Possible alternatives for updating IFRS 3 reference to the Conceptual Framework

Issues Paper

Objective

1 The objective of this session is to seek the view of EFRAG TEG on whether, and if so how, updating a reference in IFRS 3 *Business Combinations* from a previous version of the IASB's Conceptual Framework to the revised Conceptual Framework should be done. The view of EFRAG TEG will be reflected in the EFRAG Secretariat's outlined draft comment letter in response to a forthcoming IASB exposure draft on the issue. EFRAG TEG will consider the draft comment letter when the IASB's exposure draft has been issued. The exposure draft is expected in Q2 of 2019.

Background and issues

2 IFRS 3 *Business Combinations* states in paragraph 11:

> To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the *Framework for the Preparation and Presentation of Financial Statements* at the acquisition date.

3 When issuing the revised *Conceptual Framework for Financial Reporting* in March 2018, the IASB updated many of the references to the Conceptual Framework in IFRS Standards to the revised Conceptual Framework. However, the reference to 'Framework for Preparation and Presentation of Financial Statements' in paragraph 11 of IFRS 3 was not updated as the IASB was concerned this could result in unintended consequences.

4 In previous versions of the Conceptual Framework, an asset was defined as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity". A liability was defined as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits".

5 The revised Conceptual Framework (for Financial Reporting) defines an asset as "a present economic resource controlled by the entity as a result of past events". An economic resource is defined as "a right that has the potential to produce economic benefits". A liability is defined as "a present obligation of the entity to transfer an economic resource as a result of past events". In the supporting guidance it is mentioned that the obligation must have the potential to require the entity to transfer an economic resource to another party (or parties).

6 Based on its own analyses and consultation with ASAF members and auditors, the IASB has concluded that updating the IFRS 3 reference to the revised Conceptual Framework would not create significant unintended consequences. The IASB has, however, identified the following two potential issues that could result from updating the reference:

(a) The new definition of a liability would in some cases result in levies being recognised earlier than under IFRIC 21 *Levies*. Accordingly, an entity might have to recognise a liability in relation to a levy in a business combination, but would have to derecognise this on day 2 as the levy cannot be recognised according to IFRIC 21. The IASB staff has illustrated this in an example which is included in the Appendix of this paper.

(b) According to the new definition, an asset should have 'the potential' to produce economic benefits. Following paragraph 67 of IAS 16 *Property, Plant and Equipment,* the carrying amount of an item of property, plant and equipment shall be derecognised when no future economic benefits are 'expected' from its use or disposal. Different interpretations of 'expected' exists. If 'expected' is interpreted to mean a higher probability-threshold than 'has the potential to', then a piece of property, plant or equipment could be recognised in a business combination but would have to be derecognised on day 2 – if it would not be 'expected' to result in future cash flows flowing to the entity. This issue did not exist under the previous definition of an asset as it also required that future economic benefits should be 'expected' to flow to the entity from an asset. Accordingly, a piece of property, plant and equipment could only be recognised in a business combination if it was 'expected' that future economic benefits would flow to the entity.

IASB proposed solution

7 The IASB considered that the issue mentioned in paragraph 6(b) above would arise infrequently in practice. It would normally be expected that any property, plant or equipment assigned a significant fair value on acquisition would produce future economic benefits in one way or another.

8 The IASB has accordingly focused on how the issue mentioned in paragraph 6(a) could be addressed. The IASB has, tentatively, decided to:

(a) Update the reference in IFRS 3 so that it refers to the revised Conceptual Framework.

(b) Specify in IFRS 3 that levies within the scope of IFRIC 21 and other obligations within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* should be recognised on the acquisition of a business only if they would be identified as present obligations by an entity applying IFRIC 21 or IAS 37.

9 In addition, the IASB has tentatively decided to clarify that in applying the IFRS 3 recognition principle, an acquirer does not recognise contingent assets.

10 Entities would be required to apply the amendments noted above to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after a date to be decided at the completion of the due process. Earlier application is permitted even without disclosing this.

11 If the exposure draft results in amendments that are issued before 1 January 2020, entities will be permitted to apply them for annual reporting periods beginning before 1 January 2020 if at the same time they also apply all the amendments made by Amendments to References to the Conceptual Framework in IFRS Standards.

Alternative solutions

12 At the September 2018 EFRAG CFSS meeting, the following alternatives were considered to deal with the issue described above in paragraph 6(a):

(a) Update IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (and IFRIC 21) to align the IAS 37 definition of a liability and IAS 37 requirements for identifying liabilities with the liability definition and supporting concepts in the revised Conceptual Framework. Updating the IFRS 3 reference to the revised Conceptual Framework would then not create any conflicts.

(b) Add requirements to IFRS 3 for subsequent recognition and measurement of liabilities within the scope of IAS 37 or IFRIC 21, so that the liabilities recognised on acquisition applying the revised Conceptual Framework would not be derecognised on day 2. Such a requirement could be similar to those already in IFRS 3 for contingent liabilities within the scope of IAS 37.

(c) Include an exception in IFRS 3 to the requirement to apply the definitions in the revised Conceptual Framework to identify the assets and liabilities recognised on the acquisition of a business. The exception should apply to all assets and liabilities that are specifically addressed by another IFRS Standard.

13 At the September 2018 meeting, EFRAG CFSS and EFRAG TEG members expressed different preferences on the alternative solutions.

14 In Agenda Paper 10 for the November 2018 IASB meeting, the IASB staff identified some benefits and disadvantages of each approach in support for its recommendation for the approach described in paragraph 8 above.

15 Against the solution mentioned in paragraph 12(a), the IASB staff mentioned that it is uncertain whether the IASB will eventually amend IAS 37 to make it compatible with the revised Conceptual Framework. Even if IAS 37 is amended, it would take some time and during that time the IASB would not be able to withdraw the 1989 Framework. Accordingly, there would have to be two Conceptual Frameworks in issue (for some time). This would be confusing.

16 The IASB staff identified the following issues with the approach mentioned in paragraph 12(b) above:

(a) Acquirers would need to apply the new liability definition and supporting concepts in the revised Conceptual Framework before other entities, and without having any standards-level requirements and guidance on how to apply those concepts. This could result in:

(i) Diversity in practice.

(ii) Possible future differences to any amendments to IAS 37, which could result in a second round of changes to IFRS 3.

(b) Changing the requirements for identifying liabilities in two steps (first for acquired liabilities and later for liabilities incurred in other ways) could increase complexity for preparers and users of financial statements. Between the first and second set of changes, preparers would have to develop different accounting policies for liabilities acquired on the acquisition of a business and liabilities incurred in other ways. Users would incur costs in analysing and interpreting the differences.

(c) Developing requirements to add to IFRS 3 could take time and investment by the IASB (developing and consulting on proposals) and its stakeholders (understanding and commenting on proposals). Requirements would be needed for the subsequent recognition and measurement of levies within the scope of IFRIC 21 and other liabilities within the scope of IAS 37. There may also be calls for further requirements to help entities apply the new liability definition and supporting concepts consistently.

17 As a result of the costs and risks described above in paragraph **Error! Reference source not found.**, the IASB staff did not recommend the approach outlined in paragraph 12(b).

18 The IASB staff did also not recommend the approach outlined in paragraph 12(c). It noted that the benefits of the approach would be that:

(a) It would be similar to the approach preparers of financial statements follow in some other circumstances when applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

(b) It could help avoid other as-yet-unidentified conflicts caused by updating the IFRS 3 reference to the revised Conceptual Framework, if there are any.

19 However, the IASB staff assessed that requiring acquirers to apply the revised Conceptual Framework's definitions only for assets and liabilities that are not within the scope of another Standard could have unintended consequences. To avoid those consequences, more research would be needed to identify whether and how such an exception could affect IFRS 3 requirements.

20 The arguments of the IASB staff to recommend the method described in paragraph 8 above were:

(a) It would allow the IASB to meet its stated aim of updating references to the Conceptual Framework without changing the requirements of existing Standards;

(b) It would largely avoid the costs and risks identified for the approach described in paragraph 12(b) above - it would be less vulnerable to diversity in practice and simpler to develop and apply; and

(c) The exception should be relatively easy to remove if and when the requirements of IAS 37 and IFRIC 21 become aligned with the definitions and concepts in the revised Conceptual Framework.

EFRAG Secretariat assessment and recommendation

21 The EFRAG Secretariat recommends EFRAG TEG to assess whether the aim of the project of updating the reference in IFRS to the revised Conceptual Framework should be to:

(a) Change the reference in IFRS 3 to the revised Conceptual Framework without introducing any changes; or

(b) Provide more useful information in the financial statements.

22 If EFRAG TEG is of view (a), the EFRAG Secretariat recommends EFRAG TEG to support the IASB's tentative decision reflected in paragraph 8 above. If EFRAG TEG is of view (b), the EFRAG Secretariat recommends EFRAG TEG to suggest the IASB to follow the approach described in paragraph 12(b) and to clarify the guidance on the definition of a liability in the revised Conceptual Framework.

23 The assessment of the EFRAG Secretariat is explained in the following paragraphs.

24 If the aim of the project is simply to change the reference in IFRS 3 to the revised Conceptual Framework without introducing any changes, the EFRAG Secretariat assesses that the approach tentatively proposed by the IASB (see paragraph 8) would be the best alternative. The other alternatives could or would result in changes in accounting practice.

25 EFRAG has previously considered that IFRIC 21, interpreting IAS 37, results in certain liabilities being recognised too late (see paragraphs 27 and 28 below). The consequence of choosing the approach proposed by the IASB is that this issue will not be addressed until, and if, the IASB amends IAS 37.

26 Therefore, if the change should result in more useful information being reflected in financial statements, the approach tentatively proposed by the IASB would not be the best alternative.

27 When revising the Conceptual Framework, the IASB specifically stated that the interpretation of IAS 37 included in IFRIC 21 results in excluding "information that many users of financial statements would find useful" (paragraph BC4.52 of the revised Conceptual Framework).

28 IFRIC 21 states that a present obligation to transfer an economic resource has only arisen when an entity does not have the ability to avoid the future transfer. When the IASB revised the Conceptual Framework, it thought it would result in more useful information to consider that a present obligation to transfer an economic resource has arisen when an entity has no practical ability to avoid the future transfer. EFRAG supported this view.

29 Only the alternatives mentioned in paragraphs 12(a) and 12(b) above would result in obligations within the scope of IAS 37 or IFRIC 21 being recognised when the entity has no practical ability to avoid the future transfer. The solution mentioned in paragraph 12(a) would introduce the improvement for the relevant liabilities no matter how they have arisen. The solution mentioned in paragraph 12(b) would only introduce the improvement for the relevant liabilities that are transferred to an entity as part of a business combination.

30 The solution mentioned in paragraph 12(a) would therefore in theory result in the most useful information. However, as concluded by the IASB staff (see paragraph 15 above):

(a) The approach might take some time to introduce and during that time, the reference to the 1989 Framework would remain. There would therefore be two Conceptual Frameworks in issue. This would be confusing.

(b) Although the approach might commit the IASB to consider amending IAS 37, it could decide not to do so.

In practice, the difference between the solutions mentioned in paragraph 12(a) and paragraph 8 would therefore be whether or not the reference in IFRS 3 should be updated to the revised Conceptual Framework or not while the IASB considers whether to amend IAS 37.

31 The EFRAG Secretariat assesses that it would be most reader friendly to update the reference in accordance with the IASB's tentative suggestion mentioned in paragraph 8 than to keep the reference to a previous version of the Conceptual Framework while it is considered whether to amend IAS 37. An additional argument for updating the reference is it would be most reader friendly in the long run if the IASB would decide not to amend IAS 37. The EFRAG Secretariat accordingly assesses that the approach outlined in paragraph 12(a) would not be preferable to the solution suggested in paragraph 8 even if the purpose of updating the reference would be to provide more useful information.

32 Instead, the EFRAG Secretariat would recommend the solution outlined in paragraph 12(b) although it would only result in more useful information for liabilities acquired in a business combination. In that regard, the EFRAG Secretariat has the following comments to the concerns expressed by the IASB staff listed above in paragraph 16:

(a) The EFRAG Secretariat shares the concern of the IASB staff that applying the new liability definition and supporting concepts could result in diversity in practice. At the September 2018 EFRAG CFSS meeting, the following example was considered:

> A government charges a levy on entities as soon as they generate revenue in 20X1. The amount each entity pays is calculated by reference to the revenue the entity generated in 20X0. The levy is within the scope of IFRIC 21.
>
> An entity's reporting period ends on 31 December 20X0. The entity generated revenue in 20X0, and in 20X1 it starts to generate revenue on 3 January 20X1.

As further explained in the Appendix, the IASB staff assesses that the guidance in the revised Conceptual Framework would result in an entity recognising a liability as the entity generates revenue in 20X0.

However, an EFRAG TEG member did not reach the same conclusion. In the view of that EFRAG TEG member, the entity had not obtained economic benefits or taken an action until 1 January or 3 January 20X1. The entity would accordingly not recognise a liability on 31 December 20X0 for the levy.

The EFRAG Secretariat considers that it is unfortunate that the definition of a liability and the supporting guidance is (already) interpreted differently on something the revised Conceptual Framework intended to improve. However, in its view, this should not be used as an argument for not using the guidance. It should be used as an argument for clarifying the guidance. In the past different interpretations of the Conceptual Framework have resulted in time-consuming discussions (e.g. on prudence and what 'reliability', 'faithful representation', 'expected' and 'probable' mean). This should, as far as possible, be avoided in the future. Updating the reference in IFRS 3 would be a good opportunity to also clarify the supporting guidance related to the definition of a liability in the revised Conceptual Framework.

(b) Similarly, the EFRAG Secretariat is of the view that if amendments following from the IASB's project *Provisions* would result in requirements that would not be compatible with the definition of a liability and the related guidance included in the revised Conceptual Framework, the IASB would need to amend the Conceptual Framework. As it appears from paragraphs 27 and 28 above, the IASB had a particular outcome in mind for liabilities within the scope of IAS 37 when revising the Conceptual Framework. Should the IASB, when/if amending IAS 37, change its mind on this issue, it would be useful to have this reflected in the Conceptual Framework. Having a Conceptual Framework reflecting a view on particular liabilities that would differ from the requirements in the Standard concerning those particular liabilities would not be useful.

(c) The EFRAG Secretariat assesses that if:

(i) (a) and (b) above would be followed; and

(ii) IFRS 3 would be updated to explain that liabilities within the scope of IAS 37 should be recognise as long as they would meet the definition of a liability and measured in accordance with IAS 37;

there would not seem to be any apparent risk that a second round of changes to IFRS 3 would be needed.

(d) Changing the requirements for identifying liabilities in two steps (first for acquired liabilities and later for liabilities incurred in other ways) would mean that preparers between the first and second set of changes would have to develop different accounting policies for liabilities acquired on the acquisition of a business and liabilities incurred in other ways. The EFRAG Secretariat, however, does not consider that developing the accounting policies would be particularly costly. On the other hand, cost will be related with having to record and account for (processing) the liabilities differently. Nevertheless, if financial statements are currently excluding information about obligations that many users of financial statements would find useful (see paragraph 27 above), the EFRAG Secretariat assesses that the benefits of providing the information will outweigh these costs.

(e) As mentioned in paragraph 16 above, the IASB staff is concerned that users would incur costs in analysing and interpreting the difference between liabilities acquired on the acquisition of a business and liabilities incurred in other ways. The EFRAG Secretariat would assess that the benefits of receiving information about some liabilities (users would otherwise not receive information about) would outweigh these costs.

(f) The IASB staff is probably correct when it states that there may be calls for further requirements to help entities apply the new liability definition and supporting concepts consistently. As mentioned under (a) above, the EFRAG Secretariat, however, does not consider this to be a problem but an opportunity for the IASB to clarify the guidance. Unclear guidance could result in time-consuming issues in the future.

(g) It is also correct that developing requirements to add to IFRS 3 could take time and investment by the IASB (developing and consulting on proposals) and its stakeholders (understanding and commenting on proposals). However, such efforts would also be needed for the solution tentatively suggested by the IASB (see paragraph 8).

Questions for EFRAG TEG

33 Does EFRAG TEG consider that the purpose of updating the reference to the Conceptual Framework in IFRS 3 should be to (see paragraph 21):

(a) Change the reference in IFRS 3 to the revised Conceptual Framework in a manner that would not result in any changes. Changes could be introduced at a later stage if/when IAS 37 is amended; or

(b) Change the reference in IFRS 3 to the revised Conceptual Framework in a manner that would result in more useful information in the financial statements about certain liabilities acquired in a business combination?

34 Does EFRAG TEG agree with the assessment of the EFRAG Secretariat summarised in paragraph 22, that is:

(a) If EFRAG TEG is of view (a) (in paragraph 33), it supports the IASB's tentative decision reflected in paragraph 8 above.

(b) If EFRAG TEG is of view (b), it supports the approach described in paragraph 12(b)?

If not, which approach does EFRAG TEG support?

35 Does EFRAG TEG consider that the IASB should clarify the guidance related to the definition of a liability as part of the project (see paragraph 32(a) above)?

36 Does EFRAG TEG have other comments it considers should be reflected in EFRAG's draft comment letter in response to the forthcoming exposure draft?

Appendix

Example illustrating a possible consequence of updating the IFRS 3 Business Combinations reference to the Conceptual Framework

(Example is copied from Agenda Paper 10 for the November 2018 IASB meeting)

Example—Levy triggered when entity generates revenue in two years

37 A government charges a levy on entities as soon as they generate revenue in 20X1. The amount each entity pays is calculated by reference to the revenue the entity generated in 20X0. The levy is within the scope of IFRIC 21 Levies.

38 An entity's reporting period ends on 31 December 20X0. The entity generated revenue in 20X0, and in 20X1 it starts to generate revenue on 3 January 20X1.

39 The entity is acquired by another entity (the acquirer) on 30 June 20X0.

Applying the 2018 Conceptual Framework

40 Applying the concepts in the 2018 Conceptual Framework, the liability to pay the levy would be viewed as arising when the entity:

(a) has obtained economic benefits or taken an action;

(b) as a consequence, will or may have to pay a levy that it would not otherwise have had to pay; and

(c) has no practical ability to avoid the activity that triggers the levy.

41 Conditions (a) and (b) are satisfied progressively through 20X0 as the entity generates revenue in 20X0. If during that time the entity has no practical ability to avoid generating revenue in 20X1, condition (c) is also satisfied. The liability would be viewed as accumulating as the entity generates revenue in 20X0.

IFRIC 21

42 IFRIC 21 states that the event that gives rise to a liability to pay the levy is the event that triggers the payment of the levy, which in this example is the generation of revenue in 20X1. The generation of revenue in 20X0 is a necessary condition for the existence of a liability. But it is not a sufficient condition, even if the entity has no practical ability to avoid generating revenue in 20X1. Applying IFRIC 21, the entity would not recognise a liability in the reporting period ending on 31 December 20X0. It would first recognise a liability on 3 January 20X1.

Acquisition and subsequent accounting

43 The entity is acquired on 30 June 20X0. If the acquirer were to apply IFRS 3 using the definitions in the 2018 Conceptual Framework, it might recognise on acquisition a liability for the amount of levy attributable to revenue earned up to 30 June 20X0. However, at 31 December 20X0, it would apply IFRIC 21 and recognise no liability. Derecognition of the liability recognised on acquisition would result in recognition of a 'day 2' gain.