IASB Meeting | Agenda reference | 8B
Staff Paper | Date | September 2009

Project: **Liabilities—amendments to IAS 37**

Topic: **Consequential amendments to IFRS 3**

Paper overview

1. This paper considers consequential amendments to IFRS 3 *Business Combinations* required by the proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

2. At present, IFRS 3 has specific requirements for contingent liabilities assumed in a business combination. It requires them to be:

   (a) recognised as of the acquisition date if they are present obligations and their fair values can be measured reliably;

   (b) initially measured at their acquisition-date fair values;

   (c) subsequently measured at the higher of:

      (i) the amount that would be recognised in accordance with IAS 37; and

      (ii) the amount initially recognised (acquisition date fair value) less, if appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*; and

   (d) disclosed by applying some of the disclosure requirements in IAS 37.

3. The revisions to IAS 37 will include removing the notion of a 'contingent liability'. So the Board will need to make consequential amendments to IFRS 3.

4. This paper recommends that:

    (a) the substance of the *recognition requirements* is retained—with only the wording being amended to reflect the deletion of the term 'contingent liability' from IAS 37;

    (b) the *subsequent measurement requirement* is changed, deleting an exception on the grounds that is no longer necessary;

    (c) various amendments are made to the *disclosure requirements*.

IFRS 3 recognition requirements

Existing IFRS 3 requirements

General principle

5. IFRS 3 specifies how entities should recognise liabilities assumed in a business combination. The general principle is that all identifiable liabilities are recognised.[1] However, IFRS 3 contains some exceptions, and these include exceptions for 'contingent liabilities', as defined in IAS 37.

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[1] IFRS 3, paragraph 10.

Definition of a contingent liability

6. IAS 37 defines the term 'contingent liability' to include three different things:

   (a) 'possible obligations' whose existence will be confirmed only by future events.

      An example might be a disputed lawsuit in which the available evidence suggests that the chance of the entity being liable is less than 50 per cent.

   (b) present obligations that are not recognised because they probably will not require an outflow of resources.

      An example might be a one-off guarantee that is unlikely to be called upon.

   (c) present obligations that are not recognised because they cannot be estimated sufficiently reliably.

      This means that any liability within the scope of IAS 37 is defined as a contingent liability if its value cannot be measured reliably. IAS 37 describes such liabilities as 'extremely rare'. Typically, they are lawsuits whose outcome is highly uncertain.

IFRS 3 recognition requirements for contingent liabilities

7. At present, IAS 37 prohibits recognition of contingent liabilities. In contrast, IFRS 3 requires an acquirer to recognise a contingent liability assumed in a business combination if the contingent liability is

   (a) a present obligation that arises from past events; and

   (b) its fair value can be measured reliably.[2]

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[2] IFRS 3, paragraph 23.

8. In effect, IFRS 3 requires entities to recognise any item within the scope of IAS 37 if the item meets the definition of a liability and its value can be measured reliably. These requirements are consistent with those proposed for the revised IAS 37.

How to preserve these requirements when IAS 37 is amended

9. Because the recognition requirements in IAS 37 will become consistent with those in IFRS 3, the wording of the requirements in IFRS 3 can be greatly simplified. The references to contingent liabilities can be removed and replaced simply with references to liabilities within the scope of IAS 37. The staff suggest that the following amendments would preserve the existing requirements of IFRS 3 when IAS 37 is amended:

> *Exception to the recognition principle*
>
> **~~Contingent liabilities~~ Liabilities within the scope of IAS 37**
>
> ~~22 [Definition of contingent liability.]~~
>
> 22 ~~The requirements in IAS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date. Instead, the~~ The acquirer shall recognise as of the acquisition date a ~~contingent~~ liability within the scope of IAS 37 assumed in a business combination if ~~it is a present obligation that arises from past events and~~ its fair value can be measured reliably. ~~Therefore, contrary to IAS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.~~ …

Should the Board preserve the existing recognition requirements?

10. Liabilities within the scope of IAS 37 are the only liabilities to which IFRS 3 applies an explicit reliable measurement recognition criterion.

11. Rather than automatically preserving the criterion, the Board might wish to reconsider whether it is needed.

Arguments for deleting the criterion

12. In support of deleting the explicit reliable measurement criterion for liabilities within the scope of IAS 37, it could be argued that:

    (a) the criterion has been deleted from IFRS 3 for other assets and liabilities, even though it is present in some of the standards (such as IAS 16 *Property, Plant and Equipment*) that apply to the assets and liabilities if acquired separately. The Basis for Conclusions explains that:

    > In its deliberations leading to the revised IFRS 3, the IASB decided to eliminate reliability of measurement as an overall criterion, which it observed is unnecessary because reliability of measurement is part of the overall recognition criteria in the *Framework*.[3]

[3] IFRS 3, Paragraph BC125.

(b) to have been willing to acquire the business, the acquirer must have been able to reach a reasonably reliable estimate of the fair values of the liabilities or received from the seller an indemnification for the amount that it cannot reliably estimate. Any indemnification asset would be recognised using the same assumptions as the indemnified liability. The impact of the amounts being unreliable would to some extent cancel each other.

(c) a reliable measurement criterion might be over-used. This might particularly be the case if preparers argue that, because liabilities within the scope of IAS 37 are typically not exchanged, their *fair values* in particular are frequently incapable of reliable measurement. Although the reliable measurement criterion is already in IFRS 3, the fact that it applies to all liabilities within the scope of IAS 37 is perhaps overlooked because it is described as applying only to 'contingent liabilities'.

Arguments for retaining the criterion

13. However, there are counterarguments in support of *retaining* the explicit reliable measurement criterion for liabilities within the scope of IAS 37:

(a) the argument that the criterion is implicit in the requirements of IFRS 3 because 'reliability of measurement is part of the overall recognition criteria in the *Framework'* is difficult to support. It would imply that the other recognition criterion in the *Framework*—ie, the 'probability' recognition criterion—is also implicit in IFRS 3. But this is not the case. The Basis for Conclusions to IFRS 3 states that:

> The revised IFRS 3 does not contain that probability recognition criterion and thus it requires the acquirer to recognise identifiable assets acquired and liabilities assumed regardless of the degree of probability of an inflow or outflow of economic benefits.[4]

(b) the Board has acknowledged that there will in 'extremely rare' cases be liabilities in the scope of IAS 37—specifically those arising from major one-off litigation—that are not be capable of reliable measurement. Even if the seller indemnifies the buyer, the amounts at which the gross liability and indemnification asset are measured could both be unreliable, and hence might provide little useful information to users of the financial statements;

(c) if there is a risk that the criterion will be over-used, a better solution would be to remind preparers that it will be needed only in extremely rare cases—not to remove the criterion altogether. The wording could be based on the comparable guidance proposed for IAS 37, eg:

> Except in extremely rare cases, an entity will be able to determine a reliable measure of the fair value of a liability within the scope of IAS 37.[5]

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4 IFRS 3, paragraph BC126.

5 The unmarked text is that proposed in paragraph 27 of the Exposure draft of Proposed Amendments to IAS 37, published June 2005. The additional underlined text would be required in IFRS 3.

Staff conclusions and recommendations

14. On the basis of the arguments in paragraph 13, the staff conclude that the reliable measurement criterion should be retained in IFRS 3 for liabilities within the scope of IAS 37.

15. Accordingly, the staff present the following recommendation.

Recommendation 1—Preserve the existing recognition requirements for contingent liabilities
The staff recommend that the Board preserve the existing recognition requirements for contingent liabilities in IFRS 3 by replacing paragraphs 22-23 of IFRS 3 with: *“22 The acquirer shall recognise as of the acquisition date a liability within the scope of IAS 37 assumed in a business combination if its fair value can be measured reliably.”* Do you agree?

16. The staff accept that there is a risk that the reliable measurement criterion might be over-used. To mitigate this risk, IFRS 3 could contain similar guidance to that in IAS 37.

17. Accordingly, the staff present the following recommendation.

Recommendation 2—Guidance to avoid over-use of the exception
The staff recommend that the Board clarify in IFRS 3 that: *“23 Except in extremely rare cases, an entity will be able to determine a reliable measure of the fair value of a liability within the scope of IAS 37.”* Do you agree?

IFRS 3 subsequent measurement requirements

Existing IFRS 3 requirements

General principle

18. The general principle in IFRS 3 is that assets and liabilities recognised in a business combination should:

    (a) initially be measured at their acquisition date fair values[6], and

    (b) subsequently be measured in accordance with other applicable IFRSs for those items[7].

Exception for contingent liabilities

19. There is an exception to the general principle for subsequent measurement of contingent liabilities:

    > After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:
    >
    > (a) the amount that would be recognised in accordance with IAS 37; and
    >
    > (b) the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.[8]

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[6] IFRS 3, paragraph 18.
[7] IFRS 3, paragraph 54.
[8] IFRS 3, paragraph 56.

20. The reason for this exception to the general principle is given in paragraph BC243 of the Basis for Conclusions:

> In developing IFRS 3, the IASB observed that not specifying the subsequent accounting for contingent liabilities recognised in a business combination might result in inappropriately derecognising some or all of those contingent liabilities after the combination.

21. This observation relates to the contingent liabilities of the type described in paragraph 6(b) of this paper, ie present obligations that are not recognised applying IAS 37 because they probably will not require an outflow of resources. IFRS 3 requires these liabilities to be recognised and needs special subsequent measurement rules to stop entities derecognising them again after acquisition, when IAS 37 applies instead.

22. The exception serves a second, smaller purpose. It avoids entities from recognising a ‘day 2’ gain immediately after acquisition if those recognised contingent liabilities that are initially measured at fair value applying IFRS 3 are subsequently measured at a lower amount applying IAS 37.

Arguments for deleting the subsequent measurement exception

23. As a consequence of amending IAS 37, the main reason for the existing exception—to avoid derecognition after acquisition—will no longer apply. The revised IAS 37 will require recognition of all present obligations (that can be reliably measured) irrespective of the probability of an outflow of resources.

24. The second benefit of the exception—ie that it avoids ‘day 2’ gains on re-measuring recognised contingent liabilities—will continue to be relevant when IAS 37 is amended. However, it could be argued that this benefit is minor and insufficient on its own to justify the additional complexity the exception adds to IFRS 3:

(a) although the IFRS 3 and IAS 37 measurement requirements for such liabilities are not the same, they are not vastly different. IFRS 3 requires measurement at fair value. IAS 37 will require measurement at 'the amount the entity would rationally pay on the reporting date to be relieved of the present obligation'. For most liabilities within the scope of IAS 37, these amounts would typically be estimated in a similar way (ie using the entity's own estimates of future cash flows).

(b) applying the exception, the amount at which the liability is measured is frozen at its acquisition date fair value unless and until the IAS 37 measure becomes higher. The measure does not remain current, and hence is less relevant than the IAS 37 measure.

Staff conclusion and recommendation

25. For the reasons in paragraphs 23 and 24, the staff conclude that, once IAS 37 is revised, the disadvantages of the subsequent measurement exception for contingent liabilities will outweigh the minor remaining benefits.

Recommendation 3—Delete the subsequent measurement exception for contingent liabilities
The staff recommend that the Board delete from IFRS 3 the subsequent measurement exception for contingent liabilities. Without this exception, all liabilities within the scope of IAS 37 and assumed in a business combination would subsequently be measured in accordance with IAS 37. Do you agree with the staff recommendation?

IFRS 3 disclosure requirements

26. IFRS 3 has two specific requirements to disclose detailed information about contingent liabilities. When IAS 37 is revised, there will no longer be a population of items defined by the term ‘contingent liability’. It will be necessary to consider whether the existing disclosure requirements remain necessary and, if so, to define the populations of items to which they should apply.

27. The two disclosures are in:

(a) paragraph B64 of IFRS 3—which requires disclosure of information about the nature and financial effect of business combinations in the period, and

(b) paragraph B67 of IFRS 3—which requires disclosure of information about adjustments to acquired assets and liabilities after they have been recognised in a business combination.

They are considered separately below.

First disclosure requirement – nature and financial effect of business combinations in period

28. Paragraph B64 of IFRS 3 contains a list of disclosure requirements that apply to each business combination that has occurred in the period and aim to enable users of financial statements to evaluate the nature and financial effect of that business combination.

29. Paragraph B64(j) contains specific requirements for contingent liabilities acquired in each business combination:

(a) for *recognised* contingent liabilities, it requires disclosure of the information required for recognised liabilities in paragraph 85 of IAS 37:

> This information includes: a description of the nature of the obligation; the expected timing of any resulting outflows; an indication of the uncertainties; and the amount of any expected reimbursement.

(b) for contingent liabilities that have *not been recognised* because their fair values cannot be measured reliably, IFRS 3 requires disclosure of:

(i) the information required by paragraph 86 of IAS 37 for (unrecognised) contingent liabilities;

> This information includes: a description of the nature of the contingent liability and, where practicable, an estimate of its financial effect, an indication of the uncertainties and the possibility of any reimbursement.

(ii) and the reasons why the liability cannot be measured reliably.

30. This information helps users understand the possible financial effect of liabilities that are have been assumed in a business combination and are subject to a particularly high degree of uncertainty. So, it can be argued that they will continue to be valuable when IAS 37 is revised and should continue to apply to obligations whose outcome is subject to a high degree of uncertainty.

31. With this in mind, the staff suggest that:

(a) *the disclosures should apply to all types of liability that remain within the scope of IAS 37.* These liabilities—litigation liabilities, asset retirement obligations, environmental obligations, non-recurring stand-ready obligations—are typically subject to an unusually high degree of uncertainty. The more predictable liabilities arising from contracts with customer (such as warranty obligations) will no longer be within the scope of IAS 37 when a new standard on revenue recognition comes into effect.

(b) *the disclosures should apply to items that are* not *recognised as liabilities in addition to those that are recognised.* The revised IAS 37 will identify two types of item that are not recognised as liabilities. These are:

(i) 'possible obligations'—situations, typically lawsuits, in which it is uncertain whether an entity has a present obligation but the available evidence suggests it does not (the first type of contingent liability identified in IAS 37 at present); and

(ii) liabilities that are not recognised because they cannot be measured reliably (the third type of contingent liability identified in IAS 37 at present).

Arguably, users seeking to understand the financial effect of a business combination need information about the uncertainties surrounding these items as much, or even more, than they need information about liabilities that have been recognised and measured.

32. Requiring disclosure for all the items in paragraph 31 would extend the scope of the present disclosure requirements: at present they apply only to recognised contingent liabilities and liabilities that have not been recognised because they cannot be measured reliably, ie not to 'possible obligations'. The Board would need to justify the extension. But the staff think that it is reasonable to argue that users of financial statements need to know about all significant possible obligations, such as lawsuits against the acquired entity, whether or not a liability has been recognised.

33. The new disclosure requirements would be straightforward to incorporate into IFRS 3. Paragraph BC64(j) could continue to cross refer to IAS 37. The Board proposes to carry forward with only minor amendments the disclosure requirements in paragraphs 85 and 86 of the existing IAS 37. It has also tentatively decided that the requirements will apply to recognised liabilities[9], liabilities that are not recognised because they cannot be measured reliably[10], and 'possible obligations' that are not recognised as liabilities[11].

34. The wording of the cross references would depend on the final wording of the disclosure requirements in IAS 37. It could be finalised when the revised IAS 37 requirements have been drafted.

Recommendation 4—require disclosures of uncertainties surrounding all IAS 37 liabilities and possible obligations assumed in a business combination
The staff recommend that the Board: (a) preserve the substance of the disclosure requirements in paragraph B64(j) of IFRS 3. (b) do so by continuing to cross-refer to disclosure requirements in IAS 37 (ie the paragraphs of the revised standard that will replace paragraphs 85 and 86 of IAS 37 at present). (c) require entities to apply the requirements to all liabilities and 'possible obligations' within the scope of the revised IAS 37'. Do you agree with the staff recommendation?

9 Exposure Draft of Proposed Amendments to IAS 37, June 2005, paragraph 68(b)-(d)
10 Ditto, paragraph 69.
11 Tentative Board decision, December 2008.

Second disclosure requirement - effects of adjustments relating to business combinations

IFRS 3 requirements

35. Paragraph B67 of IFRS 3 requires entities to disclose specific information, the objective of which is to enable users of financial statements to evaluate the financial effects of adjustments recognised in the current reporting period in relation to business combinations of current and previous periods.

36. B67(c) has a specific requirement for recognised contingent liabilities. It requires entities to disclose the information required by paragraphs 84 and 85 of IAS 37:

> Paragraph 84 requires entities to reconcile the opening and closing amounts recognised, separately identifying additional amounts recognised, amounts used, amounts reversed and increases due to the passage of time.
>
> Paragraph 85 (as noted earlier in this paper) requires entities to disclose: a description of the nature of the obligation; the expected timing of any resulting outflows; an indication of the uncertainties; and the amount of any expected reimbursement

Whether the disclosure requirement for contingent liabilities remains necessary

37. The staff think that there will no longer be a need for paragraph B67(c) when IAS 37 is revised. This because the original purpose of the requirement was to extend the disclosure requirements for liabilities recognised in accordance with IAS 37 to *contingent* liabilities recognised in accordance with IFRS 3. Because the recognition requirements of the two standards will become the same when IAS 37 is revised, all contingent liabilities recognised applying IFRS 3 will become subject to the disclosure requirements of IAS 37. There will no longer be a need to extend them.

38. Some people might note that deletion of paragraph B67(c) would lead to some loss of information. This is because the IAS 37 disclosure requirements (which will apply instead) do not require entities to identify liabilities that have been assumed in business combinations separately from those that have arisen in other ways. However in response it could be argued that:

(a) the population of items affected is very small. It is only those items that are not at present recognised as liabilities applying IAS 37 but are recognised applying IFRS 3, ie present obligations that probably will not result in an outflow of economic benefits.

(b) as noted in paragraph 29(a) above, information about the nature of and uncertainties surrounding those items is already required to be disclosed for acquisitions in the *current* period. So that information won't be lost.

(c) the other information required by B67(c)—ie a reconciliation of opening and closing balances for liabilities assumed in business combinations—is of value only if it discloses large adjustments. But if there are any large adjustments, they would be have to be disclosed in accordance with the more general requirements of paragraph B67(e):

> B67(e) requires disclosure of any gain or loss recognised in the current reporting period that:
>
> (a) relates to the identifiable assets acquired or liabilities assumed in a business combination; and
>
> (b) is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements.

Recommendation 5—Delete disclosure requirements in paragraph 67(c) of IFRS 3
The staff recommend that the Board delete paragraph 67(c) from IFRS 3 on the grounds that will no longer be needed when IFRS 3 is revised. Do you agree with the staff recommendation?