IFRS

STAFF PAPER

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IASB® Meeting

Project	**Reference to the *Conceptual Framework* (Amendments to IFRS 3)**		
Paper topic	Matters raised by respondents to the Exposure Draft		
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Purpose of paper

1. In May 2019, the International Accounting Standards Board (Board) published Exposure Draft *Reference to the Conceptual Framework* (Exposure Draft), which proposed amendments to IFRS 3 *Business Combinations*.

2. Respondents broadly supported the proposals. However, respondents raised three matters the staff think merit further consideration. These matters are discussed in this paper.

Background information

Exposure Draft proposals

3. The Exposure Draft proposed:

   (a) to update the recognition principle in IFRS 3, so it refers to the *Conceptual Framework for Financial Reporting* issued in March 2018 (2018 *Conceptual Framework*) instead of the *Framework for the Preparation and Presentation of Financial Statements* issued in 1989 (1989 *Framework*).

(b) to avoid an unintended consequence of updating the reference, by adding to IFRS 3 an exception to its recognition principle. The exception would apply to liabilities and contingent liabilities that would be within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or IFRIC 21 *Levies* if incurred separately. For these items, an acquirer would apply IAS 37 or IFRIC 21, instead of the 2018 *Conceptual Framework*, to identify the present obligations it had assumed in a business combination.

(c) to add to IFRS 3 an explicit statement that an acquirer should not recognise contingent assets acquired in a business combination.

Feedback from respondents[1]

4. Most respondents supported all the proposals they commented on. However, some respondents suggested that updating the reference to the *Conceptual Framework* could have unintended consequences beyond those addressed by the proposals in the Exposure Draft. Respondents suggested three further amendments.

5. They suggested the Board:

(a) add to IFRS 3 another exception to its recognition principle (discussed in paragraphs 6–29);

(b) clarify which aspects of the proposed requirements for contingent liabilities apply the IFRS 3 recognition principle and which aspects are exceptions to that principle (discussed in paragraphs 30–36); and

(c) clarify whether updating the reference to the *Conceptual Framework* will change IFRS 3 requirements for recognition of assets and liabilities whose fair values are subject to measurement uncertainty (discussed in paragraphs 37–43).

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1 IASB November meeting *Agenda Paper 10 Reference to the Conceptual Framework (Amendments to IFRS 3)—Comment letter analysis*.

Suggestion 1—add to IFRS 3 another exception to its recognition principle

Reason for providing recognition exceptions

6. The definitions of assets and liabilities in the 2018 *Conceptual Framework* are different from those in the 1989 *Framework*. The differences are such that updating the reference without making any other changes to IFRS 3 could increase the population of assets and liabilities qualifying for recognition in a business combination. Some of these assets or liabilities might not qualify for recognition applying other applicable IFRS Standards after the acquisition date. So, the acquirer would first recognise the assets or liabilities at the time of the business combination and then derecognise them immediately afterwards. The resulting ‘day 2’ loss or gain would not depict an economic loss or gain, so would not faithfully represent any aspect of the acquirer’s financial performance.

Exposure Draft proposal

7. The Board concluded that the problem of day 2 losses or gains would be significant in practice only for liabilities accounted for after the acquisition date applying IAS 37 or IFRIC 21. To avoid the problem, the Exposure Draft proposed to add to IFRS 3 an exception to its recognition principle. For liabilities and contingent liabilities that would be within the scope of IAS 37 or IFRIC 21 if incurred separately, an acquirer would apply IAS 37 or IFRIC 21 respectively, instead of the 2018 *Conceptual Framework*, to identify the obligations it had assumed in a business combination.

Comments received

8. Almost all respondents supported the proposed exception. However, some respondents identified another possible source of day 2 losses and gains, for which they suggested a second exception was required. These respondents—mainly accounting firms—suggested that, applying the 2018 *Conceptual Framework*, an acquirer of a business might recognise at the acquisition date current tax liabilities or assets it would not recognise subsequently applying IFRIC 23 *Uncertainty over Income Tax Treatments*.

9. Their reasoning was that:

   (a) the 2018 *Conceptual Framework* has removed from the definitions of an asset and a liability the requirement for ‘expected’ inflows or outflows of economic benefits. Instead, an asset need only have the ‘potential’ to produce economic benefits, and a liability the ‘potential’ to require the entity to transfer an economic resource. So, when the reference to the *Conceptual Framework* is updated, IFRS 3 will require acquirers to recognise in a business combination uncertain current tax liabilities and assets with a low probability of future outflows or inflows of economic benefits.

   (b) IFRIC 23 applies a ‘probable’ threshold for reflecting the effect of uncertainty over income tax treatments. Some uncertain tax liabilities recognised on the acquisition of a business might not qualify for recognition subsequently applying IFRIC 23.

10. A few respondents suggested that problems would arise only for *current* tax liabilities and assets because IFRS 3 already has an exception to its recognition and measurement principle for *deferred* tax liabilities and assets. Paragraph 24 states that:

    > The acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with IAS 12 *Income Taxes*.

11. An accounting firm suggested extending the scope of this exception to current tax liabilities and assets. The firm suggested that extending the scope in this way would not only avoid any day 2 losses and gains that could arise as a result of updating the reference to the *Conceptual Framework*; it would also eliminate the day 2 losses and gains that can arise at present because of existing differences between IFRS 3 and IFRIC 23 measurement requirements.

Staff analysis

12. In this section, the staff consider:

    (a) the requirements of IFRIC 23 (paragraphs 13–14);

    (b) how uncertainty over income tax treatments could affect the current tax liabilities and assets recognised applying IFRS 3 (paragraphs 16–24); and

    (c) the pros and cons of extending the scope of the existing exception for deferred tax liabilities and assets (paragraphs 25–27).

Requirements of IFRIC 23

13. IFRIC 23 is an interpretation of IAS 12 *Income Taxes*. It applies when it is unclear how a tax law applies to a transaction or circumstance. An entity prepares, or plans to prepare, its income tax filings assuming the law applies in one way. However, the entity will not know whether its treatment is acceptable until the relevant taxation authority (or a court) takes a decision in the future. Until then, the extent of the entity's liability to pay (or right to recover) income tax remains uncertain.

14. IFRIC 23 clarifies how an entity reflects that uncertainty in recognising and measuring its income tax liabilities and assets. IFRIC 23 specifies that:

    (a) if the entity concludes it is *probable* that the taxation authority will accept the uncertain tax treatment, the entity determines its current tax liability (or asset) and deferred tax liability (or asset) consistently with the treatment it has used or plans to use in its income tax filings. The entity does not adjust the filed amounts to reflect the possibility of the uncertain tax treatment being rejected.

    (b) if the entity concludes it is *not probable* that the taxation authority will accept the uncertain tax treatment, the entity reflects the effect of the uncertainty in calculating its current tax liability (or asset) and deferred tax liability (or asset). It reflects the uncertainty by adjusting the filed amounts to reflect either the most likely outcome or the expected value (probability weighted average) of the possible outcomes, depending on which method better predicts the resolution of the uncertainty.

How uncertainty over income tax treatments could affect the current tax liabilities and assets recognised applying IFRS 3

15. This section discusses how uncertainty over income tax treatments could affect the current tax liabilities and assets recognised applying IFRS 3. The staff think the analysis depends on whether:

    (a) the uncertainty affects only the *measurement* of a current tax liability (or asset) (see paragraphs 16–19); or

    (b) there is also uncertainty about the *existence* of a current tax liability (or asset) (see paragraphs 20–24).

If the uncertainty affects only the measurement of a current tax liability or asset

16. In some (perhaps most) cases, only some of an entity’s transactions have an uncertain tax treatment and decisions about whether and how to reflect that uncertainty affect only the measurement of the entity’s total current tax liability (or asset).

17. IFRS 3 does not specify any exceptions to its measurement principle for current tax liabilities or assets. This means that:

    (a) at the acquisition date, an acquirer measures a current tax liability (or asset) at its acquisition-date fair value. That fair value would reflect all the possible outcomes of an uncertain tax treatment, and the probability of each outcome.

    (b) subsequently, the acquirer measures the current tax liability (or asset) applying IAS 12 as interpreted by IFRIC 23. As explained in paragraph 14, applying IFRIC 23, an acquirer might not reflect the uncertainty in the measure of its current tax liability (or asset), or might reflect the uncertainty at an amount that differs from its fair value.

18. The difference between the measurement bases applied at the acquisition date and subsequently could result in a day 2 loss or gain for an acquirer. However, it would not necessarily do so. The seller of a business might contractually indemnify the acquirer for an unfavourable outcome of an uncertain tax treatment. In that case, the acquirer would recognise the indemnification asset on the same basis as the uncertain tax

treatment both at the acquisition date and subsequently.[2] As a result, any day 2 loss or gain on the income tax liability or asset might be offset by a compensating day 2 gain or loss on the indemnification asset.

19. Updating the reference to the *Conceptual Framework* does not change the measurement requirements of IFRS 3, so would not change the way acquirers account for uncertain tax treatments that affect only the measurement of a current tax liability (or asset).

If there is uncertainty about the existence of a current tax liability or asset

20. As discussed in paragraph 16, in some (perhaps most) cases, uncertain tax treatments affect only the measurement of a current tax liability (or asset). However, in some cases, an uncertain tax treatment could be the sole source of a possible current tax liability (or asset). This would be the case if the uncertainty affects the whole of an entity's filing (for example, if it is uncertain whether an entity is required to submit an income tax filing in a jurisdiction) or if reflecting the uncertainty could change a current tax asset into a current tax liability. In these cases, the uncertainty about the tax treatment could create uncertainty about whether a current tax liability (or asset) even exists.

21. In deciding whether to recognise a current tax liability (or asset) whose existence is uncertain, an acquirer would have to decide which of the IFRS 3 recognition requirements to apply. The staff think an acquirer could apply the requirements in IFRS 3 for contingent liabilities and contingent assets. Our reasoning would be that:

    (a) the acquirer has a possible current tax liability (or asset) whose existence is uncertain and will be confirmed only by a future event—a decision of the relevant taxation authority or court. This possible liability (or asset) meets the definitions of a contingent liability (or contingent asset) set out in IAS 37 and applied in IFRS 3.

    (b) for recognition of contingent liabilities and assets, IFRS 3 has specific requirements that apply instead of the general recognition principle. It could be argued that these requirements apply to all contingent liabilities and assets—not only those that would be within the scope of IAS 37 if incurred separately. In

[2] Paragraphs 27 and 57 of IFRS 3.

support of such an argument we note that IFRS 3 specifies that one of its requirements for contingent liabilities (the subsequent measurement requirement in paragraph 56) does not apply to contingent liabilities accounted for in accordance with IFRS 9 *Financial Instruments*. This exception would not be required if the requirements for contingent liabilities applied only to contingent liabilities within the scope of IAS 37.

22. If an acquirer applied the IFRS 3 requirements for contingent liabilities to a possible current tax liability, there might be no conflicts between the acquisition date accounting and subsequent accounting:

(a) IFRS 3 requires an acquirer to recognise a contingent liability if it is a present obligation that arises from past events and its fair value can be measured reliably—even if an outflow of economic resources is not probable.[3] IFRS 3 does not specify how management decides whether a possible obligation is a present obligation. Because IFRS 3 does not deal with this issue, it might be appropriate to apply the approach specified in IAS 37. Paragraph 15 of IAS 37 states that:

> In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.

If an acquirer applies the approach specified in IAS 37, the recognition threshold it applies (more likely than not) could be the same as that specified by IFRIC 23 (probable).

(b) any contingent liability recognised at the acquisition date would subsequently be recognised and measured applying 'subsequent recognition and measurement' requirements for contingent liabilities in IFRS 3, thus avoiding day 2 losses or gains that could otherwise arise because of differences between the measurement requirements of IFRS 3 and those of IFRIC 23.[4]

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[3] Paragraph 23 of IFRS 3.

[4] Paragraph 56 of IFRS 3.

23. A current tax contingent *asset* might be less common. However, an acquirer could decide it has a contingent asset if the acquired entity has claimed, or plans to claim, a refund of income tax from the tax authorities but is uncertain whether it has a right to that refund, and the seller has not indemnified the acquirer against the risk of the claim being unsuccessful. IFRS 3 prohibits recognition of contingent assets. So, applying the requirements of IFRS 3, the acquirer would not recognise the contingent asset on the acquisition date, but might recognise it (and a day 2 gain) subsequently, applying the ‘probable’ threshold in IFRIC 23.

24. The IFRS 3 requirements for contingent liabilities and contingent assets apply instead of the general recognition principle and do not refer to the *Conceptual Framework* definitions of an asset and a liability. Consequently, we think that updating the reference to the *Conceptual Framework* will not necessarily change the IFRS 3 requirements for situations in which it is uncertainty about the existence of a current tax liability or asset.

Pros and cons of extending scope of existing exception

25. As noted in paragraph 10, differences between the requirements of IFRS 3 and IFRIC 23 can give rise to a day 2 loss or gain only for *current* tax liabilities and assets, because IFRS 3 provides an exception to its recognition and measurement principle for *deferred* tax liabilities and assets. Both at the date of acquisition and subsequently, an acquirer recognises and measures deferred tax liabilities and assets in accordance with the requirements of IAS 12.

26. As one respondent suggested (see paragraph 11), extending this exception so that it also applies to current tax would not only avoid any unintended consequences of updating the reference to the *Conceptual Framework*, it would also eliminate the day 2 losses and gains that can arise at present because of differences between the measurement requirements in IFRS 3 and those in IFRIC 23.

27. However, the purpose of this project is to amend IFRS 3 only to the extent required to avoid any unintended consequences of updating the reference to the *Conceptual Framework*. Extending the scope of the exception for deferred tax would go beyond

this purpose—it would also change existing IFRS 3 measurement requirements. Not all stakeholders would necessarily support the exception—it is not be the only method of avoiding day 2 measurement losses and gains, and some stakeholders might argue that other methods (such as adding subsequent measurement requirements) would result in more useful information. Also, extending the scope of the existing exception could have unintended consequences and give rise to new application issues.

Staff conclusion

28. The staff conclude that:

    (a) as explained in paragraphs 16–24, there are existing conflicts between the requirements of IFRS 3 and those of IFRIC 23 and these will not necessarily be made worse by updating the IFRS 3 reference to the *Conceptual Framework*. So there is no reason in this project to make an exception to the IFRS 3 recognition principle for current tax liabilities or assets.

    (b) although the existing conflicts could be resolved by extending the scope of the existing recognition and measurement exception for deferred tax liabilities and assets, it is beyond the scope of this project to consider changes to IFRS 3 to resolve existing conflicts.

Staff recommendation and question for the Board

29. The staff recommend that the Board confirms the Exposure Draft proposal to add to IFRS 3 an exception to its recognition principle only for liabilities and contingent liabilities within the scope of IAS 37 or IFRIC 21. The staff recommend the Board does not add an exception for current tax liabilities and assets.

Question 1—exception for current tax liabilities and assets
Do you agree with the recommendation in paragraph 29?

Suggestion 2—clarify which aspects of the requirements for contingent liabilities are exceptions to the recognition principle

Comments received

30. A national standard-setter and an accountancy body asked the Board to clarify which aspects of the proposed requirements for contingent liabilities apply the IFRS 3 recognition principle and which aspects are an exception to that principle. In the view of those respondents, the requirement to recognise contingent liabilities with a low probability of future outflows (paragraph 23 of IFRS 3) is currently an exception to the requirement to apply the 1989 *Framework* but will become an application of the requirement to apply the 2018 *Conceptual Framework*. This is because the 1989 *Framework* includes a ‘probable outflows’ criterion for recognition of liabilities, but the 2018 *Conceptual Framework* does not. The respondents suggested the new status of paragraph 23 will not be clear if, as proposed in the Exposure Draft, that paragraph remains within the section headed ‘Exception to the recognition principle’: further clarification is needed, at least in the Basis for Conclusions.

Staff analysis

31. The proposed amendments were drafted so all the IFRS 3 requirements for initial recognition of provisions, contingent liabilities and contingent assets are located together. The respondents are correct to point out that those requirements include both exceptions to the IFRS 3 recognition principle and applications of that principle.

32. This feature of the requirements could be clarified by moving the requirements that apply the recognition principle out of the section ‘Exception to the recognition principle’. However, against making such a move, it could be argued that:

    (a) the requirements for provisions, contingent liabilities and contingent assets are related and will be clearest if all located together in IFRS 3. These requirements include exceptions to the recognition principle, so identifying the requirements as exceptions makes it clear that an acquirer applies them instead of the recognition principle to the extent they are not consistent with the recognition principle.

(b) several other existing IFRS 3 requirements are located within sections described as ‘exceptions’ but include both exceptions and applications. Paragraph BC264 discusses this matter, giving contingent liabilities and employee benefits as examples. And paragraph BC280 explains why the IFRS 3 requirement to recognise and measure deferred tax applying IAS 12 is described as an exception to both the recognition and measurement principles:

> BC280 The Boards considered identifying deferred tax assets and liabilities as an exception to only the measurement principle because most, if not all, of the requirements of IAS 12 and SFAS 109 are arguably consistent with the revised standards’ recognition principle. … However, the boards concluded that exempting deferred tax assets and liabilities from both the recognition and the measurement principles would more clearly indicate that the acquirer should apply the recognition and measurement provisions of IAS 12 and SFAS 109 and their related interpretations or amendments.

33. Alternatively, without moving any of the requirements for provisions, contingent liabilities and contingent assets out of the section headed ‘Exception to the recognition principle’, the Board could redraft the requirements to distinguish aspects that apply the recognition principle from aspects that are an exception to the recognition principle. However, reaching conclusions on this matter could take time and debate and would not necessarily make the requirements clearer. Indeed, redrafting could make the requirements less clear because the extent to which the proposed amendments change existing requirements would become less obvious.

34. If the Board decides not to move or redraft the proposed requirements, it could explain its decision in the Basis for Conclusions accompanying the amendments. That explanation would include an observation that the requirements for provisions, contingent liabilities and contingent assets include both exceptions to the recognition principle and applications of the principle. This observation could be sufficient to avoid misunderstandings.

Staff recommendation and question for the Board

35. For the reasons in paragraphs 32–33, the staff recommend that the Board confirms the Exposure Draft proposal to locate all the requirements for initial recognition of provisions, contingent liabilities and contingent assets within the section headed 'Exception to the recognition principle', without distinguishing aspects that that are exceptions to the principle from aspects that apply the principle.

36. If the Board agrees with the staff recommendation, the staff can add to the Basis for Conclusions a paragraph explaining the Board's decision in a way that clarifies that those requirements include both exceptions to, and applications of, the recognition principle.

Question 2—distinguishing exceptions from applications
Do you agree with the staff recommendation in paragraph 35?

Suggestion 3—clarify requirements for reliable measurement

Comments received

37. An accountancy body referred to paragraph BC125 of the Basis for Conclusions accompanying IFRS 3. This paragraph explains an amendment the Board made to IFRS 3 when it revised the Standard in 2008:

> BC125 [The pre-2008 version of] IFRS 3 included another recognition criterion for assets acquired or liabilities assumed in a business combination. That criterion required an asset or liability to be recognised separately from goodwill only if it could be reliably measured. 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 a part of the overall recognition criteria in the [1989] *Framework*.

38. The accountancy body suggested that when the Board updates IFRS 3 to refer to the 2018 *Conceptual Framework* instead of the 1989 *Framework*, questions could arise as to whether reliability of measurement is still an 'implicit' criterion for recognition of assets and liabilities in a business combination. The accountancy body asked the Board to clarify how updating the reference will affect this aspect of IFRS 3.

Staff analysis

39. IFRS 3 contains specific requirements and guidance for assets and liabilities whose fair values are most susceptible to measurement uncertainty (such as intangible assets, contingent liabilities and contingent assets). An acquirer applies the requirements and guidance to decide which assets and liabilities qualify for recognition in a business combination.

40. Paragraph BC125 wrongly suggests that, in applying IFRS 3 (and hence perhaps any IFRS Standard), an entity applies not only the recognition criteria specified in that Standard, but also recognition criteria discussed in the 1989 *Framework*. Such a suggestion is inconsistent with the stated purpose and status of 1989 *Framework*, which, like the 2018 *Conceptual Framework*, stated that it was not an IFRS Standard and did not override any IFRS Standard.[5]

41. Paragraph BC125 not only mis-represents the status of the *Conceptual Framework*. It could also wrongly suggest that, because the 1989 *Framework* and 2018 *Conceptual Framework* discuss measurement uncertainty in different ways, updating the reference in paragraph 11 of IFRS 3 changes IFRS 3 requirements for assets and liabilities whose fair values are subject to measurement uncertainty.

[5] Paragraph 2 of the *Introduction to the Framework for the Preparation and Presentation of Financial Statements*, July 1989.

Staff recommendation and question for the Board

42. The staff recommend that the Board clarifies in the Basis for Conclusions on the amendments that updating the reference to the *Conceptual Framework* does not change IFRS 3 requirements for recognition of assets and liabilities whose fair values are subject to measurement uncertainty.

43. The explanation could include an observation that paragraph BC125 misrepresents the status of the *Conceptual Framework*.

Question 3—measurement uncertainty
Do you agree with the recommendation in paragraph 42?