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BCUCC between wholly owned entities

Issues Paper

Objective

- 1 The objective of the paper is to seek EFRAG TEG and EFRAG CFSS views on the accounting approach to business combinations under common control between entities that are wholly owned by the controlling party. The input received will be presented at the Accounting Standards Advisory Forum (ASAF) meeting in April 2019.

Background

- 2 The IASB's research project on Business Combinations under Common Control (BCUCC) explores how to account for transfers of a business or entity under common control. Currently, such transactions are outside the scope of IFRS 3 *Business combinations* and accounted for in different ways. The IASB is planning to publish a discussion paper on the project in the first half of 2020.

BCUCC that affect non-controlling interest

- 3 So far, the IASB has considered possible approaches to account for a sub-set of BCUCC where non-controlling interest (NCI) is present in the receiving entity. Two measurement approaches have been explored based on the information needs of the primary users of the receiving entity's financial statements and the cost-benefit analysis of providing the information together with operational complexity of applying the approach and structuring opportunities.
- 4 For BCUCC that affect NCI, the IASB has discussed whether and how the acquisition method set out in IFRS 3 should be modified to provide the most useful information about such transactions. Possible modifications include:
 - (a) additional disclosures;
 - (b) recognise a contribution in equity instead of recognising a gain, if fair value of acquired net assets exceeds the consideration paid; or
 - (c) recognise a distribution from equity instead of recognising goodwill, if the consideration paid exceeds fair value of the acquired interest.
- 5 Additionally, the IASB discussed if all BCUCC transactions where NCI is present in the receiving entity should be treated in the same way. Various qualitative and quantitative factors have been explored to make such distinction including if the shares of the receiving entity are listed or not, the NCI shareholders are related parties and the relative size of NCI.
- 6 The IASB staff suggests that different measurement approaches could be applied to BCUCC that affect NCI in the receiving entity based on a cost-benefit analysis of providing current value information and considering structuring opportunities.

Therefore, it may be appropriate to restrict the use of a current value measurement approach only to some BCUCC where NCI is present in the receiving entity.

BCUCC between wholly owned entities

- 7 Another sub-set are BCUCC where no NCI is present in the receiving entity, but the receiving entity has external lenders and other creditors; or when the BCUCC is preparatory to a public sale expected to bring in prospective equity investors.
- 8 The IASB staff has conducted a few research and outreach activities to consider the information needs of debt and equity investors when proposing a measurement approach for BCUCC that affect lenders and other creditors in the receiving entity and prospective equity investors, but do not affect NCI.

Lenders and other creditors in BCUCC

- 9 Generally, lenders and other creditors are exposed to credit risk of their debt investments that reflects liquidity risk of the borrower. Therefore, the goal of the credit analysis is to assess the liquidity risk of the borrower by performing predominantly cash flow analysis and considering the level of total gross debt.
- 10 Debt investors and credit analysts use information in the entity's general purpose financial statements to assess recoverability of the existing debt and in making decisions about providing resources to the entity, however, the focus of their credit analysis always remains on the entity's ability to service its debt.

Cash flow analysis

- 11 Information needs of lenders and credit analysts include information about cash flows, cash flow projections and cash-flow based ratios which are typically derived from the statement of profit or loss, the statement of cash flows and the notes to the financial statements.
- 12 Debt investors and credit analysts use information in the entity's financial statements as a starting point for the cash flow projections in their models. If a current value approach is applied in a BCUCC, the recognition of the identifiable acquired net assets at fair value will result in the subsequent recognition of additional amortisation and depreciation in the statement of profit or loss which debt investors and credit analysts remove in developing cash flow projections. If a predecessor approach¹ is applied, this adjustment would not need to be made in developing those cash flow projections.
- 13 Similarly, debt investors and credit analysts tend to rely most heavily on ratios based on cash flow measures such as debt payback ratios and debt service ratios. Most of the resulting ratios will be largely unaffected by whether a current value approach or a predecessor approach is used to account for a BCUCC.
- 14 Consequently, credit analysis does not focus on the statement of financial position and would be largely unaffected by whether a current value approach or a predecessor approach is used for a BCUCC.

Focus on total gross debt

- 15 An entity's ability to service its debt and to raise new debt is affected not only by its ability to generate cash flows but also by its existing total gross debt, including both recognised and unrecognised commitments. In a BCUCC the receiving entity can

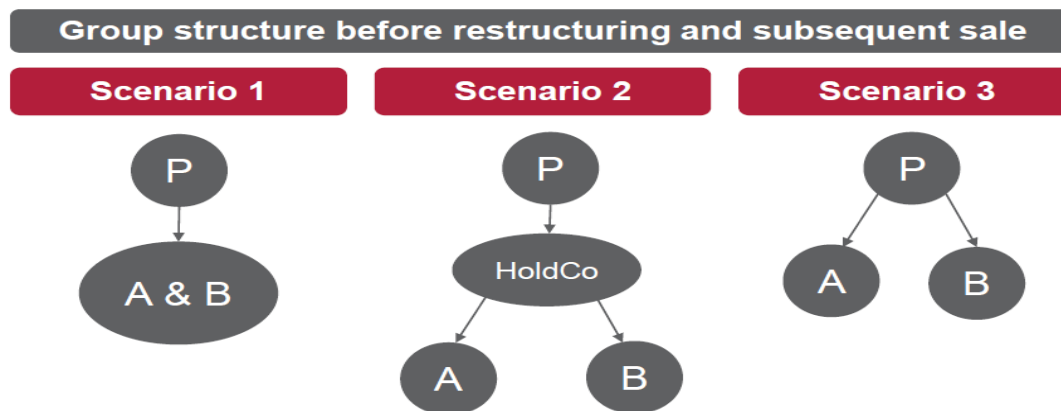
¹ Under the predecessor approach the combining entities are accounted for at their historical carrying amounts and any difference between the proceeds transferred or received and the carrying amounts of the net assets is recognised in equity in the transferring and receiving entities.

assume new debt, unrecognised commitments or contingent liabilities which can sometimes result in an increase in its liquidity risk.

- 16 When assessing the total gross debt of the entity, debt investors and credit analysts are interested in information about the nominal amounts rather than the fair value of the debt due to the focus on cash flows in the credit analysis.
- 17 The carrying amounts of debt included in the receiving entity's statement of financial position applying either a current value approach or a predecessor approach will generally not be sufficient for credit analysis and need to be supplemented with information provided in the notes to financial statements about the maturity, priority ranking and collateral related to the level of gross debt. Consequently, the qualitative characteristics of the debt will not be affected by whether a current value approach or a predecessor approach is applied to BCUCC.

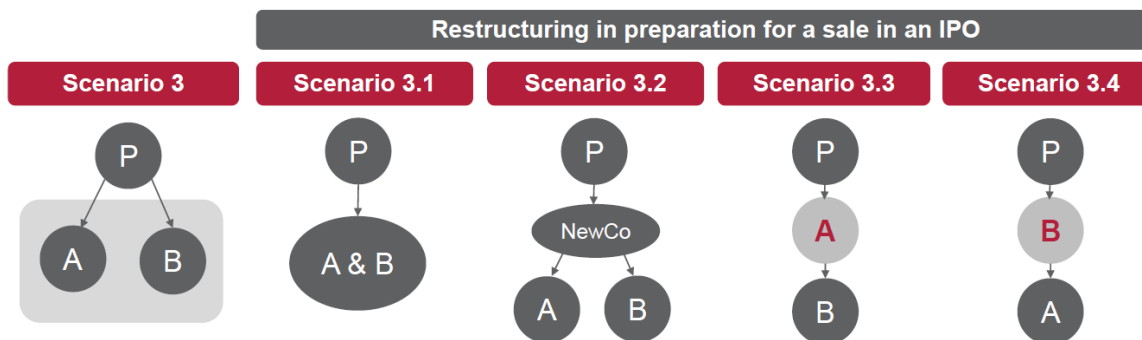
Prospective equity investors in BCUCC

- 18 Equity investors are generally interested in maximising the returns on their investments and are sensitive to both increases and decreases in projected cash flows. Their analysis tend to focus on valuation.
- 19 The IASB staff has analysed different scenarios for BCUCC involving prospective equity investors and the appropriate measurement approach to be applied. The analysis is contained in the following paragraphs.
- 20 The diagram below includes different group structures before restructuring and subsequent sale. In all three scenarios, entity P controls and wholly owns businesses A and B. In Scenarios 1 and 2, businesses A and B are contained within existing legal entities. However, in Scenario 3, businesses A and B are separate legal entities directly owned by entity P.



Source: the IASB

- 21 Entity P decides to sell businesses A and B together in an IPO. In Scenarios 1 and 2, businesses A and B can be sold together as they are either contained in a single legal entity or can be sold by selling their holding company. Scenario 3, however, requires restructuring in preparation for a sale in an IPO and the possible variations are illustrated in the diagram below.



Source: the IASB

- 22 The IASB staff is of the view that in all three scenarios the economic substance of the transaction remains the same – the sale of businesses A and B to new investors. In Scenarios 1 and 2, the prospective investors will receive historical information about businesses A and B. Accordingly, the sub-scenarios of Scenario 3 should also be accounted for applying a predecessor approach to achieve consistent accounting treatment for economically similar transactions.

Questions for EFRAG TEG and EFRAG CFSS

- 23 Does EFRAG TEG and EFRAG CFSS agree with the IASB staff's conclusions in paragraphs 14 and 17 that the result of the analysis by debt investors and credit analysts of the entity's ability to service and raise debt would not depend greatly on whether a current value approach or a predecessor approach is applied to account for a business combination under common control?
- 24 Does EFRAG TEG and EFRAG CFSS agree with the IASB staff's conclusion in paragraph 22 that a predecessor approach would provide useful information to prospective equity investors about business combinations under common control between wholly owned entities undertaken in preparation for an IPO?
- 25 Does EFRAG TEG and EFRAG CFSS agree with the IASB staff's proposal to pursue different approaches for business combinations under common control that affect NCI in the receiving entity and those that affect lenders and other creditors in the receiving entity, in particular:
- a current value approach for all or some transactions that affect NCI in the receiving entity; and
 - a different approach, such as a predecessor approach, for transactions that affect lenders and other creditors in the receiving entity but do not affect NCI?

Agenda Papers

- 26 In addition to this Issues paper, agenda papers for this session are:
- Agenda paper 11-02 – ASAF 08 BCUCC Cover Paper - for background only;
 - Agenda paper 11-03 – ASAF 08A BCUCC Overview of the staff approach - for background only; and
 - Agenda paper 11-04 – ASAF 08B Lenders and other creditors in BCUCC – for background only.