination information* – OPI 1 suggests an approach similar to the one proposed in the IASB's DP i.e., to include the transferred company from the combination date, without re-statement;
- *focus of the DP's proposals* - possible differences would arise for the reporting of the transaction from the perspective of the transferor (the seller). The DP considers that the guidance in IFRS 10 *Consolidated Financial Statements* is sufficient and does not address how the transferor should report for the BCUCC. However, in practice the IFRS 10 guidance is incomplete (for example, for the accounting for a spin-off from a subsidiary to the parent company; a transfer of a business to an associate where there is a conflict between the guidance in IAS 28 *Investments in Associates and Joint Ventures* and IFRS 10). There are many open issues on the seller side and there is also some support for uniformity in accounting for BCUCC from the seller and the buyer's perspective;
- *separate financial statements* – it is not clear whether a merger of a consolidated subsidiary into a parent company (addressed by OPI 2) is captured in the scope of the DP. Considering the BCUCC transaction from the perspective of the separate financial statement of the receiving company, control of assets and liabilities is acquired, however, at the consolidated level control already existed before the transaction;
- *application of the acquisition method* - the use of fair values seems appropriate when the company is listed, however, there are different types of listings, such as for debt instruments.

Marcello Bianchi commented that the absence of specific principles for BCUCC create information gaps and divergence of methods applied lead to non-comparability. Measurement methods are important to qualify the information will be presented to the market. He elaborated further on particular proposals in the DP:

- *differentiating criterion* – the differentiating criterion proposed by the IASB depends on the characteristics of the acquirer (i.e., whether the acquirer is listed and whether the NCS are affected by the transaction). Another possible approach could be to consider the economic substance of the transaction. However, the latter approach could be more difficult to apply and therefore sympathy is expressed for the IASB's criterion to consider the presence of NCS;
- *the IASB's decision tree* – the IASB's decision tree is based on NCS. Instead, the modification proposed by EFRAG that starts from the listing status and highlights that the presence of NCS is not the only significant element. There could be bondholders with widespread interests. This is a point that still needs to be investigated;
- *definition of a public market* - what means by 'public market'. The existing definition of a public market in IFRS Standards also includes over-the-counter markets which increase complexity. It would be necessary to clarify which markets (e.g., regulated and/or not regulated) should be considered for the purposes of the BCUCC project;
- *focus of the DP's proposals* - the IASB's approach is convincing because it is simple to apply but its rigidity could compromise the purpose of similar transactions being treated in a similar way. The task of the standard setter is not to have mandatory rules but to standardize with default models and allow companies to be a complaint with the approach (i.e., comply or explain).

Question 4 – What advice can you give to the IASB considering the relevance of separate financial statements for Italian companies?

Luca Cencioni expressed support for the project and its conceptual starting point to consider the information needs of users of financial statements as in the *Conceptual Framework*. In the DP, the criterion is linked to differentiating users' needs. However, the IASB seems to not fully support this criterion, as it provides an exemption from the proposed requirements. He also made the following remarks on the IASB's proposals:

- *optional exemption and a related-party exception* – optional exemption is a practical expedient while the related-party exception intends to exclude the use of fair values if all NCS are related parties. There is a lot of difference between listed and unlisted entities and related parties are not all the same with a different set of information available. In this respect, the DP should be conceptually more coherent;
- *differentiating criterion* - the economic substance of the BCUCC which is the differentiating criterion in OPI 1 of when to apply each measurement method is not considered in the DP;
- *measurement of assets and liabilities under a book-value method* - the IASB embraced an idea to measure the assets and liabilities received at the carrying amounts in the books of the transferred company and not the ultimate parent company. This aspect introduced a negative divergence from US GAAP;
- *separate financial statements* - Italian companies would like to see the IASB extending the project to cover the separate financial statements. Otherwise, the availability of a guidance for BCUCC would only offer a new reference point to apply IAS 8.

Emanuele Flappini added that there is another problem with the application of the acquisition method in the sub-consolidated and separate financial statements, such as bringing new line items on the balance sheet and therefore duplicate the impairment tests in listed companies within a group. This proliferation of carrying values on different group levels would lead to significant reconciliations between the sub-consolidated financial statements and separate financial statements and also lead to everlasting goodwill.

Alessandro Turris complemented the discussion of the impact of the DP on the separate financial statements by adding another perspective: the IASB excluded the acquisition of a subsidiary under common control in the separate financial statements from the scope of the DP because it is addressed by IAS 27 *Separate Financial Statements.* This could lead to a conclusion that such investments are measured at cost and the predecessor value is not allowed. Considering the relevance of the issue further analysis would be required. He further commented on:

- *application of the acquisition method* - the IASB's proposal to modify application of the acquisition method for BCUCC by reporting a contribution to equity when there is underpayment in the transaction instead of reporting a bargain purchase in the Statement of Profit or Loss is questionable. Whether there is any reason beyond prudence is not clear;
- *pre-combination information* – under the proposals of the DP if a newco bought a business, the transaction would fall within the scope of the project and the DP prescribes prospective accounting for the transaction, without re-statement. When there is a group restructuring that is not a business combination, the transferred business is in substance the acquiring entity, so the relevant figures to be presented are the historical ones (pre-combination), not only the prospective ones (post-combination). This is currently done in practice and the IASB may want to reconsider this aspect.

Marcello Bianchi highlighted that the proposals in the DP must avoid creating disadvantages for capital markets and enable access to the main markets. This is relevant in Europe where rigid regulatory rules caused an upsurge of delisting on the capital markets. In addition, effective international harmonization must be ensured, for example, to US GAAP.

Closing of the event

Tommaso Fabi OIC Technical Director thanked the participants and panellists for the interesting points of the view that they illustrated on the IASB DP BCUCC and closed the meeting.