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IFRS Developments

Amendments to IFRS 3 - Reference to the *Conceptual Framework*

What you need to know

- The IASB issued amendments to IFRS 3 to update the reference to the 2018 *Conceptual Framework*.
- Further, the amendments add an exception to the recognition priniciple for liabilities and contingent liabilities within the scope of IAS 37 or IFRIC 21.
- The amendments also clarify exisiting guidance for contingent assets.
- The amendments are effective for annual reporting periods beginning on or after 1 January 2022 and apply prospectively. Earlier application is permitted.

Background

In May 2020, the International Accounting Standards Board (IASB or Board) issued Amendments to IFRS 3 *Business Combinations* - Reference to the *Conceptual Framework*. The amendments are intended to replace a reference to the *Framework for the Preparation and Presentation of Financial Statements*, issued in 1989 (*Framework*), with a reference to the *Conceptual Framework for Financial Reporting* issued in March 2018 (2018 *Conceptual Framework*) without significantly changing its requirements.

The Board also added an exception to the recognition principle of IFRS 3 to avoid the issue of potential 'day 2' gains or losses arising 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.

At the same time, the Board decided to clarify existing guidance in IFRS 3 for contingent assets that would not be affected by replacing the reference to the *Framework*.

The amendments are effective for annual reporting periods beginning on or after 1 January 2022 and apply prospectively. Earlier application is permitted if, at the same time or earlier, an entity also applies all of the amendments contained in the *Amendments to References to the Conceptual Framework in IFRS Standards* (March 2018), which was issued at the same time as the 2018 *Conceptual Framework*.

Building a better working world

Recognition exception for liabilities and contingent liabilities within the scope of IAS 37 or IFRIC 21

The recognition principle in IFRS 3 specifies that the assets and liabilities recognised in a business combination must meet the respective definitions of assets and liabilities in the *Framework*, although, after the acquisition date, an acquirer accounts for most types of assets and liabilities recognised in a business combination in accordance with other IFRS standards applicable to those items.

When the Board issued the 2018 *Conceptual Framework*, it also updated most of the existing *Framework* references to the 2018 *Conceptual Framework* in IFRS standards. However, it did not update the reference in IFRS 3, because it was concerned that doing so without changing any other requirements in IFRS 3 could have unintended consequences.

In particular, the changes to the definitions of assets and liabilities in the 2018 *Conceptual Framework* could increase the population of assets and liabilities recognised in a business combination. This could give rise to 'day 2' gains or losses, when some of these assets or liabilities might not qualify for recognition under other applicable IFRS standards that are applied subsequent to the acquistion date.

The Board analysed the possible unintended consequences and concluded that the problem of 'day 2' gains or losses may only be significant in practice for liabilities accounted for after the acquisition date by applying IAS 37 or IFRIC 21. To avoid this problem, the Board decided to add an exception to the recognition principle in IFRS 3.

By applying the definition of a liability in the 2018 *Conceptual Framework*, an acquirer might recognise a liability at the acquisition date that would not be recognised subsequently under IFRIC 21. A 'day 2' gain would be recognised immediately after the acquisition date. This is due to the requirements of IFRIC 21 where an entity recognises a liability for a levy only when it conducts the activity that triggers payment of the levy. Whereas when applying the 2018 *Conceptual Framework*, an entity recognises a liability when it conducts an earlier activity, if:

a. Conducting that earlier activity means it may have to pay a levy that it would not otherwise have had to pay

   And

b. It has no practical ability to avoid the later activity that will trigger payment of the levy

This recognised 'day 2' gain would not be an economic gain, so would not faithfully represent any aspect of the entity's financial performance.

Further, IFRIC 21 is an interpretation of IAS 37. Therefore, the problem of 'day 2' gains could also arise for other obligations within the scope of IAS 37 that are conditional on a future activity of the entity. To avoid this problem, IFRS 3 was amended to include an exception from the requirements of paragraph 11 of IFRS 3 for liabilities and contingent liabilities that would be within the scope of IAS 37 or IFRIC 21, if these are incurred separately, rather than assumed in a business combination. The exception requires entities to apply the criteria in IAS 37 or IFRIC 21, respectively, to determine whether a present obligation exists at the acquisition date. The exception refers to both IFRIC 21 and IAS 37 as IFRIC 21 also applies to levies whose timing and amount are certain and so are outside the scope of IAS 37.

Clarification of the guidance for contingent assets

IFRS 3 prohibits the recognition of contingent assets acquired in a business combination. This prohibition was not, however, explicitly stated in IFRS 3, although it could be inferred from the IFRS 3 recognition principle, and is discussed in paragraph BC276 of the *Basis for Conclusion* (the *Basis*) to the standard.

The Board, therefore, decided to add a new paragraph to IFRS 3 to clarify that contingent assets do not qualify for recognition at the acquisition date. This new paragraph was added under the 'Exceptions to the recognition principle' section of the standard, as the Board thought that it would be clearer if the requirements for recognising contingent liabilities and contingent assets were in the same place. The *Basis* has also been amended to explain the Board's rationale.

Transition and effective date

The amendments to IFRS 3 are required to be applied to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2022. Earlier application is permitted if, at the same time or earlier, an entity also applies all of the amendments contained in the *Amendments to References to the Conceptual Framework in IFRS Standards* (March 2018), which was issued at the same time as the 2018 *Conceptual Framework*.

How we see it

We agree with the amendments to IFRS 3 and we believe that they will help to promote consistency in financial reporting.

The amendments will avoid potential confusion from having more than one version of the *Conceptual Framework* in use and address some of the issues that such alignment may have caused.

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ED None