Business Combinations under Common Control
Key messages for EFRAG's draft comment letter

Objective

1 The objective of this paper is to discuss and agree on the key messages for EFRAG's draft comment letter (DCL) on the upcoming IASB's discussion paper *Business Combinations under Common Control* ('BCUCC').

Introduction

2 To facilitate the discussion, the EFRAG Secretariat proposes a number of key messages to be included in the DCL. These key messages have been based on the feedback received from previous EFRAG TEG and EFRAG TEG Working Group meetings.

3 The EFRAG Secretariat is planning to present to EFRAG TEG a draft comment letter in January 2021 for a recommendation to the EFRAG Board. The timing of EFRAG's DCL is crucial so that the EFRAG Secretariat can have a basis for the outreach activities to be started thereafter.

4 Appendix 1 is a summary of the November 2020 EFRAG User Panel discussions and Appendix 2 is a summary of the IASB's tentative decisions.

General comments

5 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key message:

(a) EFRAG welcomes the IASB's discussion paper on BCUCC. The project aims to develop guidance on how to account for BCUCC. Currently, there is diversity in practice in the way entities account for BCUCC transactions and it is difficult for users of financial statements to compare the effects of BCUCC on entities' financial position and financial performance.

Question for EFRAG TEG

6 Does EFRAG TEG agree with the key message suggested above?

Scope of the BCUCC project

7 The IASB's preliminary view is that it should develop proposals on all transfers of a business between entities under common control, even if the transfer does not meet the definition of a business combination in IFRS 3.

8 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) EFRAG is of the view that the scope as defined by the IASB is an appropriate starting point for the project;

(b) However, EFRAG considers that it would be useful to clarify the scope by providing some practical examples of transactions included in the scope;

(c) In addition, clarification is needed on whether the project applies to consolidated financial statements and/or separate financial statements of the receiving entity as there would be challenges when reporting BCUCC in the separate financial statements;

(d) EFRAG's tentative view is that defining 'transitory control' would be useful, however, it might lead to a rules-based approach and result in some BCUCC falling out of the scope of the project. A question to constituents is to be included in EFRAG's DCL regarding whether 'transitory control' is a critical element for the scope.

Question for EFRAG TEG

9 Does EFRAG TEG agree with the key messages suggested above?

Measurement method for BCUCC

Considerations in selecting the measurement method

Neither acquisition method nor book-value method applied to all BCUCC

10 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) In general, EFRAG agrees that there should not be a single measurement approach for all BCUCC. BCUCC transactions are usually governed by the controlling party and may have different economic substance.

(b) EFRAG considers that the proposed selection of measurement methods as illustrated in paragraph 18 of Appendix 2 is an appropriate dividing line as to when to apply the acquisition method and when to apply a book-value method to BCUCC.

(c) In practice, there are potential interactions between BCUCC and prudential regulatory requirements, tax laws and insolvency laws which might influence the accounting for BCUCC.

(d) Additionally, EFRAG notes that entities might structure BCUCC transactions differently to apply either the acquisition method or a book-value method. However, the existence of non-controlling shareholders of the receiving entity is an objective test which will reduce accounting arbitrage.

In principle, acquisition method to be applied if BCUCC affects non-controlling shareholders of the receiving entity

11 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) In principle, EFRAG supports the application of the acquisition method if BCUCC affects the non-controlling shareholders of the receiving entity. EFRAG notes that a BCUCC that is similar to an acquisition in the scope of IFRS 3 will be accounted for similarly to a business combination that is not under common control thereby increasing comparability and ensuring consistency in reporting.

Book-value to be applied to all other BCUCC

12 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) In principle, EFRAG agrees with applying the book-value method to transactions that do not affect non-controlling shareholders of a receiving entity.

(b) EFRAG recommends that the IASB should further consider the scoping of a book-value method. In particular, an entity which issued bonds and has no listed equity instruments would qualify to apply a book-value method. This raises concerns about the lack of relevance of the approach for bond holders.

Trade-off between costs and benefits of information and other practical considerations

Acquisition method for the receiving entity's equity instruments that are traded in a public market

13 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) EFRAG generally agrees for the acquisition method to be applied to BCUCC when the receiving entity's equity instruments are publicly traded. This will provide useful information to non-controlling shareholders which otherwise might not be available to them. Applying the acquisition method to publicly-traded entities can also be a way to keep management accountable for how the entity's resources are being used.

The exemption from and exception to the acquisition method

14 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) On the exemption (i.e. the receiving entity is permitted to apply a book-value method if it has informed all its non-controlling shareholders about it and they do not object):

(i) EFRAG supports the exemption from the acquisition method because EFRAG considers that the measurement choice would depend on the non-controlling shareholders' information needs and a cost-benefit assessment for either method. However, EFRAG acknowledges that:

- the receiving entity would have a choice on which measurement method to use which may result in decreased comparability both within and across entities.
- conceptually, BCUCC transactions qualifying to apply the exemption from the acquisition method will affect NCS in a privately-held receiving entity and their information needs are the same as the NCS in a receiving entity which equity instruments are publicly traded.

(ii) However, EFRAG observes that it might be operationally difficult to apply the exemption. For example, obtaining confirmation whether the NCS object to using a book-value method, what the appropriate notification period should be, the number of NCS and their changeability.

(iii) Furthermore, it should be noted that BCUCC are not limited to transfers of entities but also include transfers of unincorporated businesses where it would be hard to determine the effect of the transaction over the NCS.

(b) On the exception (i.e. the receiving entity is required to apply the book-value method if all non-controlling shareholders are related parties to the receiving entity as defined in IAS 24 *Related Party Disclosures*):

(i) EFRAG supports the exception to the acquisition method for BCUCC affecting the non-controlling shareholders of a privately-held receiving entity. EFRAG also supports that the application is mandatory.

(ii) However, EFRAG considers that there should be a conceptual basis for creating the exception rather than being primarily driven by cost-benefit considerations because such an exception does not exist in IFRS Standards for the acquisition of assets and assumption of liabilities between related parties.

Should the exemption from and the exception to the acquisition method be extended to publicly-traded entities?

15 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) EFRAG **does not support** extending the exemption from the acquisition method to publicly-traded receiving entities with NCS because:

(i) it might be even more difficult to operationalise the exemption from the acquisition method compared to privately-held receiving entities. Publicly-traded receiving entities might have a larger number of external NCS which could change regularly and therefore it would be difficult to trace and obtain consent from NCS regarding what measurement method to be applied; and

(ii) extending the exemption to publicly-traded entities with NCS will allow different measurement methods to be used for similar BCUCC. Consequently, some NCS will be provided with fair value information and some NCS will have book value for the same type of BCUCC transaction. This will result in reduced comparability within and across entities.

(b) EFRAG supports extending the exception to the acquisition method to publicly-traded receiving entities. If all NCS are related parties to the receiving entity, their interest and information needs will be met without having to rely on general purpose financial statements. Extending the exception to publicly-traded receiving entities, will be also a cost-benefit relief for entities where the NCS's interests are already considered. Furthermore, EFRAG suggest the IASB to consider extending the exception to bond holders because they have the same interest and information needs as shareholders.

Questions for EFRAG TEG

16 Does EFRAG TEG agree with the EFRAG Secretariat in paragraph 10(b) above that the dividing line on when to apply the acquisition method or the book value method is appropriate? Please explain. The EFRAG Secretariat notes that the separation would have to be on a robust basis such as public accountability as defined in IFRS for SMEs.

17 Does EFRAG TEG agree with the other key messages suggested above?

How to apply the acquisition method

18 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) EFRAG is supportive of the application of the acquisition method to BCUCC affecting the non-controlling shareholders in a publicly-traded receiving entity;

(b) EFRAG agrees with recognising a contribution to the receiving entity's equity instead of recognising a gain in the statement of profit or loss if the consideration paid is lower than the acquired net assets;

(c) EFRAG agrees not to require recognition of a distribution from equity by the receiving entity if the consideration paid is higher than the acquired net assets. EFRAG agrees to recognise the initial measurement in goodwill instead.

Question for EFRAG TEG
19 Does EFRAG TEG agree with the key messages suggested above?

How to apply a book-value method

20 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) EFRAG is generally supportive of how to apply the book-value method to BCUCC but with some specific considerations on:

(b) **Acquired net assets**:

(i) See question in paragraph 21 below whether EFRAG TEG agrees to measure the assets and liabilities received using the transferred entity's book values;

(ii) Questions to constituents regarding:

- what approach is currently being applied in the financial statements, together with a description of this approach; and
- whether constituents agree with the IASB proposals to use the transferred entity's book values and to explain the reasons why or why not.

(c) **Consideration paid**:

(i) *in own shares* – EFRAG is of the view that some guidance is needed if the consideration paid is in the form of shares, for e.g., whether this would be measured at fair value or carrying amount;

(ii) *in assets* – EFRAG agrees with the IASB proposals. However, EFRAG notes that the approach taken by the IASB to measure the consideration paid in the form of assets at their book values at the date of the combination may appear to be inconsistent with the scenario when the entity first sells the asset at fair value and uses the cash proceeds received as consideration in a BCUCC. However, EFRAG considers that these are two different situations because the transaction in the form of assets is not a disposal of assets while if the entity first sells the assets, there would be a disposal of these assets;

(iii) *by incurring or assuming liabilities* – EFRAG generally agrees with the IASB proposals to measure the carrying amounts of those liabilities determined at the combination date in accordance with applicable IFRS Standards. However, EFRAG notes that the consideration paid in the form of assets would be measured on a different basis compared to the consideration paid by incurring or assuming liabilities which may result in some adverse accounting outcomes such as a negative effect on equity.

(d) **Recognition in equity**:

(i) EFRAG agrees with not specifying in which component or components of equity the difference between consideration paid and net assets acquired should be presented;

(ii) However, EFRAG considers that the impact on equity might be significant in cases when the consideration paid is at fair value. This impact will also depend on how far in the past the transferred entity was acquired by the controlling party. The longer the time since the acquisition, the more significant will be the negative impact on the receiving entity's equity.

(e) **Transaction costs** – EFRAG agrees to recognise transaction costs incurred in BCUCC as an expense in the period in which they are incurred and to recognise costs related to the issue of debt or equity instruments in accordance with IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*.

(f) **Pre-combination information** – In general, retrospective restatement of the receiving entity's financial statements would enable users of financial statements to perform trend analysis as if the transaction had occurred prior to the combination date. However, this would not provide relevant information as at the date of the transaction. Therefore, EFRAG agrees with the IASB proposals to provide pre-combination information only about the receiving entity.

(g) **Conceptual basis of the measurement approach** – EFRAG suggests that the IASB further aligns the book-value method with the measurement bases under the *Conceptual Framework* or to better explain the conceptual differences if there is a departure from the guidance in the *Conceptual Framework.*

Questions for EFRAG TEG

21 Based on feedback received from EFRAG TEG and EFRAG TEG Working Groups, some agree to measure the assets and liabilities received using the transferred entity's book values while some others preferred to consider the carrying amounts in the consolidated financial statements of the transferred entity's controlling party instead. Keeping in mind suggested questions to constituents in paragraph 20(b)(ii) above, which view does EFRAG TEG support to be included in EFRAG's DCL? Please explain.

22 Does EFRAG TEG agree with the other key messages suggested above?

Disclosure requirements

23 Considering the feedback received from EFRAG TEG and EFRAG TEG Working Groups, the EFRAG Secretariat suggests the following key messages:

(a) EFRAG supports the disclosure requirements under both the acquisition and the book-value method.

(b) EFRAG suggests that disclosure requirements under the book-value method should include an explicit statement that an entity which discloses the amount of gain or loss that relates to assets and liabilities received in BCUCC, is not required to disclose respective fair value information about the transaction.

(c) EFRAG also suggests that entries in equity resulting from a BCUCC be separately disclosed in the statement of changes in equity.

Question for EFRAG TEG

24 Does EFRAG TEG agree with the key messages suggested above?

Appendix 1: Summary of 19 November EFRAG User Panel discussions

25 Referring to the IASB's decision tree, the EFRAG User Panel members agreed with the IASB proposals as there was a need for a structured approach. Members broadly agreed that the decision tree was objective and logical.

26 In terms of experience in BCUCC transactions, one member indicated that intra-company and tax-driven transactions were done with, at least, the consideration being at fair value while another did not encounter these transactions and therefore considered them to be theoretical.

27 Two members indicated that any group restructuring should not create additional equity.

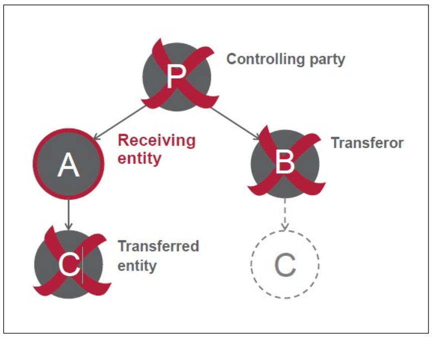
28 Members generally agreed that the proposed disclosure requirements for BCUCC were in the right direction. Some members asked what disclosures were removed for the book value approach in order to assess if they were missing additional information. The EFRAG Secretariat will email these to the EFRAG User Panel in order to obtain their input.

Appendix 2: Summary of the IASB tentative decisions

Scope of the BCUCC project

1 The IASB's preliminary view is that it should develop proposals on all transfers of a business between entities under common control, even if the transfer does not meet the definition of a business combination in IFRS 3.

2 The project considers reporting requirements for a receiving entity in a combination under common control, i.e. Entity A in the diagram below.



Source: IASB

3 The scope of the BCUCC project should include all transfers of businesses in which all of the combining entities are ultimately controlled by the same party, even if the transfer is:

(a) preceded by an external acquisition or followed by an external sale of one or more of the combining companies (i.e. an acquisition or a sale outside the group); or

(b) conditional on an external sale of the combining companies such as in an initial public offering (i.e. a sale outside the group).

4 The focus of the project is how a receiving entity A should report the combination in its consolidated financial statements and in its individual and separate financial statements if the transferred business is not an entity (e.g. an unincorporated business or an unincorporated branch or other part of an entity).

Measurement method for BCUCC

Considerations in selecting the measurement method

Neither acquisition method nor book-value method applied to all BCUCC

5 In 2019, the IASB discussed and concluded that a single measurement approach for all business combinations under common control was not appropriate.

In principle, acquisition method to be applied if BCUCC affects non-controlling shareholders of the receiving entity

6 The IASB tentatively decided that a distinction based on whether non-controlling shareholders (NCS) of the receiving entity A acquire a residual interest in the transferred entities or businesses is a viable approach to use in determining when to apply an acquisition method and when to apply a book-value method to BCUCC transactions.

Book-value to be applied to all other BCUCC

7 The IASB tentatively decided that the forthcoming discussion paper should propose a book-value method for all other transactions within the scope of the project, including all combinations between wholly owned companies. That is, when a current value approach would not be applied, a book-value method should be used.

Trade-off between costs and benefits of information and other practical considerations

Acquisition method for the receiving entity's equity instruments that are traded in a public market

8 The IASB tentatively decided to apply a current value approach based on the acquisition method as set out in IFRS 3 to all transactions that affect non-controlling shareholders of the receiving entity if the receiving entity's equity instruments are publicly traded.

The exemption from and exception to the acquisition method

9 In order to take into consideration the cost constraint and to limit opportunities for accounting arbitrage that could otherwise arise, e.g., in some cases non-controlling shareholders in a private entity may have access to information about the transaction without having to rely on the entity's general purpose financial statements, the IASB tentatively decided to propose the following.

10 If the receiving entity's equity instruments are **not publicly traded**:

(a) the receiving entity is permitted to apply a book-value method if it has informed all its non-controlling shareholders about it and they do not object (the **exemption** from the acquisition method); or

(b) the receiving entity is required to apply the book-value method if all non-controlling shareholders are related parties to the receiving entity as defined in IAS 24 *Related Party Disclosures* (the **exception** to the acquisition method).

How to apply the acquisition method

11 When a current value approach is used to account for BCUCC, the receiving entity A should apply the acquisition method in IFRS 3 complemented by presenting a **contribution** to the receiving entity's equity when the acquired identifiable net assets exceed the consideration transferred instead of recognising that excess as a gain on a bargain purchase in the statement of profit or loss.

12 The IASB decided not to require recognition of a distribution from the receiving entity, when the consideration transferred is in excess of the value received, and to include the excess consideration in the initial measurement of goodwill.

How to apply a book-value method

13 The IASB tentatively decided that when a book-value method is used to account for BCUCC the method should be applied by the receiving entity A as follows:

(a) **assets and liabilities** received should be measured at the carrying amounts included in the financial statements of the transferred entity; and

(b) **pre-combination information** in primary financial statements should be provided only about the receiving entity i.e. comparative figures should not be restated for all the combining entities;

(c) consideration paid in BCUCC:

(i) **consideration paid in the form of assets** should be measured at the receiving entity's book values for those assets at the combination date;

(ii) **consideration paid by incurring liabilities to the transferor or assuming liabilities** from the transferor should be measured at the amount determined at the combination date using the IFRS Standards applicable for initial recognition of a liability of that type.

(d) **recognise as a change in equity** any difference between the consideration paid and the carrying amounts of assets and liabilities received. However, the

IASB has tentatively decided not to specify in which component or components of equity this difference should be presented;

(e) recognise **transaction costs** as an expense in the statement of profit or loss in the period in which they are incurred. Recognise costs related to the issue of debt or equity instruments in accordance with IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*.

14 The IASB tentatively decided not to prescribe how the receiving entity should measure the consideration paid in its own shares as it is usually subject to legal requirements which differ between jurisdictions.

Disclosure requirements

Disclosure requirements under the acquisition method

15 When the acquisition method is used to account for BCUCC the receiving entity would apply all disclosure requirements in IFRS 3 and the disclosures suggested in the discussion paper *Business Combinations – Disclosures, Goodwill and Impairment.*

16 Additionally, the IASB tentatively decided that it should provide guidance on applying the disclosure requirements of IFRS 3 and IAS 24 *Related Party Disclosures* to BCUCC. For example, an entity needs to disclose information about the governance process over the financial terms of the combination.

Disclosure requirements under a book-value method

17 The IASB has tentatively decided that the receiving entity should apply the following disclosure requirements in IFRS 3 and in the discussion paper *Business Combinations – Disclosures, Goodwill and Impairment* and disclose the following information when a book-value method is used to account for BCUCC:

(a) the disclosure objective of providing information to help users of financial statements to evaluate the nature, the financial effect and the expected benefits of a combination;

(b) the name and the description of the transferred entity, the combination date, the percentage of voting equity interests transferred to the receiving entity, the primary reasons for the combination and a description of how the receiving entity obtained control;

(c) the recognised amounts of each major class of assets and liabilities assumed, including information about recognised amounts of liabilities arising from financing activities and defined benefit pension liabilities;

(d) the carrying amount of non-controlling interest;

(e) the requirement to provide aggregate information for individually immaterial combinations;

(f) the disclosure requirements for combinations that occur after the end of the reporting period but before the financial statements are authorised for issue;

(g) the amount and an explanation of any gain or loss that relates to assets and liabilities received if such disclosure is relevant to understanding the combined entity's financial statements; and

(h) the requirement to disclose whatever additional information is necessary to meet the applicable disclosure objectives.

(i) disclose the amount recognised in equity for the difference between the consideration paid and the carrying amounts of assets and liabilities received, and the component of equity in which that difference is presented.

Illustration of the IASB's tentative decisions on when a current value approach and a predecessor approach would apply

18 Below is a summary of the IASB's tentative decisions: