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Assessment of approaches for BCUCC
Issues Paper

Objective

1 The purpose of this paper is to map the advantages and disadvantages of the following approaches to account for the transfers of a business or entity when all the parties are ultimately controlled by the same controlling party:

(a) The acquisition method;

(b) The predecessor method;

(c) The fresh start method; and

(d) The allocation of cost method.

2 The purpose of the paper is thus not to identify a preferable method for the transfers mentioned in paragraph 1, but to prepare for such a discussion and hence EFRAG's draft comment letter in response to the forthcoming IASB Discussion Paper on the issue which is currently planned to be issued in the second half of 2018.

Comparison with prior analyses

2 When listing the advantages and disadvantages in this paper, the Basis for Conclusions accompanying IFRS 3 *Business Combinations* ('the Basis for Conclusions') and the EFRAG/OIC Discussion Paper *Accounting for business combinations under common control* have been consulted. The EFRAG/OIC Discussion Paper assumed that the Basis for Conclusions was correct that reflecting the cash generating abilities associated with the acquired business through initial measurement at fair value is deemed to provide users with the most relevant financial information.

3 Subsequent studies co-sponsored by EFRAG have shown that users may generally find fair value less useful than assumed in the Basis for Conclusions. It may therefore not be appropriate to generalise the IASB's conclusion about the use of fair value in business combinations within the scope of IFRS 3 to other situations.

4 The study *Professional investors and the decision usefulness of financial reporting* thus finds that:

"In line with prior research, the study finds that professional investors view information in the income statement as more relevant than balance sheet line items, especially where investors' objective is to assess the performance of management. The qualitative analysis suggests that, regardless of their objective, investors are concerned with discretion and managerial judgement for certain balance sheet line items (such as fair values) and, consequently, information in the income statement as well (such as changes in fair values)."

5 The study *The use of information by capital provides – Academic literature review* noted that in the current academic literature:

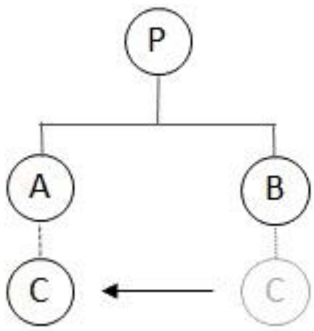
> "There is some evidence that fair value is preferred to historic cost for certain asset classes[1], but this is not the case where fair value is arrived at using unobservable inputs as part of 'mark to model' valuations."

6 The analyses included in this paper are accordingly not based on the assumption that measurement at fair value always results in the most relevant and/or useful information. Instead, it builds on EFRAG's discussions on measurement in relation to the Conceptual Framework.

Advantages and disadvantages of approaches to account for BCUCC

7 On the following pages, the EFRAG Secretariat has listed some advantages and disadvantages of the methods listed above in paragraph 1 when assessing the outcome of methods against the qualitative characteristics of useful financial information to be included in the forthcoming Conceptual Framework for Financial Reporting. EFRAG TEG members will be asked for their comments and suggestions on additional advantages and disadvantages of the methods. Similar to the current IASB project on BCUCC, the analysis only focuses on the usefulness of the information for external users (excluding group companies).

8 The assessments reflect the usefulness of the information when the various methods are applied for the financial statements of the receiving party ('A' in the illustration below).



P is referred to as the controlling party, A is the receiving party, B is the transferring party and C is the transferred business or entity.

9 The assessments are thus only valid for transfers of a business or entity under common control – and not for business combinations included in the scope of IFRS 3.

Acquisition method

10 Under the acquisition method the receiving party should account for the transfer in accordance with IFRS 3. The usefulness on the resulting information on various parameters is considered below. The EFRAG/OIC Discussion Paper *Accounting for business combinations under common control* illustrated two alternatives to the 'full' IFRS 3 approach. Under the first alternative, goodwill was not recognised in the balance sheet of the receiving party and under the second alternative neither goodwill nor identifiable intangible assets were recognised in the balance sheet of the receiving party. These variations are not considered in the analysis.

Relevance

[1] An experiment referred to in the study shows that German investors are misled by fair value accounting for liabilities. Another study finds that professional investors prefer fair value for liquid non-operating assets when it is based on mark-to-market (rather than mark-to-model) but not for non-liquid operating assets. A theoretical study of fair value versus historical cost report that mark-to-market accounting is most problematic for assets that are long-lived, illiquid, and senior.

Information has predictive value

- To the extent that expectations about future cash flows are based on the amounts reported in the statement of financial position, the acquisition method would likely result in information that has better predictive value than, for example, the predecessor method (see below). This is due to the fact that the acquisition method results in more identifiable assets being recognised than the predecessor method, and because these assets are measured at fair value (which could provide an estimate of their cash generating potential).
- If predictions of future outcomes (cash flows) are mainly based on the statement of financial performance (see paragraph 4), measuring identifiable assets at fair value (i.e. applying the acquisition method) could result in useful information if the costs recognised from using the assets (including depreciation and amortisation) will result in profit margins being reflected in the statement of financial performance that are useful for predicting future profit margins. In a case in which:
    - The transferred business or entity is integrated in the receiving party – i.e. the transferred business or entity will not generate cash flows independently from the receiving party (i.e. the cash flows of the acquired business will change (timing, uncertainty and amount) as a result of the transfer);
    - The fair values of the identifiable assets transferred reflect the amounts the receiving party would have paid to acquire these assets individually; and
    - The transaction price related to future revenue has not been agreed (i.e. cases in which the transferred business or entity is not part of any executory or partly satisfied contracts[2] that does not meet the definition of a financial instrument).

    the acquisition method may be relatively more useful than some of the other methods for predicting future cash flows. Under these circumstances, the transaction is similar to the receiving party purchasing the assets separately (plus goodwill). In other words, fair value[3] would be the cost price of those assets.

On the other hand:

- If the transferred business or entity will operate independently after it has been transferred (e.g. a transfer of the shares in subsidiary from one entity in a group to another entity in the group for tax reasons), it could be assumed that the 'normal' measurement bases required by IFRS Standards would result in the information that is most useful for predicting future cash flows. That is, the remeasurement of assets and liabilities at fair value resulting from the application of the acquisition method would not be useful. There are at least three reasons for this: (1) If measurement at fair value for almost all items in the financial statements would result in the most useful information, it could be assumed that IFRS Standards would generally require this (unless the measurement uncertainty would be considered to be too high). It was clear from various consultations related to the Conceptual Framework, that the IASB's constituents generally did not think that fair value measurement would always result in the most useful information. (2) The acquisition method would result in inventories being measured at fair value. Accordingly, when the inventory is sold, the statement of profit or loss will not appropriately reflect the margins and the volatility in these. The information may accordingly not be particularly useful for predicting future cash flows. (3) Not changing the measurement would facilitate comparable financial information from previous periods where the transferred entity operated independently as comparative figures could be prepared as if the transferred business or entity had "always" been controlled by the receiving party.
- If the fair values do not reflect the values for the receiving party (i.e. the values the receiving party attaches to the various assets (and liabilities) of the transferred

[2] An example on this that has previously been considered by EFRAG TEG was a ship yard. When a contract for a ship was made, the price would be based on the current price of steel. The ship yard would at the same time order the necessary steel at the current market price. EFRAG TEG considered that it would not result in useful information to measure the cost of the steel used to produce a ship at its current price when the revenue from the ship was recognised (or to remeasure the value of the steel at any reporting date during the construction of the ship). Doing so would not reflect the profit margin of the ship and hence the profit margin that could be expected in the future.

[3] As noted later in this paper, the acquisition method in IFRS 3 does not result in all assets and liabilities being measured at fair value.

business or entity are different from value the market attach to them), the margins resulting from matching the cost of the transferred assets with the income of a period may not be a good prediction of future margins. If the fair values of some of the identifiable net assets are higher than the expected value in use for the receiving party, the receiving party would likely not have acquired those assets (and will accordingly likely not acquire those assets in the future). For example, a transferred business or entity might have had IT equipment that would not be compatible with the receiving party's IT equipment (and will therefore not be used). Although the equipment could be sold, the entity chooses not to do so because it fears that a buyer would be able to restore confidential information stored on the system. The impairment loss or depreciation cost of the IT equipment will not be recurring as the receiving entity will not buy IT equipment which is not compatible with its equipment on a stand-alone basis.

- If the transferred business or entity is a party in contracts for which the transaction price has been agreed, it may not reflect future margins to match the revenue resulting from these contracts with the fair value of the assets used to satisfy those contracts (as the agreed contract price may have been set based on historical cost prices).

Information has confirmatory value

- Recognising goodwill based on the difference of the consideration transferred and the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed would to some extent enable an assessment of whether the consideration transferred from the receiving party was appropriate for the benefits it receives from the transferred business or entity (assessment of stewardship). The Discussion Paper *Accounting for business combinations under common control* noted that an assessment of stewardship in relation to the acquisition price would not be relevant from the perspective of the receiving party. The reason stated is that the transfer and the terms of it are directed by the (ultimate) controlling party of both the transferring party and the receiving party. However, from the perspective of the users of the financial statements of the receiving party (such as creditors and minority interests) information that could be used to assess whether the consideration paid was appropriate considering the net assets received would likely be useful.
- Recognising identifiable assets at fair value could enable an assessment of whether the assets are used in the best manner (assessment of stewardship) in the periods after the transfer. Such an assessment could be done by comparing the actual return on assets with a benchmark.
- Recognising acquisition-related cost in profit or loss could reduce the usefulness of the information for the assessment of stewardship as the cost of the transaction are then not matched with the future benefits. However, in business combinations under common control, acquisition-related cost might be limited.
- Measurement of inventories of the transferred business or entity at fair value as of the date of the transfer may make the margins in the following periods less useful for the assessment of stewardship as the margins reported could be a mixture of margins resulting from inventory measured at cost (items of inventory produced/purchased after the transfer of the business or the entity) and at fair value (items of inventory produced/purchased before the transfer).
- When the transferred business or entity is a party in contracts for which the transaction price has been agreed before the transfer, the acquisition method may not result in useful information for assessing stewardship. As mentioned above, the acquisition method will result in revenue from contracts negotiated before the transfer being matched with the fair value of the assets used to satisfy those contracts.
- The acquisition method allows post-transfer financial results to be compared with pre-transfer results, but not against previous periods as if the receiving party had "always" controlled the transferred business or entity.

Prudence is reflected

- The acquisition method does not reflect asymmetric prudence in addition to the requirements in IFRS Standards for the subsequent measurement of assets and liabilities. Compared with other IFRS Standards, the recognition on acquisition-related cost in profit or loss could be considered prudent, on the other hand, not impairing acquired goodwill if it has been replaced by internally generated goodwill could be considered imprudent.

Faithful representation

Reflecting substance

- The acquisition method will largely reflect a business combination similar to separate acquisitions of the identifiable assets and liabilities of the transferred business plus goodwill. The acquisition method is thus reflecting what is received in the transaction. A few issues, however, arise with the acquisition method reflected in IFRS 3, as not all items in a business combination are measured at fair value and the 'substance' of the goodwill amount is questionable (see below on understandability).
- When the consideration paid by the receiving party does not equal the fair value of the transferred business or entity, it could be argued that the receiving party has received or paid a contribution from or to the controlling party[4]. While the method to account for the transfer does not directly affect whether such a transfer will be reflected, measurement at fair value may indicate better than predecessor accounting whether the receiving party's consideration equals the fair value of the transferred business or entity.

Complete

- The acquisition method will result in more items meeting the definition of an asset being recognised than e.g. the predecessor method. It could, accordingly be argued, that the acquisition method will result in a more complete depiction than some alternative methods.

Neutral

- In relation to the Conceptual Framework project, EFRAG noted that a neutral depiction would be achieved by following accepted standards. Neutrality was, accordingly considered being affected by how an entity would apply the accepted standards rather than the standards themselves. In relation to this project it may, however, also be useful to consider whether the requirements can result in economically similar situations being accounted for differently. This would mean that the requirements would allow an entity to structure an economic situation in a specific manner in order to affect how it would be reflected in the financial statements and accordingly perceived by the users of the financial statements. Use of the acquisition method in a transfer included in the scope of this project may not result in economically similar situations being accounted for similarly. The reason is that the transaction may not take place on arm's length terms, as the controlling party decides how the transaction should be carried out, which include the business or entity to be transferred and who the receiving party should be. If the objective of the controlling party is to merge two businesses, the choices it makes about who the receiving party should be and what should be the transferred business or entity would have consequences for the financial statements when the acquisition method is applied. Current IFRS Standards include guidance on what party should be considered the acquirer in a business combination. Accordingly, the party identified as the acquirer according to the IFRS Standards may be different from the party identified as the legal acquirer by the controlling party. However, under the current guidance, in many cases, the controlling party would be able to structure the transfer in such a way that it can control what party should be considered the receiving party for financial reporting purposes. In addition, the controlling party could choose to transfer businesses and entities between the parties it controls in order to have the assets and liabilities of the parties being measured at fair value.

Measurement uncertainty

[4] Most respondents to the EFRAG Discussion Paper agreed with the argument presented in the EFRAG/OIC Discussion Paper *Accounting for business combinations under common control* that over-/underpayments for the transferred business or entity should be considered as transfers from/to the receiving party from the controlling party. A few respondents, however, thought it should not always be a requirement to present the over-/ underpayments as such transfers.

- Measurement uncertainty may be significant. The transactions may not take place on an arm's length basis which in some cases may result in the range of estimates being wider as there may not be total amount based on an arm's length transaction to which the sum of the individual estimates can be related. In many cases the inputs used for the estimation for the fair value of identifiable assets and liabilities would be level 3 inputs. As noted in paragraph 5 above, users do not find fair value information based on level 3 input particularly useful.

Comparability

- The acquisition method does not involve restatement of comparative figures as if the transferred business or entity had always been controlled by the receiving party. Accordingly, comparisons of the combined entities performance with previous years is not possible. The comparison to be made would be how (the group of) the receiving entity has performed before and after the transferred business or entity was transferred.
- Use of the acquisition method for business combinations under common control makes such business combinations comparable to business combinations included in the scope of IFRS 3 and to the purchase of assets and liabilities outside business combinations (see, however, the comments relating to relevance).
- Use of the acquisition method results in financial statements of entities that have grown by acquisition include more types of assets than those entities that have grown organically. The acquisition method accordingly makes comparisons between the two different types of entities difficult.

Verifiability

- Some fair value estimations may include forward-looking information that are difficult or not possible to verify.

Timeliness

- It would require more work and hence take longer time to prepare the information in accordance with acquisition method than in accordance with the predecessor method.

Understandability

- Generally, the information provided would be similar to a situation in which an entity purchased the identifiable assets separately. The information would therefore normally be understandable. Some issues may, however, reduce the understandability. These include the facts that:
  - Some items are not measured at fair value.
  - The entity might not had acquired certain of the assets separately (if it had to pay the fair value).
  - The value assigned to goodwill (and other assets and liabilities) in a business combination under common control which may not take place on arm's length terms.
  - Goodwill may be difficult to understand – particularly, perhaps, if the transfer has not taken place on arm's length terms.
  - After some time, goodwill may mainly be internally generated goodwill – which could otherwise not be recognised.

Costs

- It would require more work and hence be costlier to prepare the information in accordance with acquisition method than in accordance with the predecessor method. Accordingly, in cases where the acquisition method is assessed to provide more useful information than less expensive approaches, it would also have to be assessed whether the benefits will exceed the costs. This would, among other things, depend on how (much) the financial statements of the receiving party are likely to be used.

Question for EFRAG TEG

11 Does EFRAG TEG agree with the assessments included in paragraph 10 above? If not, what should be changed or what additional observations should be made?

Predecessor method

12 Under the predecessor method, the net assets of all combining entities are accounted for at their historical carrying amounts. However, those carrying amounts can be different depending on which perspective is taken. The term 'predecessor method' may therefore be misleading as the term is referring to a group of methods. In this paper, the following two perspectives are considered:

(a) The controlling party – this approach would mean that the assets and liabilities of the transferred business or entity will be measured at the amounts (that would have been) used in the controlling party's consolidated financial statements. That is, the measurement will reflect the values of using the acquisition method as of the date when the controlling party achieves control of the transferred business or entity. Under this approach, the receiving party would recognise any "existing" goodwill and identifiable assets and liabilities that would be used when consolidating the transferred business or entity. In the following, this approach would be referred to as the pushdown accounting approach. The approach can be applied in a version where pushdown accounting is also used for the receiving party's figures and in a version where the historical carrying amounts of the receiving party are used. In this paper only the latter approach is considered.

(b) The transferred entity or business – this approach would mean that assets and liabilities of the transferred business or entity will be measured based on the amounts used in the financial statements of the transferred business or entity. In the following, this approach would be referred to as the historical carrying amounts approach.

13 The differentiation between the predecessor method approaches outlined in paragraph 12 above is not applicable when the transferred entity is not acquired by the group but is internally set up.

14 In addition to presenting different perspectives, the predecessor method can also be applied with and without adjustments of comparative figures. In the two versions of the predecessor method presented in this paper, the comparative figures have been adjusted to present how the financial statements would have looked like had the transfer happened earlier (or had the receiving party always controlled the transferred business or entity).

15 This paper does not examine the different approaches of accounting for any difference between the consideration transferred by the receiving party and the relative carrying amount of the equity of the transferred business or entity. Under one approach, when the receiving party is issuing shares in exchange for the transferred business or entity, the financial statements just after the transfer is generated by adding the two sets of financial statements just before the transfer (i.e. just before any shares are transferred from the receiving party to the owners of the transferred business or entity). Under another approach, any difference between the cash transferred and the carrying amount of the part of the equity of the transferred business or entity is booked in equity.

16 Assessment of usefulness of financial information provided by predecessor method carrying amounts recognised in the controlling party's consolidated financial statements (pushdown accounting approach) is provided below:

Relevance

Information has predictive value

- Under the pushdown approach, the predecessor carrying amounts used for the controlling party's financial statements, reflect the fair value amounts of the net assets of the transferred entity or business when it became (ultimately) controlled by the controlling party, assuming the transferred business or entity was externally acquired and not initially set up by the controlling party. When the transferred business or entity is recently acquired by the controlling party, those predecessor carrying amounts will likely reflect the fair value of most of the assets and liabilities of the transferred business or entity. Accordingly, when the transferred business or entity has recently become under the control of the controlling party, the predecessor method will result in measuring the assets and liabilities at an amount close to their fair values (except for item where the fair value fluctuates significantly). Similar to the acquisition method, if expectations about future cash flows are formed on the basis of information from the statement of financial position, this information may be useful for predicting future cash flows. The usefulness, however, diminishes the longer the time gap is between the controlling party's acquisition of the transferred business or entity and the transfer to the receiving party, as the fair value measurement becomes outdated. The method will accordingly not be as good as the acquisition method and the fresh start method for presenting the fair values of the assets of the transferred business or entity in the statement of financial position of the receiving entity.
- As mentioned above, users seem, however, to make more use of the statement of profit or loss than the statement of financial position when predicting future cash flows. Under that assumption, the predecessor method under the pushdown approach could result in useful information when the transferred business or entity, after the acquisition of the controlling party, became integrated in the operations and the transfer to the receiving party does not result in changes to the transferred business or entity's cash generating abilities (see the discussion above related to the acquisition method). The predecessor method would thus preserve information about margins, when this information could be useful for predicting future margins. The bigger the time gap is between the acquisition of the transferred entity by the controlling party and the transfer to the receiving party, the more information will be available for predicting future cash flows. In addition, the information on margins may become more useful. On the other hand, predicting profit margins will be affected by which predecessor accounting approach is being applied by the receiving entity. Profit margins calculated under the pushdown accounting approach would – at least when the transfer happens closely after the acquisition by the controlling party - be lower than those calculated under the historical carrying amounts approach as a result of higher cost of sales due to the stepped-up carrying amounts recognised under the pushdown approach. In addition, in cases in which the transferred business or entity after the acquisition of the controlling party continues to operate in an independent manner, the carrying amount approach of the predecessor method will result in more information being available for predicting future cash flows (see below).

Information has confirmatory value

- When the transfer of the transferred business or entity happens shortly after the acquisition of the transferred business or entity by the controlling party, the measurement of the net assets of the transferred party may be useful for the assessment of whether the consideration made in exchange was reasonable. The usefulness of the information for this purpose, however, diminish as the time gap between the acquisition by the controlling party and the transfer to the receiving party of the transferred entity or business increases. The acquisition method will accordingly result in more useful information for this purpose than the predecessor method.
- Applying pushdown accounting will enable investors to carry out trend analysis and performance assessments which would take into account the goodwill and the identified intangible asset of the transferred entity or business that are (or would

be) recognised in the consolidated financial statements of the controlling party. Such an approach would enable users to assess the stewardship of management of the receiving party. However, the usefulness of the information for this purpose will depend on the time gap between the acquisition by the controlling party of the transferred business or entity and the transfer to the receiving party. The more time passes between the initial acquisition and the subsequent transfer, the more outdated the fair value revaluation becomes and the less useful the information will be to assess whether assets are used in the best manner. For assessing whether assets are used in the best manner, the acquisition method would thus result in more useful information than the predecessor method.

- The pushdown predecessor method will enable assessments of the performance of a period against previous periods for which financial information is provided as if the transferred business or entity had “always” been controlled by the receiving party until the date of the acquisition of the transferred party by the controlling party.

Prudence is reflected

- In general terms, the predecessor method based on pushdown carrying amounts does not introduce additional prudence as the predecessor carrying amounts are carried forward from the controlling party’s financial statements.

Faithful representation

Reflecting substance

- Normally, a party would acquire something because the party expects that the acquisition will be beneficial for it. Transfers of a business or entity under common control may be conducted for different purposes such as tax planning, preparation of IPOs, spin-offs or because of corporate reorganisations (such as discontinued operation). It could accordingly be argued, that a transfer of an entity under common control should be reflected differently from an acquisition. However, in this paper, it is assessed that irrespectively of whether an entity acquires a business or entity or the business or entity is transferred to the receiving party, the receiving party is getting a business or entity, which should be accounted for. The pushdown predecessor method does not completely reflect this, as financial statements would reflect the situation as if the receiving party has controlled the transferred business or entity since the control was established by the controlling party. Even if the comparative figures would not be adjusted, the predecessor method would not reflect the substance of the transfer as good as the acquisition method as the transfer may involve assets not recognised in the financial statements used for the consolidation of the transferred entity. Accordingly, the method does not reflect what it is the receiving entity is getting as well as the acquisition method. However, if comparative figures would not be adjusted, the closer the transfer takes place to the acquisition of the transferred entity by the controlling party, the closer the information resulting from the predecessor method under the pushdown approach would be to the information resulting from applying the acquisition method.

Complete

- If the transferred entity was acquired long time ago, the goodwill recognised at the time of the acquisition goodwill will have been materialised or be impaired and subsequent internally generated intangible assets will not be recognised. Accordingly, the information may be less complete compared to if the acquisition method was applied.
- Similar to acquisition method of accounting, the pushdown accounting will consider and account for historical goodwill and identifiable intangible assets which would provide more complete information compared to the application of historical carrying amounts. When the acquisition was completed recently, the pushdown accounting approach provides financial data similar to the one when the acquisition method of accounting was used.

Neutral

- The application of the pushdown predecessor method may reduce the neutrality issues created by the acquisition method of accounting whereby the net assets of the transferred entity are being remeasured at fair value and the receiving entity's net assets are kept at historical cost. However, the financial statements may still be affected by the decisions of which party should be the receiving party and which party should be the transferred business or entity.

Measurement uncertainty

- The predecessor method does not introduce any additional measurement uncertainty. However, there may still be uncertainty related to the measurement following the application of the acquisition approach at the time when the controlling party acquired the transferred business or entity.

Comparability

- Using the controlling party's carrying amounts enables trend analysis to be performed (if comparative figures are provided) as if the transferred entity had been part of the receiving party (or receiving parties group) from the date the transferred entity was acquired by the controlling party.
- Comparability of information might be impaired when comparing entities acquired within the group (where pushdown carrying amounts are used) and entities acquired outside the group (where acquisition method of accounting is applied).
- The extent to which the information is comparable to information for entities that have grown organically depends on the time gap between the acquisition of the transferred entity by the controlling party and the transfer to the receiving party. However, even when the time gap is large, the fact that the pushdown predecessor method can result in financial statements including goodwill (which could be internally generated goodwill), results in the information never being completely comparable to information from entities that have grown organically.

Verifiability

- The application of the predecessor method does not introduce additional issues in relation to verifiability as the carrying amounts are unchanged from the controlling party's financial statements.

Timeliness

- The predecessor method would not require the preparer to collect additional information and accordingly, the method would result in timely information for users. As opposed to the acquisition method where the fair values for the identified assets and assumed liabilities have to be obtained, the pushdown carrying amounts have been generated at the time the acquisition was completed and all the necessary information is already available and ready to use.

Understandability

- The way the information provided by pushdown accounting is generated makes it consistent with the information provided by the acquisition method of accounting. When the pushdown approach is used, the measurement of some assets and liabilities will be based on the fair values of these assets and liabilities as of the date when the business or entity was acquired by the controlling party. Some of the issues related to the understandability of the information resulting from applying the acquisition method could therefore also exist when applying the predecessor method.

Costs

- The pushdown carrying amounts are already available in the consolidated financial statements of the controlling party. No further costs will be incurred by the receiving entity to generate this information.
- Generally applying pushdown accounting would eliminate some practical difficulties with respect to managing and maintaining two sets of accounting

records for the transferred entity which would be required under the acquisition method. This would also remove the need to perform two separate impairment analysis; keep two sets of depreciation and amortisation balances along with their corresponding tax balances; recording different gains and losses when individual assets are sold.

- It may require more time and resources from users to understand the application of pushdown accounting compared to historical carrying amounts.

17 An assessment of usefulness of financial information provided by the historical carrying amount predecessor method is provided below.

Relevance

Information has predictive value

- To the extent that expectations about future cash flows are based on the statement of financial position, the historical cost information resulting from the application of the carrying amount approach of the predecessor method results in information that is less useful for predicting future cash flows than, for example, the acquisition method.
- However, to the extent that expectations are based on the statement of profit or loss, the predecessor carrying amounts recognised by the transferred party would reflect historical data and would allow to maintain historical profit and loss trends that are deemed relevant to users interested in predicting future cash flows. Under the carrying amount approach of the predecessor method, the profit or loss trends are thus not distorted by increased amortisation and depreciation expense calculated on the stepped-up values of the acquired assets as well as potential impairment charges[5]. When the transferred business or entity continues to operate and generate revenue relatively independently from other entities within the group following the transfer, the predecessor carrying amounts are accordingly considered to better retain the trend information that is sought by users. However, when the transferred business or entity following the transfer is restructured in such a way that in practice it does not operate independently, then the trend information would be naturally interrupted and in this respect the predecessor method carrying amounts would not be more useful compared to the acquisition method fair values.

Information has confirmatory value

- Using the carrying amounts predecessor method will not provide information that would be useful for assessing whether the consideration transferred by the receiving party was reasonable compared to the value of the business or entity received.
- When the assets and liabilities are recorded at the carrying amounts of the transferred entity and the post-combination revenues may be overstated (and expenses understated) because of the embedded gains that were generated by the transferred business or entity but not recognised in its financial statements. This may reduce the usefulness of the carrying amounts predecessor method for assessing the management of the receiving entity.
- The carrying amounts predecessor method will not be as useful as some of the other approaches for assessing whether the assets transferred are used in the best manner.
- By applying the carrying amounts predecessor method, it will be possible to assess the performance of a period against previous periods for which financial information is provided as if the transferred business or entity had "always" been controlled by the receiving party.

Prudence is reflected

- Similar to when the pushdown approach is used, the predecessor method based on historical carrying amounts does not introduce additional prudence as the

[5] PwC *In depth* No US2014-08 December 5, 2014.

predecessor carrying amounts are carried forward from the transferred party's financial statements.

Faithful representation

Reflecting substance

- The carrying amount predecessor method (under which comparative figures are adjusted) would not reflect the transfer and would accordingly not reflect the actual economic substance.

Complete

- Using the predecessor method would reflect all the already recognised assets and liabilities, however, no internally generated assets would be recognised based on the common-control transaction. This makes the information less complete as it does not reflect assets and liabilities that were not included in the pre-combination financial statements of the transferred entity.

Neutral

- The application of the predecessor method removes the neutrality issues created by the acquisition method of accounting whereby the net assets of the transferred entity being measured at fair value and the receiving entity at historical cost.

Measurement uncertainty

- There is no additional measurement uncertainty associated with the predecessor method of accounting.

Comparability

- The use of the predecessor method would allow users to perform a continuous trend analysis and compare the entity information with similar information for previous periods as if the receiving party had "always" controlled the transferred business or entity.
- The information would not be comparable to "normal" acquisitions of assets and liabilities and business combinations within the scope of IFRS 3.
- The information of the combination of the receiving party and the transferred business or entity will be comparable to financial statements of entities that have grown organically.

Verifiability

- The application of the historical predecessor approach does not introduce additional issues in relation to verifiability as the carrying amounts are unchanged.

Timeliness

- The historical predecessor approach would not require the preparer to collect additional information and accordingly the method would not prevent users from receiving timely information.

Understandability

- The information provided to users would be classified and presented in the same way before and after the transfer. Therefore, the understandability of the general financial information will not be affected by the predecessor method.
- The historical predecessor may be easier for some users to understand compared to the pushdown method as the pushdown method can result in goodwill, which users sometimes may find difficult to understand (see the assessment of the acquisition method).

Costs

- The predecessor method carrying amounts are already available and there is no additional costs or fees to the receiving party when using the existing information. The predecessor method is quick and less expensive method to account for the transfer because it does not require to hire valuation to value acquired assets and assumed liabilities.

Question for EFRAG TEG

18 Does EFRAG TEG agree with the assessments included in paragraphs 14 and 17 above? If not, what should be changed or what additional observations should be made?

19 Does EFRAG TEG considers that there are other versions of the predecessor method that should be considered and assessed?

Fresh start method

20 The fresh start method is not used in any existing IFRS Standards. It is used in the US upon emergence from bankruptcy and accounting requirements similar to the fresh start method have been/are allowed in a few EU countries. As the fresh start method is not used in existing IFRS Standards, the exact manner in which the IASB might suggest it being used for the transactions in the scope of this project is unknown. The following assessment is of a method under which:

(a) Identifiable assets and liabilities of the receiving party and the transferred business are measured at fair value (or, that is, in accordance with the guidance under IFRS 3, whereby most, but not all assets and liabilities are measured). This would mean that some intangible assets that have not previously been recognised will be recognised.

(b) The fair value of the receiving party and the transferred business is estimated.

(c) Any difference between the net value of identified assets and liabilities and the fair value estimated under b) is recognised as goodwill.

Relevance

Information has predictive value

- Similar to the acquisition method, the fresh start method may provide useful information to the extent expectations about future cash flows are based on the statement of financial position. In addition to providing fair value information about the assets and liabilities of the transferred business or entity, the fresh start method also provide fair value information about the receiving party's assets and liabilities.
- Similar to the acquisition method, the fresh start method may provide useful information for predicting future cash flows when:
  - The transferred business or entity and the receiving party become integrated following the transfer;
  - The fair values of the identifiable assets of the transferred business or entity and the receiving party reflect the amounts the combined party would have paid to acquire these assets individually; and
  - The transaction price related to future revenue has not been agreed (i.e. cases in which the combined parties are not part of any executory or partly satisfied contracts).

  Similar to the acquisition method, the fresh start method may in other circumstances result in less useful information for predicting future cash flows.

Information has confirmatory value

- Information about the fair values of the assets and liabilities of the transferred entity is useful for assessing whether the consideration was reasonable.
- Recognising identifiable assets at fair value could enable an assessment of whether the assets are used in the best manner (assessment of stewardship) in the periods after the transfer. Such an assessment could be done by comparing the actual return on assets with a benchmark.
- Measurement of inventories of both the transferred business or entity and the receiving party at fair value as of the date of the transfer may make the margins in the following periods less useful for the assessment of stewardship as the margins reported could be a mixture of margins resulting from inventory measured at cost (items of inventory produced/purchased after the transfer of the business or the entity) and at fair value (items of inventory produced/purchased before the transfer).
- When either the transferred business or entity or the receiving party is a party in contracts for which the transaction price has been agreed before the transfer, the fresh start method may not result in useful information for assessing stewardship. As mentioned above, the method will result in revenue from contracts negotiated before the transfer being matched with the fair value of the assets used to satisfy those contracts.
- As the fresh start method would result in a new valuation of all assets and liabilities and may result in additional assets being recognised, the information would not be useful for confirming expected trends in historical financial information.
- Under the fresh start method, comparative figures will not be presented in the financial statements from periods before the transfer of the business or entity. This may impair the confirmatory value.

Prudence is reflected

- The fresh start method does not reflect asymmetric prudence.

Faithful representation

Reflecting substance

- For the measurement of the assets and liabilities of the transferred business or entity, the assessment of the acquisition method applies.
- Remeasuring the assets and liabilities of the receiving party at fair value at the time of the transfer, does not mirror any real event. As mentioned above, the assignment of the roles of the receiving party and the transferred business or entity may be arbitrary given the common control. It could therefore be argued that it would better reflect the substance of the transaction by considering both the official receiving party and the official transferred business or entity as being acquired and accordingly measured at fair value. On the other hand, this argument would not be more convincing than an argument for measuring the combined entity based on the carrying amounts for both the official receiving party and the official transferred business or entity.

Complete

- Because all identifiable assets and liabilities of both the receiving party and the transferred business or entity will be included in the statement of financial position, the fresh start method will result in an even more complete reflection than the acquisition method.

Neutral

- For the receiving party's financial statements, use of the fresh start method would eliminate the neutrality issues that could arise by applying the acquisition method (see above). The fresh start method would result in both the receiving party and the transferred business or entity being measured at fair value. However, this does not mean that the ultimate parent is not able to determine whether one entity should be the receiving party or the transferred business or entity, or whether it should be another entity. There would thus still be an issue in relation to neutrality, but it is not an issue that is directly related to the financial statements of the receiving party.

Measurement uncertainty

- Similar to the acquisition method, measurement uncertainty may be significant. In addition in the case of the fresh start method, both the financial statements of the transferred business or entity and the financial statements of the receiving party will have to be restated. In many cases the inputs used for the estimation for the fair value of identifiable assets and liabilities would be level 3 inputs. As noted in paragraph 5 above, users do not find fair value information based on level 3 input particularly useful.

Comparability

- The fresh start method will destroy comparability over time for the entities. The results will also not be comparable with business combinations within the scope of IFRS 3 or companies that have grown organically. The information resulting from the fresh start method may, however, be comparable with the information provided by newly started entities.

Verifiability

- Some fair value estimations may include forward-looking information that are difficult or not possible to verify.

Timeliness

- It would require even more work and hence take longer time to prepare the information in accordance with acquisition method than in accordance with the acquisition method.

Understandability

- Although it may be difficult to understand what the purpose of the fresh start method is in the case of transfers of a business or entity under common control, it should be easy to understand most of the items in the financial statements as they are measured similarly. As with the acquisition method, the following issues may, however, reduce the understandability:
    - Some items are not measured at fair value;
    - The entity might not had acquired certain of the assets separately (if it had to pay the fair value);
    - The value assigned to goodwill (and other assets and liabilities) in a business combination under common control which may not take place on arm's length terms;
    - Goodwill may be difficult to understand. Initially it may mainly be a deferred tax asset. If the transfer has not taken place on arm's length terms the meaning may also be questionable;
    - After some time, goodwill may mainly be internally generated goodwill – which could otherwise not be recognised.

Costs

- The costs of applying fresh-start accounting will generally be higher than the acquisition method. It would thus be the most costly of the methods considered.

Allocation of cost

21 Under the allocation of cost method, the consideration transferred by the receiving party is allocated to the acquired net assets. The allocated amount may thus result

in some assets being measured at an amount that is higher or lower than the fair value.

22 Paragraph 2(b) of IFRS 3 describes the allocation of cost method for acquired asset or a group of assets and stipulates that the cost of a group of assets shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase.

23 The IFRS Interpretations Committee has recently discussed the application of the allocation of cost to the acquisition of group of assets and has concluded that there are two possible ways to apply the allocation of cost method:

(a) Approach 1 – under this approach the entity applies the following steps:

(i) Identify and recognise the individual identifiable assets acquired and liabilities assumed at the date of acquisition;

(ii) Determine the individual transaction price for each identifiable asset and liability by allocating the cost of the group based on the relative fair values of those assets and liabilities at the date of acquisition; and

(iii) Apply the initial measurement requirements in the applicable Standards to each identifiable asset acquired and liability assumed. Any difference between the initial measurement of the individual asset or liability and its allocated transaction price should be accounted for by applying the relevant requirements.

(b) Approach 2 - under this approach the entity applies the following steps:

(i) Identify and recognise the individual identifiable assets acquired and liabilities assumed at the date of acquisition;

(ii) For any identified asset or liability that is required by the relevant Standards to be initially measured at an amount other than cost (such as: financial assets/liabilities, liabilities (or assets) under IAS 19 *Employee Benefits*, liabilities related to share-based payment transactions, assets held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*), the entity initially measures such asset or liability according to those Standards; and

(iii) The entity deducts from the transaction price of the group the amounts allocated to the assets and liabilities initially measured at an amount other than cost, and then allocates the residual transaction price to the remaining identifiable assets and liabilities based on their relative fair values at the date of the acquisition.

24 The IFRS IC concluded that accounting for the acquisition of group of assets using one of the two approaches described in paragraph 23 above would not be expected to have a material effect on the amounts that entities report.

25 When the acquisition involves a group of assets and liabilities, as a first step in both Approach 1 and Approach 2, the acquirer must identify and recognise the individual assets acquired (including intangible assets that are recognised under IAS 38) and liabilities. Consequently, under the allocation of cost method the entity would recognise more assets compared to the predecessor method.

26 In the following assessment of the decision-usefulness of the information provided by the allocation of cost method, no distinction is made between the two different approaches listed in paragraph 23.

Relevance

Information has predictive value

- To the extent that expectations about future cash flows are based on the statement of financial position, it is questionable how useful the carrying amounts resulting from the allocation of cost method are. Although the transaction price is allocated to assets based on their relative fair values, the resulting amounts do not represent fair values. The acquisition method and the fresh start method would accordingly result in more useful information in that case.
- The application of this method means that new carrying values will be attributed to the acquired assets and assumed liabilities which will inhibit the continuation of trend analyses based on predecessor carrying amounts. In cases in which the transferred business or entity after the transfer will generate cash flows similar to before the transfer (i.e. it will not be integrated in the activity of the receiving party), the allocation of cost method may accordingly result in information that is less useful for predicting future cash flows than the predecessor method.
- On the other hand, if the transferred party is integrated into the receiving party's existing operation, trend analyses of the transferred business or entity may be less useful. In those cases, it could be considered whether the allocation of cost method would result in more useful information for predicting future cash flows than the acquisition method and the fresh start accounting method. The allocation of cost method is consistent with accounting for acquisition of an asset or group of assets where no goodwill is recognised. This information could be useful for predicting future cash flows. However, as the allocation of cost method will neither result in assets (and liabilities) and hence related expenses (or income) being measured at fair value or value in use, the information provided by the acquisition method seems to provide more useful information for predicting future cash flows than the allocation of cost method (under which measurement and resulting margins are less clearly linked to future cash flows than under the acquisition method or fresh start accounting method).
- The allocation of cost method will result in inventories being measured at a higher or lower value than cost. Accordingly, when the inventory is sold, the statement of profit or loss will not appropriately reflect the margins and the volatility in these. The information may accordingly not be as useful for predicting future cash flows as some of the other methods.

Information has confirmatory value

- Allocating the cost to the transferred assets and liabilities could result in the recognition of an impairment loss if the consideration transferred is higher than the value for the receiving entity of the transferred business or entity. As stated in paragraph 10 (the assessment of the acquisition method), some users may find this information useful. However, an impairment loss will not be recognised if there would be sufficient headroom to absorb the excess of the consideration transferred over the value of the transferred business or entity. In addition, the financial statements will not reflect if the consideration transferred is lower than the value of the transferred business or entity. The acquisition method would therefore produce information that would be more useful for an assessment of whether the consideration was too high or too low.
- Although the allocation of the transaction price is based on fair values, the resulting allocated figures would not represent fair values. The allocation of cost method would accordingly not result in as useful information for assessing whether assets are used in the best manner as the acquisition method or the fresh start method.
- Similar to under the acquisition method, measuring inventories at the allocated cost price may make the margins in the following periods less useful for the assessment of stewardship.
- The allocation of cost method does not make it possible to make comparisons with prior years as if the transferred business had "always" been controlled by the receiving party.

Prudence is reflected

- The application of the allocation of cost method can result in some identifiable assets and liabilities being initially measured in accordance with the requirements of the applicable IFRS Standards, however, the remaining identifiable assets and liabilities will be measured by allocating the remainder of the transaction price relative to their fair values. For the latter assets and liabilities, the associated/allocated cost might result in overstatement/understatement of assets and liabilities.

Faithful representation

Reflecting substance

- The allocation of cost method will reflect that a transfer has taken place. However, it will be reflected as a transfer of identifiable assets and liabilities (without any goodwill). If the consideration in the transfer is either higher or lower than the fair value of the transferred business or entity, the receiving party is either transferring or receiving resources from the controlling party, which should be reflected as such. Accordingly, when the fair value of the transferred business or entity is higher (or lower) than the sum of the fair value of identifiable assets and liabilities, the allocation of cost method does not properly reflect all the assets (gains) related to the transaction. In addition, as the cost price is not allocated to goodwill, the amount being attached to each asset and liability following the transfer may not reflect the related consideration.

Complete

- The allocation of cost to the acquired net assets may result in new assets being recognised by the receiving party such as identifiable intangible assets recognised under IAS 38 which have not been recognised by the transferring party as they did not qualify for recognition being internally generated. The method accordingly results in more complete information than the predecessor method.

Neutral

- The issue identified for the acquisition method in relation to neutrality would also exist when applying the allocation of cost method.

Measurement uncertainty

- Allocating the consideration transferred based on the relative fair values of the acquired net assets can create measurement uncertainty from the perspective of the reliability of the fair values used to allocate the transaction cost. This uncertainty would correspond to the uncertainty under the acquisition method, but in addition, the fair value of the assets and liabilities that should not be measured at fair value in accordance with IFRS 3 (e.g. pension liabilities) should be estimated under the cost allocation approach.

Comparability

- The allocation of cost method will assign different value to the identifiable assets and liabilities of the transferred entity or business without recognising goodwill. This remeasurement will reduce comparability to previous periods' financial information, to entities that have grown organically as well as to newly acquired entities financial information for which the acquisition method was applied.

Verifiability

- As the allocation of cost will be based on the fair values of the assets and liabilities of the transferred business or entity, the same issues apply to the verifiability under the allocation of cost method as under the acquisition method.

Timeliness

- The application of the allocation of cost method is dependent on obtaining the fair values for the acquired net assets. Similar to the acquisition method, it will take longer time to obtain those values compared to the predecessor method of accounting.

Understandability

- The information resulting from applying the allocation of cost method might be more difficult for users to understand compared to the alternative methods assessed in this paper when goodwill is part of the transfer. In this case, the values at which assets and liabilities will be measures will neither represent the cost price (as the total cost price is not allocated to goodwill) nor fair value (as fair value is only used for the allocation of the cost price). In addition, understandability may be impaired by the different manners in which the method can be applied: whether the initial measurement is based on the requirements of applicable IFRS Standards or an allocation of the transaction price (see paragraph 23 above).

Costs

- The allocation of cost method will be costlier for the receiving party to apply compared to the predecessor method as the entity would need to obtain fair values for the purposes of allocating the transaction price to the acquired net assets.

Questions for EFRAG TEG

27 Does EFRAG TEG agrees with the assessments included in paragraphs 20 and 26 above? If not, what should be changed or what additional observations should be made?

28 Does EFRAG TEG considers that there are additional methods for accounting for transfers of a business or entity under common control that should be considered? If so, which?

Summary of the methods

29 The table below provides a condensed and simplified summary of the assessments of the:

(a) Acquisition method (AM);

(b) Pushdown predecessor method (PPM);

(c) Carrying amount predecessor method (CAPM);

(d) Fresh start method (FSM); and

(e) Allocation of cost method (ACM).

The method with more shared circles is assessed to be better on a given parameter. The number of shaded circles is just an indication of the relative strength of a given method in relation to a given parameter – not an exact figure. In addition, four unshaded circles does not necessarily mean that a given method does not provide any useful information on a given parameter – just that other methods may provide more useful information. Finally, the parameters are not equally important.

	AM	PPM[a]	CAPM	FSM	ACM
RELEVANCE					
Predictive value of statement of financial position	●●●○	●●○○	●○○○	●●●●	●●○○
Predictive value of profit or loss if independent cash flows	●○○○	●●○○	●●●●	○○○○	●○○○
Predictive value of profit or loss if not independent cash flows	●●●○	●●○○	●○○○	●○○○	●○○○

Possible to assess whether consideration was reasonable	●●●●	●●○○	●○○○	●●●○	●●○○
Possible to assess whether assets are used in the best manner	●●●●	●●○○	○○○○	●●●●	●●○○
Possible to assess stewardship based on margins after transfer	●○○○	●●○○	●●●○	●○○○	●○○○
Possible to compare with previous periods	●○○○	●●○○	●●●●	○○○○	●○○○
FAITHFUL REPRESENTATION					
Reflecting substance	●●●●	○○○○	○○○○	●●○○	●●○○
Completeness	●●●○	●●○○	●○○○	●●●●	●●○○
Neutral	●●○○	●●●○	●●●●	●●●●	●●○○
Low measurement uncertainty	●○○○	●●●○	●●●●	○○○○	●○○○
COMPARABILITY					
Comparison of before and after the transfer	●●●●	○○○○	○○○○	○○○○	●●●○
Comparison as if “always” controlled by receiving party	○○○○	●●○○	●●●●	○○○○	○○○○
Comparison to business combinations under IFRS 3	●●●●	●○○○	○○○○	●○○○	●○○○
Comparable to entities that have grown organically	●○○○	●●○○	●●●●	○○○○	●○○○
VERIFIABILITY	●●○○	●●●○	●●●○	●○○○	●●○○
TIMELINESS	●●○○	●●●●	●●●●	●○○○	●●○○
UNDERSTANDABILITY	●●●○	●●●○	●●●○	●●●○	●●○○
NOT COSTLY	●●○○	●●●○	●●●●	●○○○	●●○○

a: For the pushdown predecessor method the usefulness of the information in relation to some of the parameters would depend on the time gap between the acquisition of the transferred business or entity by the controlling party and the transfer to the receiving party.