IFRS

STAFF PAPER

November 2019

IASB® Meeting

Project	**Reference to the *Conceptual Framework* (Amendments to IFRS 3)**
Paper topic	Comment letter analysis

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Purpose of session

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*. The Board requested comments by 27 September 2019.

2. In this paper, the staff summarise and respond to the comments received, identifying matters we plan to analyse further for discussion at a future Board meeting.

3. At this meeting, Board members will be invited to ask questions about, and comment on, the matters discussed in this paper. The Board will not be asked to make any decisions.

Summary of Exposure Draft proposals

4. The Exposure Draft proposed:

   (a) to update the recognition principle in paragraph 11 of 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. For 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, an acquirer should apply the relevant Standard, instead of the 2018 *Conceptual Framework*, to identify the obligations it has 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.

Overview of responses

5. The Board received 47 comment letters:

Stakeholder type	Number responding
National standard-setters	20
Accountancy bodies	10
Preparers of financial statements	8
Accounting firms	5
Regulators	2
Individuals and academic institutions	2
Total	**47**

6. Most respondents supported all the proposals they commented on.

7. Respondents commented on:

(a) proposal 1—to update the reference to the *Conceptual Framework* (see paragraphs 9–10);

(b) proposal 2—amendments to avoid unintended consequences of updating the reference:

(i) the exception for liabilities and contingent liabilities within the scope of IAS 37 or IFRIC 21 (paragraphs 11–19);

(ii) further amendments respondents think might be needed to address other possible consequences of updating the reference (paragraphs 20–27);

(c) proposal 3—to clarify IFRS 3 requirements for contingent assets (paragraphs 28–32);

(d) other aspects of IFRS 3 (paragraphs 33–37);

(e) transition and early application (paragraphs 38–40); and

(f) implications for other projects (paragraphs 41–46).

8. The Appendix to this paper lists other one-off and drafting comments.

Proposal 1—to update the reference to the *Conceptual Framework*

Exposure Draft proposal

9. The first proposal in the Exposure Draft was to remove from IFRS 3 a reference to an old version of the Board's *Conceptual Framework*. At present, paragraph 11 of IFRS 3 requires the assets and liabilities recognised in a business combination to meet the definitions of assets and liabilities in the 1989 *Framework*. The Board proposed to replace this reference with a reference to the current version—the 2018 *Conceptual Framework*.

Comments received

10. All respondents supported this proposal, a few adding that their support assumed there would be no unintended consequences beyond those identified by the Board. Some respondents said they welcomed the Board's efforts to streamline IFRS Standards. Some referred to the unnecessary complexity or confusion that can arise from having more than one version of the *Conceptual Framework* in use.

Proposal 2—(a) exception for liabilities and contingent liabilities within the scope of IAS 37 or IFRIC 21

Reason for exception

11. 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 those 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

12. 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 second proposal in the Exposure Draft was 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 the relevant Standard, instead of the *Conceptual Framework*, to identify the obligations it has assumed in a business combination.

Comments received

13. Almost all respondents supported the proposed exception. A few respondents said they supported it as a temporary solution, on the assumption that the Board will align IAS 37 and IFRIC 21 with the 2018 *Conceptual Framework* in the future (see paragraph 42).

14. A few respondents did not support the proposed exception. These respondents agreed that IFRS 3 should be amended to avoid day 2 losses or gains, but disagreed with the method the Board proposed to achieve this outcome:

(a) an accounting firm and a national standard-setter disagreed with the proposal to create another exception from the IFRS 3 recognition principle. They think all items meeting the 2018 *Conceptual Framework* definition of a liability should be recognised in a business combination, with day 2 gains being avoided by adding to IFRS 3 requirements for the subsequent recognition and measurement of liabilities that would otherwise be within the scope of IAS 37 or IFRIC 21. The accountancy firm explained that:

> Recognition of contingent liabilities such as levies based on the 2018 *Conceptual Framework* would result in recognition that more closely resembles the commercial and economic reality in a business combination and therefore would improve financial reporting over utilising the current recognition criteria in IFRIC 21. While we appreciate the Board's concerns about day 2 losses or gains, we note that IFRS 3 paragraph 56 already provides guidance on the subsequent accounting for contingent liabilities recorded at fair value in a business combination that would otherwise not qualify for recognition under IAS 37 and this guidance could simply be expanded to situations where a contingent liability (including a levy) was recorded in a business combination despite not meeting the current recognition criteria in IFRIC 21. *CL45 PwC*

(b) an individual suggested removing the reference to the *Conceptual Framework* from IFRS 3 and instead specifying that the assets and liabilities recognised in a business combination should meet the definitions applied in existing IFRS Standards. He noted that, applying such an approach, the 2018 *Conceptual Framework* definitions would come into effect for business combinations as the Board aligned other IFRS Standards with the 2018 *Conceptual Framework*.

Staff response

15. While developing the Exposure Draft proposals, the Board considered the alternative methods of avoiding day 2 gains suggested by respondents. In paragraphs BC24–BC29 of the Basis for Conclusions, the Board described these methods and explained its reasons for rejecting them.

16. In rejecting the method suggested in paragraph 14(a), the Board noted there are at present no Standards-level requirements on how to apply the 2018 *Conceptual Framework* definitions and supporting concepts to levies and other obligations conditional on the entity's future actions. Acquirers might reach different views on how to apply the concepts, leading to diversity in practice.

17. In rejecting the method suggested in paragraph 14(b), the Board noted that requiring entities to apply existing IFRS Standards, instead of the *Conceptual Framework*, to identify the assets and liabilities to recognise in a business combination would be a wider-reaching change than the narrow-scope exception proposed in the Exposure Draft. That wider-reaching change could have unintended consequences, which could be identified only by conducting further research, and may require further consequential amendments to IFRS 3.

18. The fact that almost all respondents supported the Board's proposals suggests they also agreed with the Board's reasons for rejecting alternative methods of avoiding day2 gains. Furthermore, the few respondents who supported an alternative method did not put forward any arguments beyond those considered by the Board while it was developing the Exposure Draft proposals.

19. Accordingly, the staff do not think the comments indicate a need for the Board to reconsider this aspect of the Exposure Draft proposals.

Proposal 2—(b) Other possible consequences of updating the reference

Comments received

20. Respondents to the Exposure Draft identified three other possible consequences of updating the reference to the *Conceptual Framework,* asking the Board to make further amendments to IFRS 3 to address these consequences.

Uncertain tax treatments

21. Respondents identified one other possible source of day 2 losses and gains. Some respondents—accounting firms plus a few others—suggested that, applying the updated reference to the *Conceptual Framework*, an acquirer of a business might recognise at the acquisition date current tax assets or liabilities it would not recognise subsequently applying IFRIC 23 *Uncertainty over Income Tax Treatments*.

> As noted in the Basis for Conclusions, the change in the reference to the Conceptual Framework in IFRS 3 may affect the recognition of assets and liabilities with a low probability of future inflows or outflows, and result in a day 2 gain/loss if the IFRS standard applicable to the item after the business combination would not permit recognition of such assets or liabilities. Applying IFRIC 23, an entity reflects the effect of the uncertainty in determining the related tax balances only if it concludes that it is not probable that a taxation authority will accept an uncertain tax treatment. Hence the removal of the probability criteria in IFRS 3 may result in recognition of uncertain current tax assets and liabilities as part of the business combination that would not satisfy the probability recognition criterion of IFRIC 23 immediately after the business combination. *CL7 Deloitte*

22. An accounting firm suggested this problem could be addressed by extending the scope of an existing exception in IFRS 3. At present, IFRS 3 requires an acquirer to recognise and measure *deferred* tax assets and liabilities applying IAS 12 *Income Taxes*. The exception could be extended so it also applies to *current* tax assets and liabilities.

23. That accounting firm further suggested that, rather than relying solely on individual exceptions to the recognition principle, the Board should add a more general exception for any situation in which applying the recognition principle would result in day 2 losses or gains.

Reliable measurement recognition criterion

24. An accountancy body referred to paragraph BC125 of the Basis for Conclusions accompanying IFRS 3. This paragraph explains one of the amendments 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*.

25. The accountancy body suggested that when the Board updates IFRS 3 to refer to the 2018 *Conceptual Framework* instead of the 1989 *Framework*, it will be unclear 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.

Distinguishing applications of the recognition principle from exceptions

26. 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, paragraph 23 of IFRS 3 (the requirement to recognise contingent liabilities with a low probability of future outflows) 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 assets and liabilities, but the 2018 *Conceptual Framework* does not. The respondents suggested

the new status of the requirement in 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 response

27. The staff think the three suggestions described in paragraphs 21–26 merit further consideration by the Board. We plan to prepare an analysis for discussion at a future Board meeting.

Proposal 3—to clarify IFRS 3 requirements for contingent assets

Exposure draft proposal

28. IFRS Standards define contingent assets as possible assets whose existence will be confirmed only by uncertain future events. IFRS 3 prohibits recognition of contingent assets, but this prohibition is stated explicitly only in paragraph BC276 of the Basis for Conclusions accompanying the Standard. To clarify the requirements and avoid any conclusion that updating the reference to the *Conceptual Framework* would change them, the Board proposed to add to IFRS 3 an explicit statement that an acquirer should not recognise contingent assets acquired in a business combination.

Comments received

29. Almost all respondents supported this proposal.

30. A few respondents said they opposed the proposal. However, their reasons suggest they disagree with the existing IFRS 3 requirements, rather than with the Board’s proposal to make those requirements more explicit. They think that entities should recognise contingent assets acquired in a business combination because, in their view:

(a) if part of the consideration paid for a business is attributable to the fair value of contingent assets acquired, recognising those contingent assets separately from goodwill would provide more useful information; or

(b) asymmetric recognition of assets and liabilities is not justified when the assets and liabilities are measured at fair value.

31. An accounting firm asked the Board to eliminate a difference between the requirements of IFRS 3 and those of IAS 37, which arises when is 'virtually certain' that a contingent asset will become non-contingent:

> Paragraph BC31 of the ED refers to paragraph BC276 of the Basis for Conclusions accompanying IFRS 3, which deals with contingent assets acquired in a business combination. Paragraph BC276 states: "… contingent assets should not be recognised, <u>even if it is virtually certain that they will become unconditional or non-contingent</u>" [emphasis added]. However, paragraph 33 of IAS 37 states: "… when the realisation of income is virtually certain, then the related asset <u>is not a contingent asset and its recognition is appropriate</u>" [emphasis added].
>
> The combination of these paragraphs is confusing and may result in an acquirer recognising a day 2 gain if the acquired business includes a 'virtually certain' contingent asset. We do not believe this was the Board's intention, considering the second proposed amendment in the ED (which aims to avoid the problem of day 2 gains or losses), nor do we believe this would faithfully represent the acquirer's economic performance. Therefore, we suggest that the Board amend paragraph BC276 of the Basis for Conclusions accompanying IFRS 3, by removing the words "even if it is virtually certain that they will become unconditional or non-contingent". Consistent with paragraph 33 of IAS 37, we believe that if realisation is virtually certain, the asset in question is not, in fact, a contingent asset. *CL33 EY*

Staff response

32. Respondents' concerns about the requirements for contingent assets relate to existing IFRS 3 requirements that are unaffected by updating the reference to the *Conceptual Framework*. Addressing such concerns is beyond the scope of this project so the staff suggest that the Board need not consider them further in finalising the amendments.

Other aspects of IFRS 3

Comments received

33. Some respondents asked the Board to address other matters they regard as problems with IFRS 3.

34. Most of these respondents referred to the difference between the measurement requirements of IFRS 3 and those of other IFRS Standards, most notably IAS 37 and IAS 12 / IFRIC 23. IFRS 3 requires acquirers to measure assets acquired and liabilities assumed at fair value at the acquisition date, but in accordance with other applicable IFRS Standards subsequently. Because IAS 37 and IAS 12 / IFRIC 23 require entities to measure provisions and current tax at an amount that can be different from fair value, day 2 losses or gains can arise. Respondents suggested that, while the Board is taking steps to address the day 2 gains that could arise from updating the reference to the *Conceptual Framework*, it should also address the 'arguably more significant and widespread' day 2 losses and gains that arise at present from differing measurement requirements.

35. A few respondents asked the Board to review other aspects of IFRS 3. Suggestions included:
    (a) removing the requirement for acquirers to recognise in a business combination contingent liabilities with a low probability of future outflows, to align the requirements of IFRS 3 with those of IAS 37; and
    (b) converging the requirements of IFRS 3 with those of USGAAP.

Staff response

36. The respondents' suggestions relate to existing IFRS 3 requirements that are unaffected by updating the reference to the *Conceptual Framework*. Addressing such concerns is beyond the scope of this project so the staff suggest that the Board need not consider them further in finalising the amendments.

37. The staff note that the concern about measurement differences (paragraph 34) was raised by respondents to the Request for Information issued as part of the Post-implementation Review (PIR) of IFRS 3. The Board did not take any further action in respect of those concerns.

Transition and early application

Exposure Draft proposals

38. The Exposure Draft proposed:

    (a) to require entities to apply the amendments prospectively;

    (b) to permit an entity to apply the amendments before their effective date if at the same time the entity also applies all the amendments made by *Amendments to References to the Conceptual Framework in IFRS Standards*; and

    (c) *not* to require an entity that applies the amendments early to disclose that it has done so.

Comments received

39. Some respondents commented on these proposals. All expressed unqualified support, except an accounting firm, which disagreed with the proposal not to require disclosure of early application:

> However, as a matter of principle, we consider it appropriate for entities that apply the proposed amendments early to disclose that fact. While the Board noted in ED paragraph BC39 that the amendments "should not significantly change the population of assets and liabilities recognised in a business combination" [emphasis added], any impact cannot be precluded. *CL33 EY*

Staff response

40. The staff plan to re-analyse the need for disclosure of early application after the Board has re-deliberated all technical aspects of the proposals.

Implications for other projects

Projects already on the Board's agenda

41. The exception proposed in the Exposure Draft is needed only because IAS 37 and IFRIC 21 are inconsistent with the 2018 *Conceptual Framework*. The Board will soon decide whether to take onto its agenda a project to amend aspects of IAS 37, including whether to align IAS 37 and IFRIC 21 with the 2018 *Conceptual Framework*.

Comments received

42. Some respondents referred to the possible project to align IAS 37 with the 2018 *Conceptual Framework*. They expressed support for this project, a few urging the Board to complete it as soon as possible.

43. A national standard-setter suggested the Board consider aligning IFRIC 21 first on the grounds that:

    (a) the Board might be able to do this more quickly than it could complete a wider-scope project to amend various aspects of IAS 37; and

    (b) amending IFRIC 21 would eliminate most of the difference between IAS 37 and the 2018 *Conceptual Framework*.

44. An accountancy body suggested there are several other IFRS Standards that are inconsistent with the 2018 *Conceptual Framework*. It suggested the Board should consider a wider project to align all these Standards with the 2018 *Conceptual Framework* to promote consistency in financial reporting and avoid confusion.

Staff response

45. The staff will soon ask the Board to decide whether to take on a project to amend aspects of IAS 37 and, if so, what to include in the scope of the project. In developing our staff recommendations for that project, we will take account of the views expressed by respondents to the Exposure Draft.

46. The staff plan to take no further action in response to the suggestion that the Board undertake a more general project to align all existing IFRS Standards with the 2018 *Conceptual Framework*. When the Board issued the 2018 *Conceptual Framework*, it stated that it would not automatically amend existing IFRS Standards to eliminate all inconsistencies. The Board considers any potential changes to Standards in the light of other priorities when developing its work plan.

Questions for the Board

Questions for the Board	
1	The staff plan to analyse further for future discussion comments on the three matters reported in paragraphs 20–26. Do you have any comments on these matters or the staff plans?
2	Do you have questions about, or comments on, any other matters discussed in this paper?

Appendix—one-off and drafting comments

	Respondent suggestion	Staff response	Action proposed
1	The new definition of liabilities in the 2018 *Conceptual Framework* might give rise to new 'low probability liabilities' being recognised. Guidance should be added to IFRS 3 for such liabilities, similar to that given for contingent liabilities. *CL18 South African Institute of Chartered Accountants*	The Board has conducted extensive research to identify other possible unintended consequences of updating the reference in IFRS 3. Nobody has identified any specific consequences other than those discussed elsewhere in this paper. The respondent does not identify any specific types of liabilities for which there might be problems.	No further action proposed.
2	Due to the reference to the 2018 *Conceptual Framework* in IFRS 3, it would be appropriate for example in relation to intangible assets, that the recognition of intangible assets should be refined in the standard much the same as dealing with contingent liabilities. *CL18 South African Institute of Chartered Accountants*	Existing requirements in IFRS 3 and IAS 38 *Intangible Assets* are such that that updating the reference to the *Conceptual Framework* will not change the way in which intangible assets are accounted for in a business combination or subsequently. See paragraphs BC12–BC13 of the Basis for Conclusions accompanying the Exposure Draft.	No further action proposed.
3	It would be helpful if the Board could provide examples to illustrate the consequences of not applying the liability recognition criteria indicated in IAS 37 and IFRIC 21, as businesses will need to understand the implications of applying the 2018 *Conceptual Framework* in recognising assets and liabilities under a business combination scenario. *CL41 Institute of Chartered Accountants of Nigeria*	The examples would be illustrating the effects of applying requirements different from those in IFRS 3. We think IFRS 3 would not be the right place for them. Examples are available elsewhere. While it was developing the *Conceptual Framework*, the Board published examples illustrating the differences between the *Conceptual Framework* and IAS 37.[1] If it takes on a project to align IAS 37 with the *Conceptual Framework*, it will discuss more examples as part of that project.	No further action proposed.

1 IASB meeting October 2016 Agenda Paper 10C: Conceptual Framework—*Testing the proposed asset and liability definitions—illustrative examples*.

	Respondent suggestion	Staff response	Action proposed
4	The wording of paragraphs 21A–23 of the ED is unclear. For example, some consider it confusing that the definition of a contingent liability in IAS 37 (included in paragraph 22 of IFRS 3) includes recognition guidance within it (i.e., that a contingent liability is not recognised if it is not probable that an outflow of economic benefits will be required). While we think ED paragraphs 21A–23 are technically correct, we recommend that the Board considers providing further clarification on the difference in recognition criteria of a contingent liability in IFRS 3 versus IAS 37. *CL33 EY*	The respondent is suggesting drafting improvements to existing IFRS 3 requirements, not to the proposed amendments. Such improvements are outside the scope of this project. We think readers of IFRS 3 now understand the difference between the IFRS 3 and IAS 37 recognition criteria for contingent liabilities, so even if the drafting is not as clear as it could be, we are not aware of a compelling reason for changing it. Improving the drafting might not be straightforward and could risk unintended consequences.	No further action proposed.
5	We believe there could be a potential tension between proposed paragraph 23A, which would prohibit recognition of contingent assets, and paragraphs 27 and 28 which require recognition of indemnification assets. This tension could exist if the indemnification asset relates to a contingent liability. In this case, the indemnification asset could be a contingent asset—recognising it would conflict with the general requirement not to recognise contingent assets. *CL9 ICAEW, CL37 Brazilian Association of Publicly-held Corporations*	A contingent asset is a possible asset whose existence is uncertain and will be confirmed only by uncertain future events. An indemnification asset (an acquirer's right to recover possible losses from the seller) is not a contingent asset, even if the loss indemnified is a contingent liability. The staff think it is not a contingent asset because there is no uncertainty about the *existence* of the right. There is uncertainty only about the *outcome*—whether the indemnified event will occur and/or the magnitude of the loss. Thus, we think there is no tension between the IFRS 3 requirement to recognise indemnification assets but not contingent assets. IFRS 3 has explicit requirements for reimbursement rights, so we do not think there is a significant risk of the requirements for contingent assets being applied to reimbursement rights.	No further action proposed.

	Respondent suggestion	Staff response	Action proposed
6	Proposed paragraph 21B refers to both a provision and a contingent liability. To improve the understandability of the Standard, some members recommend that the IASB consider separating the two concepts. For example, by deleting the reference to contingent liability in paragraph 21B so that this paragraph focusses on the treatment of provisions in the context of a business combination. Paragraph 21B could then also include a reference to paragraph 14 (which includes the concept of legal and constructive obligations), and to paragraphs 15–26 of IAS 37 that provides guidance on how to understand the complete definition of a provision in IAS 37. Paragraph 23 on contingent liabilities could then be clarified to state that a "present obligation" and "reliable estimate" should be interpreted as discussed in paragraphs 15–22 and 25–26 of IAS 37. *CL10 International Organization of Securities Commissions*	We will consider this suggestion when drafting. At present our tentative view is that because the exception for provisions is identical to that for contingent liabilities, a single exception that covers both (as proposed in the Exposure Draft) is the clearest and simplest way of drafting the exception. We do not think that the exception for provisions need to refer to the fact that obligations can be constructive or legal. And, because the exception applies only to identifying whether there is a present obligation, we do not think it should refer to paragraphs 23–26 of IAS 37 (which discuss other recognition criteria in IAS 37).	To consider in drafting.
7	We have reviewed the Basis for Conclusions and its association with the proposed amendments and have observed that it is difficult to comprehensively read, understand and associate such conclusions with the proposed amendments. As a result, we recommend revising and clarifying the final text of the Basis for Conclusions for the amendments. *CL28 Group of Latin American Accounting Standard Setters*	We will consider how to make the drafting of the Basis for Conclusions on the amendments clearer.	To consider in drafting.