IFRS Accounting Standards discussion fora: Business combinations and BCUCC

2023

Addis Ababa, Ethiopia

WORLD BANK GROUP

AABE

Accounting and Audit Board of Ethiopia

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Applicable version of IFRS Accounting Standards

Unless specified otherwise, the accounting requirements that are the subject matter of this discussion forum are IFRS Accounting Standards as issued by the International Accounting Standards Board that are applicable for annual period beginning on or after 1 January 2023 without early applying new and amended IFRS Accounting Standards that have a later mandatory application date.

Aims

» Develop a more cohesive understanding of IFRS accounting and reporting for business combinations and business combinations under common control (BCUCC) in Ethiopia.

» Enhance capacity in Ethiopia to apply IFRS 3 *Business Combinations* more consistently.

» Enhance capacity in Ethiopia to apply the 'IAS 8 hierarchy' in determining and applying an entity's accounting policy for BCUCC.

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Index of issues

- Business combinations under common control (BCUCC)
  - Issue 1: determining accounting policy for BCUCC
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Business combinations under common control (BCUCC)

Business combinations under common control (BCUCC) Ethiopian context

The Ethiopian Government sometimes reorganises the state-owned enterprises (SOEs) under its control, typically by combining two or more previously independent SOEs into one SOE. Usually, no purchase consideration is paid.

Because IFRS Accounting Standards do not explicitly specify accounting for business combinations under common control (BCUCC) SOEs are unsure about how to determine their accounting policy for BCUCC and how to apply it.

Issue 1: determining accounting policy for BCUCC

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Determining accounting policy for BCUCC
What do you think?

Since adopting IFRS Accounting Standards, BCUCC involving Ethiopian SOEs have occurred.

Because IFRS Accounting Standards do not explicitly specify accounting for BCUCC, uncertainty exists about how to determine an accounting policy for BCUCC.

How to determine an accounting policy for BCUCC?

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Determining accounting policy for BCUCC
Summary of discussion

How to determine an accounting policy for BCUCC? Discussants' consensus view = determine accounting policy for BCUCC by applying IAS 8.10–.12 (sometimes called 'the IAS 8 hierarchy') which specifies how management must use its judgement in developing its accounting policy for any transaction, other event or condition that IFRS Accounting Standards do not explicitly specify accounting for.

The aim of applying the IAS 8 hierarchy is to develop an accounting policy that "results in information that is: (a) relevant to the economic decision-making needs of users; and (b) reliable, in that the financial statements: (i) represent faithfully the financial position, financial performance and cash flows of the entity; (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form; (iii) are neutral, ie free from bias; (iv) are prudent; and (v) are complete in all material respects." (IAS 8.10)

Determining accounting policy for BCUCC
Summary of discussion

The process for making the judgements in developing an accounting policy by applying the IAS 8 hierarchy is for management to "consider the applicability of, the following sources in descending order: (a) the requirements in IFRSs dealing with similar and related issues; and (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Conceptual Framework for Financial Reporting (Conceptual Framework)*." (IAS 8.11)

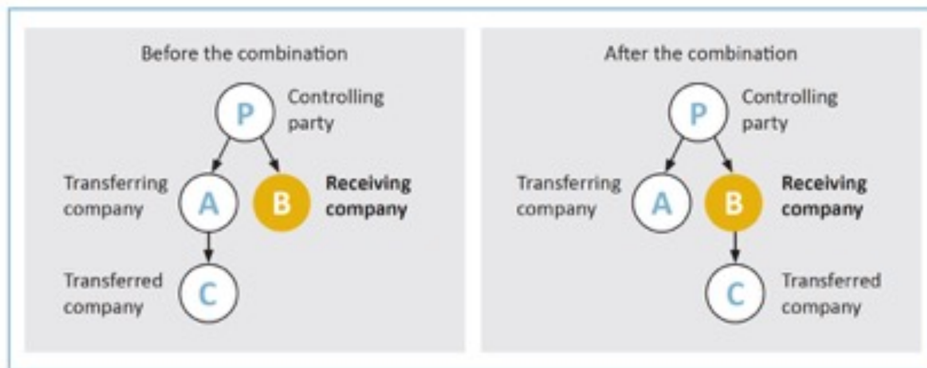
Management can if they want to (but do not have to) "also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11." (IAS 8.12)

Note: the IFRS Interpretations Committee observed that when management develops an accounting policy through analogy to an IFRS Accounting Standard dealing with similar and related matters, it needs to use its judgement in applying **all aspects** of the IFRS Accounting Standard that are applicable to the particular issue (see IFRIC Update March 2011).

Selected accounting literature relevant to determining an accounting policy for BCUCC
Summary of discussion

An example of accounting literature relevant to determining an accounting policy for BCUCC is the IASB, Discussion Paper DP/2020/2 *Business Combinations under Common Control* which illustrates an example of a BCUCC using the diagrams presented below. For ease of understanding, the terminology used in these diagrams is adopted in the slides that follow.

Diagram IN.1—A business combination under common control



Source: IASB, Discussion Paper DP/2020/2 *Business Combinations under Common Control*

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Determining accounting policy for BCUCC
Summary of discussion

Whose eyes must management look through when determining its accounting policy for BCUCC? Discussants' consensus view = primary users' eyes, ie existing and potential investors lenders and other creditors that are not in a position to demand bespoke information from Receiving company. In particular, for the BCUCC presented in the diagram on the previous slide:

- Receiving company non-controlling interests' eyes likely provide a most relevant perspective because they are investors that likely are not in a position to require Receiving company to provide information directly to them.
- Receiving company's management must not look through the Controlling companies' eyes. Consequently, it is irrelevant that from the perspective of Controlling company the exchange transaction does not change the composition of the assets under Controlling company's control (ie it controls all assets of the group before and after the combination).

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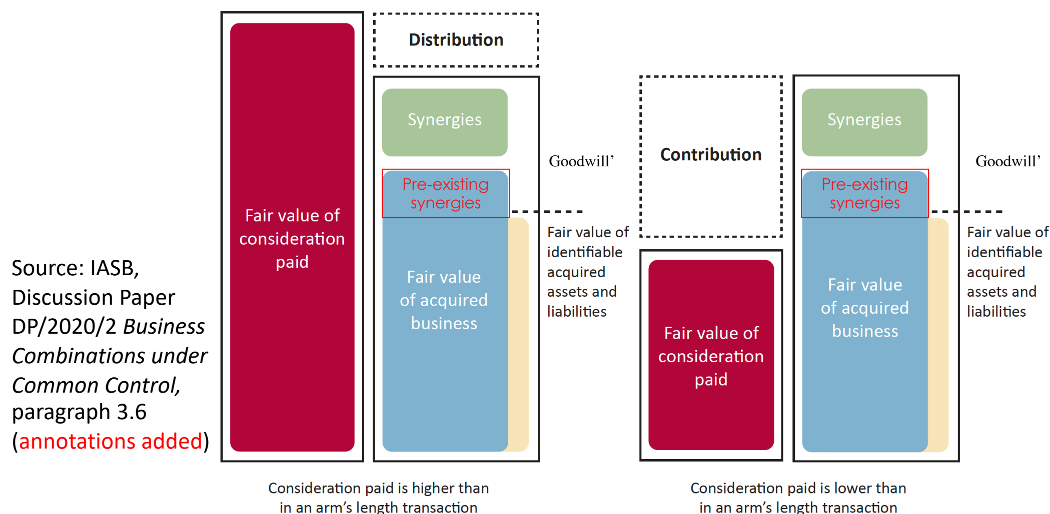
Determining accounting policy for BCUCC
Economics of a BCUCC from the receiving entity's perspective
Summary of discussion



Determining accounting policy for BCUCC
Summary of discussion

Which method of accounting for business combinations under common control provides the most relevant information (ie reveals the most economics) about the exchange transaction? Discussants' consensus view = different methods are most relevant in different circumstances (see slides that follows). Potentially appropriate methods identified as most relevant in different circumstances include:

» acquisition accounting (as set out in IFRS 3 *Business Combinations*);

» fresh-start accounting—basically start afresh with all of the combined assets and liabilities measured at their fresh-start-date fair value; and

» a book value method—on initial recognition the acquirer uses the acquiree's carrying amounts—as required or permitted by some standards issued by those national standard-setters that have a similar conceptual framework to that used by the IASB.

Selected accounting literature relevant to determining an accounting policy for BCUCC
Summary of discussion

- When developing IFRS 3, the IASB and the US national accounting standard-setter, the Financial Accounting Standards Board (FASB), considered other methods of accounting for 'true mergers' or 'mergers of equals'. The boards concluded that if they were to be accounted for using a method other than the acquisition method, the fresh-start method would be better than the pooling of interests method (see paragraph BC35 of the Basis for Conclusions on IFRS 3).*
  - However, the boards concluded that all business combinations are economically similar. Accordingly, specifying the same method to account for all combinations enhances the comparability of the resulting financial reporting information (see paragraph BC39 of the Basis for Conclusions on IFRS 3).
  - Nevertheless, in the first part of their respective business combinations projects, both the IASB and the FASB acknowledged that a case could be made for using the fresh-start method to account for the relatively rare type of business combination that does not clearly qualify as an acquisition (see paragraph BC56 of the Basis for Conclusions on IFRS 3).

* Note: this conclusion was drawn within the context of 'true mergers' or 'mergers of equals' of parties that are independent of one another. In drawing their conclusions documented in paragraphs BC29–BC57 of the Basis for Conclusions on IFRS 3, the boards did not consider mergers of entities that are under common control.

Determining accounting policy for BCUCC
Summary of discussion

- Discussants' consensus view = in an exchange transaction **acquisition accounting** (as set out in IFRS 3) likely provides the most relevant information. This is particularly relevant from the perspective of the receiving company non-controlling interests.
- However, in some circumstances **fresh-start accounting** could provide more relevant information. For example, in those BCUCC in the Ethiopian SOE sector when the affected SOEs are all wholly-owned by the Ethiopian Governments and there is no discernible purchase consideration paid/received in the BCUCC.
  - Fresh-start accounting would also provide current values of Receiving company's pre-existing assets, liabilities and contingent liabilities.
  - However, some argue that one-time updating of all historical cost data to fair value would obscure trends in the historical financial information and that they might observe that fresh-start accounting is not required for business combinations that are within the scope of IFRS 3.

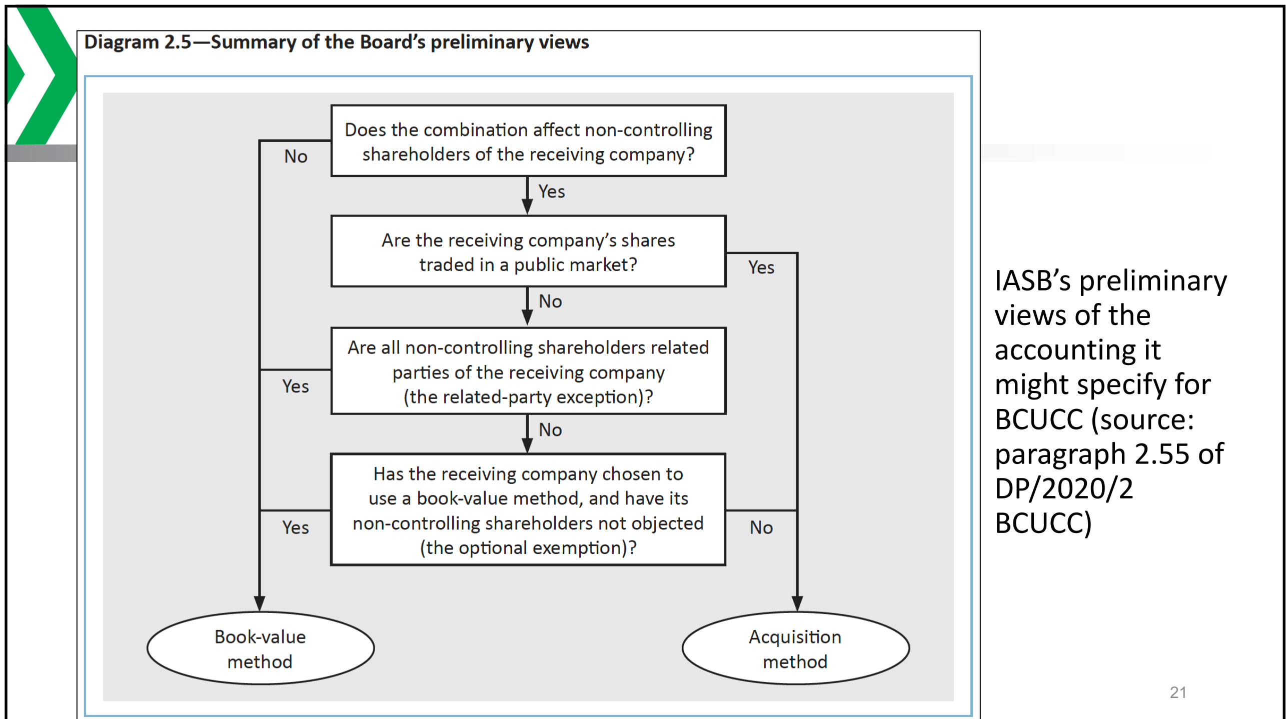
Determining accounting policy for BCUCC
Summary of discussion

- Discussants' consensus view = it is difficult to see how a **book value method** could provide information about the exchange transaction that is relevant to, for example, the NCI in Receiving company. Moreover, because book value methods record the net assets acquired at their pre-existing carrying amounts (rather than their acquisition-date fair values), the information that book value methods provide about the cash-generating abilities of those net assets is less useful than the information provided by the acquisition method (and fresh-start accounting).
  - Support for that conclusion can be found in paragraph BC37 of the Basis for Conclusions to IFRS 3. Both boards also concluded that the information provided by the pooling of interests method is less relevant because it has less predictive value and feedback value than the information that is provided by other methods.
  - It is also less complete, because it does not reflect assets acquired or liabilities assumed that were not included in the pre-combination financial statements of the combining entities (in this case, goodwill and contingent liabilities).
  - The pooling of interests method also provides a less faithful representation of the combined entity's performance in periods after the combination. For example, by recording assets and liabilities at the carrying amounts of predecessor entities, post-combination revenues may be overstated (and expenses may be understated) as the result of embedded gains that were generated by predecessor entities but that were not recognised by them (see paragraph BC38 of the Basis for Conclusions on IFRS 3).
  - Moreover, because the pooling method records the combination in terms of the pre-combination carrying amounts of the parties to the transaction, it fails to record, and thus to hold management accountable for, the investment made in the combination (see paragraph BC41 of the Basis for Conclusions on IFRS 3).

Determining accounting policy for BCUCC
Summary of discussion

If Receiving company was wholly owned by Controlling company, would your view of the book value method be different?

- Discussants' consensus view = No. However, without NCI application of the cost constraint might well justify the IASB specifying different accounting.
  - The IASB believes, see DP/2020/2, acquisition accounting:
    - is cost-beneficial when the receiving company has NCI; and
    - is less likely to be cost-beneficial when the receiving company with NCI is a private company.



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Issue 2: accounting for a BCUCC

Accounting for BCUCC
What do you think?

Because IFRS Accounting Standards do not explicitly specify accounting for BCUCC, uncertainty exists in Ethiopia about how to apply the accounting policy entities determined (by applying the IAS 8 hierarchy) for BCUCC.

How to apply an accounting policy determined for BCUCC?

Accounting for BCUCC
Summary of discussion

How to apply an accounting policy determined for BCUCC?

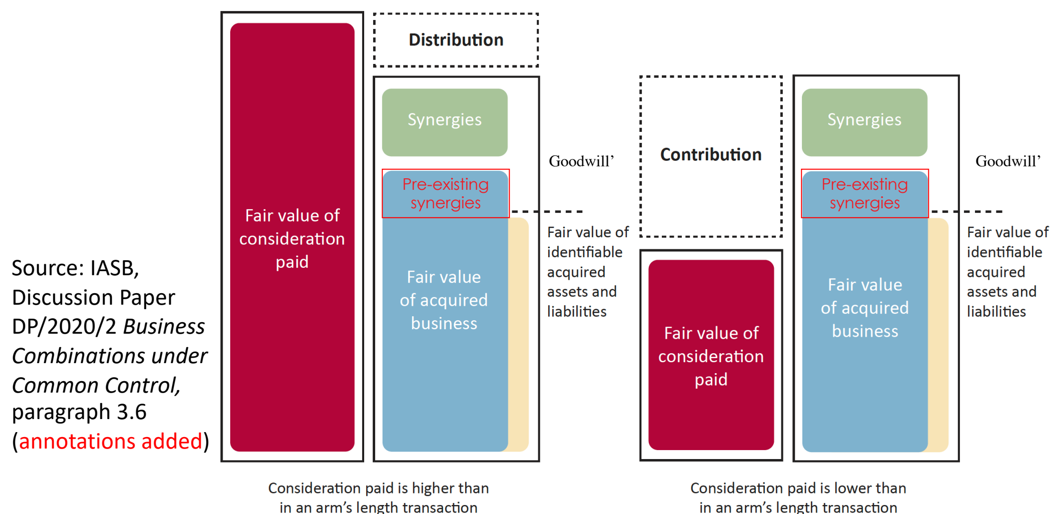
Discussants' consensus view = applying the accounting policy determined (using the IAS 8 hierarchy) for BCUCC requires judgement. Different judgements are needed for applying different methods of accounting for BCUCC.

The slides that follow, illustrate the mechanics of different methods of accounting for BCUCC. (Note only one of the many variants of the book value methods is illustrated.)

First, recall the IASB's diagrammatic representation of the economics of a BCUCC exchange transaction, viewed from the receiving entity's perspective

Diagram 3.2—Distribution from equity or contribution to equity

Source: IASB, Discussion Paper DP/2020/2 *Business Combinations under Common Control,* paragraph 3.6 (annotations added)



Economics of a BCUCC from Receiving Company's perspective when the exchange transaction priced at the market; 25% NCI; and $50 transaction costs. *Summary of discussion.*

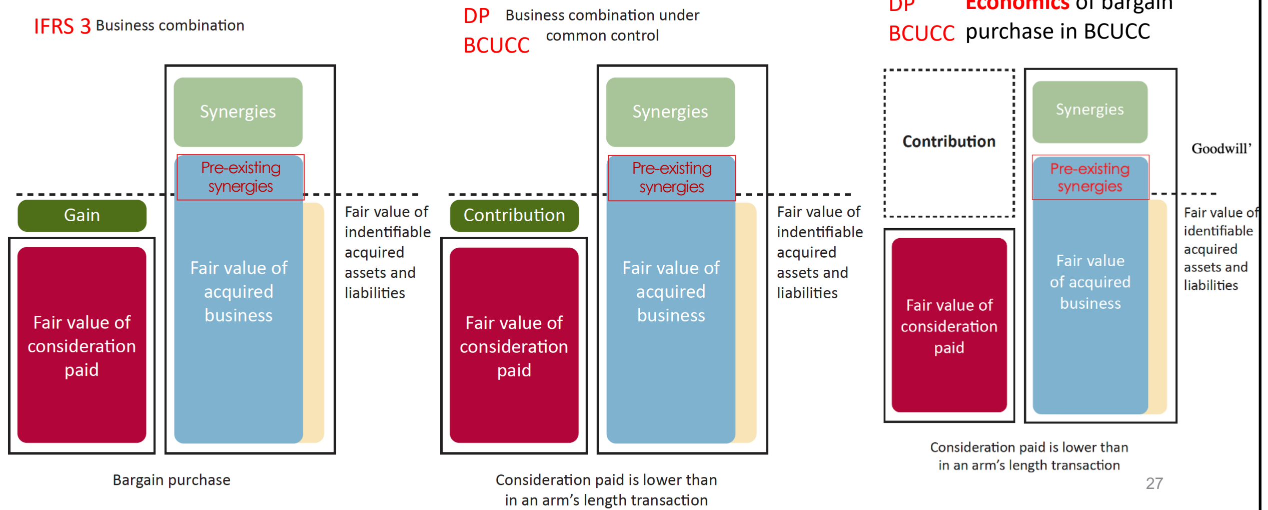
Date	Assets	Liabilities	Equity	Income	Expense
Before BCUCC	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)		
BCUCC	↑$400 identifiable ↑$100 unidentifiable (goodwill) **↓$500 cash**	↑$50 for transaction costs	↓$50 (via profit or loss)		↑$50 transaction costs
After BCUCC	**$1,100**	**$150**	**$950** (including $237.5 NCI)		

Note: the transaction costs erode NCI by $12.5.

Contrasting the acquisition method specified in IFRS 3, the IASB's preliminary BCUCC acquisition method, and the economics in an underpayment scenario

source: paragraphs 3.6 and 3.19 of DP/2020/2 BCUCC

Diagram 3.3—Measuring a bargain purchase gain and a contribution to equity



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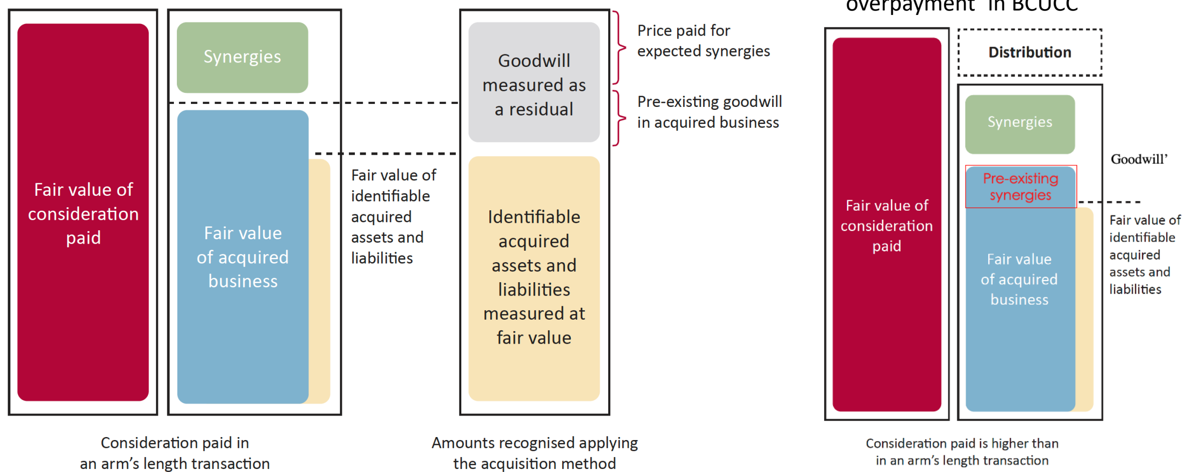
Contrasting the acquisition method specified in IFRS 3, the IASB's preliminary BCUCC acquisition method, and the economics in an 'overpayment' scenario

source: paragraphs 3.5, 3.6 and 3.14 of DP/2020/2 BCUCC

IFRS 3 and IASB's tentative view of **ACCOUNTING** for BCUCC

Diagram 3.1—Key features of the acquisition method



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Acquisition method accounting for a BCUCC from the Receiving Company's perspective
Consider three scenarios

Pre-acquisition carrying amount of Transferred company's assets = $100. Transactions costs = $50. Receiving company is 75% owned by controlling party (ie 25% NCI).

- **Scenario A: Economics: $500 cash** exchanged for $400 identifiable assets and $100 unidentifiable assets (synergies).
- **Scenario B: $300 cash** exchanged for $400 identifiable assets and $100 unidentifiable assets (synergies).
- **Scenario C: $700 cash** exchanged for $400 identifiable assets and $100 unidentifiable assets (synergies).

Using the elements of financial position and the elements of financial performance describe separately for each of Scenarios A–C the accounting for the exchange transaction on 01/01/2022 using the acquisition method by analogy to IFRS 3 *Business Combinations* from Receiving company's consolidated financial statements perspective.

Acquisition method accounting for a BCUCC from the Receiving Company's perspective: Scenario A at the market (25% NCI)
Summary of discussion

Date	Assets	Liabilities	Equity	Income	Expense
Before BCUCC	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)		
BCUCC	↑$400 identifiable ↑$100 unidentifiable (goodwill) **↓$500 cash**	↑$50 for transaction costs	↓$50 (via profit or loss)		↑$50 transaction costs
After BCUCC	**$1,100**	**$150**	**$950** (including $237.5 NCI)		

Note: the accounting for the BCUCC is consistent with the economics (see slide above).

Acquisition method accounting for a BCUCC from the Receiving Company's perspective: Scenario B at $200 discount to the market *Summary of discussion*

Date	Assets	Liabilities	Equity	Income	Expense
Before BCUCC	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)		
BCUCC	↑$400 identifiable **↓$300 cash**	↑$50 for transaction costs	↑$100 contribution from owners ↓$50 (via profit or loss)		↑$50 transaction costs
After BCUCC	**$1,200**	**$150**	**$1,050** (including $262.5 NCI)		

Note: inconsistently with the economics (see slide above), the $100 goodwill asset is omitted from the accounting, and

- consequently the contribution from the controlling owner is understated by $100 resulting in the economic wealth
- 'transfer' from the controlling owner to the NCI being understated by $25 in the accounting.

Acquisition method accounting for a BCUCC from the Receiving Company's perspective: Scenario C at $200 premium to the market *summary of class discussion*

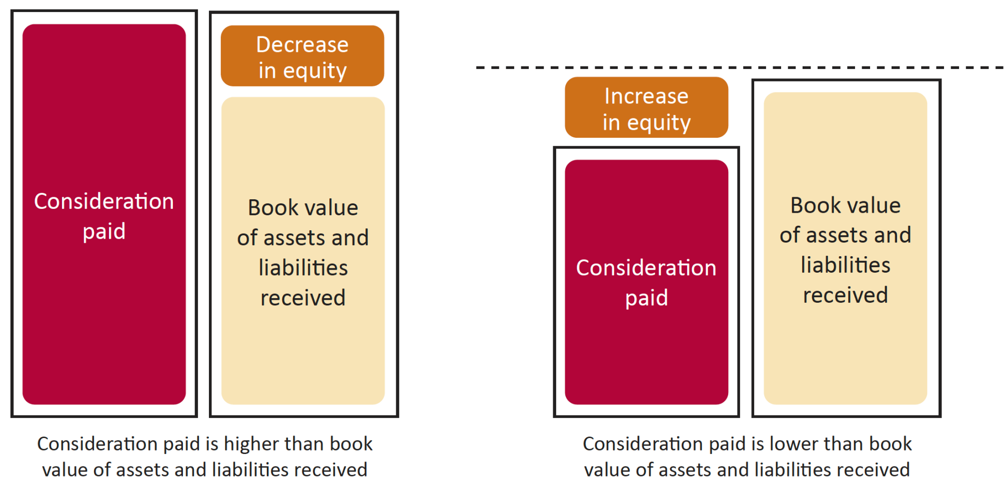
Date	Assets	Liabilities	Equity	Income	Expense
Before BCUCC	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)		
BCUCC	↑$400 identifiable ↑$300 unidentifiable (goodwill) **↓$700 cash**	↑$50 for transaction costs	↓$50 (via profit or loss)		↑$50 transaction costs
After BCUCC	**$1,100**	**$150**	**$950** (including $237.5 NCI)		

Note: inconsistently with the economics (see slide above), the goodwill asset is potentially overstated by $200 in the accounting

- and consequently the $200 economic distribution to the controlling owner is omitted from the accounting and
- resulting in the economic wealth transfer from the NCI to the controlling owner being understated by $50 in the accounting.

IASB's preliminary view of accounting for a BCUCC using a book-value method

Source: IASB, Discussion Paper DP/2020/2 Business Combinations under Common Control, paragraph 4.24



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A book value method of accounting for a BCUCC from the Receiving Company's perspective

Consider three scenarios

Pre-acquisition carrying amount of Transferred company's assets = $100. Transactions costs = $50. Receiving company is 75% owned by controlling party (ie 25% NCI).

- » **Scenario A: Economics: $500 cash** exchanged for $400 identifiable assets and $100 unidentifiable assets (synergies).
- » **Scenario B: $300 cash** exchanged for $400 identifiable assets and $100 unidentifiable assets (synergies).
- » **Scenario C: $700 cash** exchanged for $400 identifiable assets and $100 unidentifiable assets (synergies).

Using the elements of financial position and the elements of financial performance describe separately for each of Scenarios A–C the accounting for the exchange transaction on 01/01/2022 using the **book-value method** from Receiving company's consolidated financial statements perspective.

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A book value method of accounting for a BCUCC from the Receiving Company's perspective: Scenario A, priced at the market

Summary of discussion

Date	Assets	Liabilities	Equity	Income	Expense
Before BCUCC	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)		
BCUCC	↑$100 identifiable assets **↓$500 cash**	↑$50 for transaction costs	↓$400 BCUCC ↓$50 (via profit or loss)		↑$50 transaction costs
After BCUCC	**$700**	**$150**	**$550** (including $137.5 NCI)		

Note: inconsistently with the economics (see above), the accounting:

- omits the $100 goodwill asset and understates the identifiable assets acquired by $300; and consequently
- presents $450 erosion of accounting total equity when the economic erosion of equity is only $50 transaction costs; and
- presents $112.5 erosion of NCI's accounting equity when the economic erosion of NCI's equity is only $12.5 (ie 25% of $50 transaction costs incurred).

A book value method of accounting for a BCUCC from the Receiving Company's perspective: Scenario B, at $200 discount to the market

Summary of discussion

Date	Assets	Liabilities	Equity	Income	Expense
Before BCUCC	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)		
BCUCC	↑$100 identifiable **↓$300 cash**	↑$50 for transaction costs	↓$200 BCUCC ↓$50 (via profit or loss)		↑$50 transaction costs
After BCUCC	**$900**	**$150**	**$750** (including $187.5 NCI)		

Note: inconsistently with the economics (see slide above), the $100 goodwill asset and $300 identifiable assets are omitted from the accounting, and consequently:

- presents $250 erosion of accounting total equity when total economic equity increased by $150 (ie $200 contribution from Controlling party (P) less $50 transaction costs); and
- presents $62.5 erosion of NCI's accounting equity when the NCI's economic equity increased by $37.5 (ie $50 contribution from Controlling party (P) less $12.5 transaction costs).

A book value method of accounting for a BCUCC from the Receiving Company's perspective: Scenario C, at $200 premium to the market
Summary of discussion

Date	Assets	Liabilities	Equity	Income	Expense
Before BCUCC	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)		
BCUCC	↑$100 identifiable **↓$700 cash**	↑$50 for transaction costs	↓$600 BCUCC ↓$50 (via profit or loss)		↑$50 transaction costs
After BCUCC	**$500**	**$150**	**$350** (including $87.5 NCI)		

Note: inconsistently with the economics (see slide above), the $100 goodwill asset and $300 identifiable assets are omitted from the accounting, and consequently:

- presents $650 erosion of accounting total equity when total economic equity was eroded by $250 (ie $200 distribution to Controlling party (P) + $50 transaction costs); and
- presents $162.5 erosion of NCI's accounting equity when the NCI's economic equity was eroded by only $62.5 (ie $50 distribution to Controlling party (P) + $12.5 transaction costs).

Fresh start accounting for a BCUCC from the Receiving Company's perspective
Consider three scenarios

Transactions costs = $50. Receiving company is 75% owned by controlling party (ie 25% NCI).

Pre-acquisition assets, liabilities and equity:

» **Receiving company:** (see next slide)

» **Transferred company:** carrying amount = $100 assets/equity.

BCUCC transactions costs = $50.

» **Scenario A: Economics: $500 cash** exchanged for $400 identifiable assets and $100 unidentifiable assets (synergies).

» **Scenario B: $300 cash** exchanged for $400 identifiable assets and $100 unidentifiable assets (synergies).

» **Scenario C: $700 cash** exchanged for $400 identifiable assets and $100 unidentifiable assets (synergies).

Using the elements of financial position and the elements of financial performance:

- describe the economics of the BCUCC; and
- describe separately for each of Scenarios A–C the accounting for the BCUCC on 01/01/2022 using the **fresh-start method**.

Economics of a BCUCC from Receiving Company's perspective Scenario A, at the market

Summary of discussion

Date	Assets	Liabilities	Equity	Income	Expense
Receiving company before BCUCC (fair values)	**$2,000** (including $700 cash)	**$200**	**$1,800** (including $450 NCI)		
BCUCC	↑$400 identifiable ↑$100 unidentifiable (goodwill) **↓$500 cash**	↑$50 for transaction costs	↓$50 (via profit or loss)		↑$50 transaction costs
After BCUCC (fair values)	**$2,000**	**$250**	**$1,750** (including $437.5 NCI)		

Note: the transaction costs erode NCI by $12.5.

Fresh-start method accounting for a BCUCC from Receiving Company's perspective: Scenario A: at the market $500

Summary of discussion

Date	Assets	Liabilities	Equity	Note: fair value
Receiving company before BCUCC (book values)	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)	$2,000 assets $200 liabilities $450 NCI
Transferred company (book values)	**$100** (no cash)		**$100**	$400 identifiable
BCUCC	$100 goodwill	$50 transaction costs		$100 assets $50 liability
After BCUCC: fresh-start (fair values)	**$2,000** (including $100 goodwill)	**$250** (including $50 transactions costs accrual)	**$1,750** (including $437.5 NCI)	$2,000 assets $250 liabilities $437.5 NCI

Note: $50 transaction costs incurred erodes the fair value of NCI by $12.5.

Fresh-start method accounting for a BCUCC from Receiving Company's perspective: Scenario B, at $200 discount to the market *Summary of discussion*

Date	Assets	Liabilities	Equity	Note: fair value
Receiving company before BCUCC (book values)	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)	$2,000 assets $200 liabilities $450 NCI
Transferred company (book values)	**$100** (no cash)		**$100**	$400 identifiable
BCUCC	$100 goodwill	$50 transaction costs		$100 assets $50 liability
After BCUCC: fresh-start (fair values)	**$2,200** (including $100 goodwill)	**$250**	**$1,950** (including $487.5 NCI)	$2,200 assets $250 liabilities $487.5 NCI

Notes:
- $50 transaction costs incurred erodes the fair value of NCI by $12.5; and
- $200 economic contribution from Controlling party (P) adds $50 to the fair value of NCI.

Fresh-start method accounting for a BCUCC from Receiving Company's perspective: Scenario C, at $200 premium to the market *Summary of discussion*

Date	Assets	Liabilities	Equity	Note: fair value
Receiving company before BCUCC (book values)	**$1,100** (including $700 cash)	**$100**	**$1,000** (including $250 NCI)	$2,000 assets $200 liabilities $450 NCI
Transferred company (book values)	**$100** (no cash)		**$100**	$400 identifiable
BCUCC	$100 goodwill	$50 transaction costs		$100 assets $50 liability
After BCUCC: fresh-start (fair values)	**$1,800** (all identifiable assets)	**$250**	**$1,550** (including $387.5 NCI)	$1,800 assets $250 liabilities $387.5 NCI

Notes:
- $50 transaction costs incurred erodes the fair value of NCI by $12.5; and
- $200 economic distribution to the Controlling party (P) erodes the fair value of NCI by $50.

What judgements must management make in applying its accounting policy for BCUCC?

Summary of discussion

- If book value method
  - No incremental judgements as carrying over extant carrying amounts
- If acquisition accounting
  - Measuring the fair values of Transferred Company's assets, liabilities and contingent liabilities
- If fresh-start accounting
  - Measuring the fair value of Transferred Company's assets, liabilities and contingent liabilities
  - Measuring the fair value of Receiving Company's assets, liabilities and contingent liabilities

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