

Draft Endorsement Advice – Reference to the Conceptual Framework (Amendments to IFRS 3)

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[dd month] 2020

Dear Mr Berrigan

Endorsement of Reference to the Conceptual Framework (Amendments to IFRS 3)

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on Reference to the Conceptual Framework (Amendments to IFRS 3) ('the Amendments'), which were issued by the IASB on 14 May 2020. An Exposure Draft of the Amendments was issued on 30 May 2019. EFRAG provided its comment letter on that Exposure Draft on 24 September 2020.

The objectives of the Amendments are to:

- Update IFRS 3 *Business Combinations* so it refers to the 2018 Conceptual Framework instead of the 1989 Framework in a manner that avoids unintended consequences, such as Day 2 gains or losses.
- Clarify aspects of IFRS 3.

The Amendments shall 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 the amendments made by *Amendments to References to the Conceptual Framework in IFRS Standards*, issued in March 2018. A description is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship and raised no issues regarding prudent accounting lead to prudent accounting and is not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship and raised no issues regarding prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS Standards. Therefore, EFRAG has concluded that the

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Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

In EFRAG's assessment of whether the Amendments would be conducive to the European public good, EFRAG has assessed whether the Amendments would improve financial reporting, would reach an acceptable cost-benefit trade-off, and whether the Amendments could affect economic growth.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, raises no issues regarding prudent accounting, and they are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

- 1 In March 2018, the revised *Conceptual Framework for Financial Reporting* ('the 2018 Conceptual Framework') was issued. At the same time, the IASB issued *Amendments to References to the Conceptual Framework in IFRS Standards*. This resulted in updating some of the references and quotations in IFRS Standards and Interpretations so that they refer to the 2018 Conceptual Framework or specify the version of the Conceptual Framework to which they refer.
- 2 Some references in IFRS Standards were not updated to refer to the 2018 Conceptual Framework. These include references that specify what material the IFRS Interpretations Committee (or its predecessors) used when interpreting particular requirements in IFRS Standards. In those cases, it is specified which version of the Conceptual Framework was used to support a particular interpretation made in the past.
- 3 In addition, the reference to the previous *Framework for the Preparation and Presentation of Financial Statements* ('the Framework') in paragraph 11 of IFRS 3 was not updated¹. Updating the reference in IFRS 3 to the revised Conceptual Framework would in some cases have resulted in entities reporting a gain or a loss without any change in the underlying economic realities. This would happen as IFRS 3 requires an acquirer to recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. 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 Conceptual Framework to which IFRS 3 paragraph 11 refers. The definitions of an asset and a liability in the 2018 Conceptual Framework is different from the definitions included in the Framework. Accordingly, the 2018 Conceptual Framework could result in additional assets or liabilities being recognised in a business combination. After the initial recognition these assets and liabilities would have to be accounted for in accordance with the IFRS Standards applicable for the specific type of assets and liabilities. In some such cases, the post-acquisition accounting required by other IFRS Standards could then lead to immediate derecognition of the assets or liabilities initially recognised. This would result in a so-called 'Day 2' gain or loss.

The issues and how they have been addressed

- 4 Maintaining the reference to the Framework in paragraph 11 of IFRS 3 means that more than one version of the Conceptual Framework would be in use. This could create confusion and would not promote consistency in financial reporting.
- 5 The Amendments accordingly replace the reference to the Framework in paragraph 11 of IFRS 3 with a reference to the 2018 Conceptual Framework. The Amendments address the issue with the Day 2 gain or loss described above in paragraph 3 by adding a further exception to the recognition principle in IFRS 3 for liabilities and contingent liabilities that would be within the scope of IAS 37 or IFRIC 21 if incurred separately, rather than assumed in a business combination. The exception requires an entity to apply the criteria in IAS 37 or IFRIC 21 respectively, in order to determine whether a present obligation exists at the acquisition date.

¹ In addition, it was required to use of a previous version of the Conceptual Framework when developing an accounting policy for specified assets (regulatory deferral accounts) which are not covered by an (endorsed) Standard.

- 6 The purpose of these amendments is thus to update the reference in paragraph 11 of IFRS 3 to the 2018 Conceptual Framework without this having any accounting consequences.
- 7 In addition, the Amendments clarify the requirements for contingent assets. IFRS 3 prohibits the recognition of contingent assets acquired in a business combination. This prohibition, however, only appears explicitly in paragraph BC276 of the Basis for Conclusions accompanying IFRS 3. The Amendments make the requirements for contingent assets explicit².

What has changed?

- 8 As mentioned above, the reference to the Framework in paragraph 11 of IFRS 3 is updated to refer to the 2018 Conceptual Framework.
- 9 An additional exception to the general recognition principle is then added, which states that for a provision or contingent liability that would be within the scope of IAS 37 if it was incurred separately rather than assumed in a business combination, the acquirer shall apply IAS 37 to determine whether at the acquisition date a present obligation exists as a result of past events. For a levy that would be within the scope of IFRIC 21 if it was incurred separately rather than assumed in a business combination, the acquirer shall apply IFRIC 21 to determine whether the obligating event that gives rise to a liability to pay the levy has occurred by the acquisition date.
- 10 Finally, it is stated explicitly that an acquirer shall not recognise a contingent asset at the acquisition date (in the current version of IFRS 3 this appears explicitly only in paragraph BC276 of the Basis for Conclusions accompanying the standard).

When do the Amendments become effective?

- 11 The Amendments shall 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 the amendments made by *Amendments to References to the Conceptual Framework in IFRS Standards*, issued in March 2018.

² The Amendments also delete a paragraph in the Basis for Conclusions accompanying IFRS 3.

Appendix 2: EFRAG's technical assessment on the Amendments against the endorsement criteria

Notes to Constituents:

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments. In it, EFRAG assesses how the Amendments satisfy the technical criteria set out in the Regulation (EC) No 1606/2002 for the adoption of international accounting standards. It provides a detailed evaluation for the criteria of relevance, reliability, comparability and understandability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether the Amendments leads to prudent accounting and finally considers whether the Amendments would not be contrary to the true and fair view principle.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS Standards in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS Standard or Interpretation against the technical criteria for European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRS Standards or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

- 1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (The IAS Regulation), in other words that the Amendments:
 - (a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (The Accounting Directive); and
 - (b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.
- 2 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.
- 3 The IAS Regulation further clarifies that 'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council

Directives without implying a strict conformity with each and every provision of this Directive' (Recital 9 of the IAS Regulation).

- 4 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.
- 5 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.
- 6 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether it meets all other technical criteria and whether they lead to prudent accounting:
 - (a) relevance: paragraphs 7-14;
 - (b) reliability: paragraphs 15-21;
 - (c) comparability: paragraphs 22-26;
 - (d) understandability: paragraphs 27-29;
 - (e) whether overall they lead(s) to prudent accounting: paragraphs 30-31; and
 - (f) whether they would not be contrary to the true and fair view principle: paragraphs 32-34.

Relevance

- 7 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.
- 8 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.
- 9 EFRAG notes that changing the reference to the Framework in paragraph 11 of IFRS 3 to the 2018 Conceptual Framework could result in "Day 2" gains or losses due to subsequent measurement of some liabilities (see paragraph 3 of Appendix 1).
- 10 EFRAG assesses that a Day 2 gain and losses would result in information that has neither predictive nor confirmatory value as they would not reflect any economic gain or loss. The information would therefore also not be useful for assessing the management's stewardship.
- 11 According to the Basis for Conclusions accompanying the Amendments, the problem of Day 2 gains or losses that would result from updating the reference in paragraph 11 of IFRS 3 to the 2018 Conceptual Framework would be significant in practice only for liabilities that an acquirer accounts for after the acquisition date by applying IAS 37 or IFRIC 21. To avoid Day 2 gains or losses as a result of updating the reference in paragraph 11 of IFRS 3, the Amendments include an exception to the general guidance that the liabilities assumed meeting the definition of a liability in the 2018 Conceptual Framework should be recognised by the acquirer as of the acquisition date. The Amendments thus require that the acquirer shall apply the guidance in IAS 37 (paragraphs 15-22) to determine whether at the acquisition date a present obligation exists as a result of past events. For a levy that would be within the scope of IFRIC 21, the acquirer shall apply IFRIC 21 to determine whether the obligating event that gives rise to a liability to pay the levy has occurred by the acquisition date.

- 12 Similar, to the evaluation included in the Basis for Conclusions accompanying the Amendments, EFRAG assesses that although Day 2 gains or losses in theory—and depending on how the definitions of an asset was interpreted under the Framework—could result from the Amendments in a few other cases, in practice it would be significant only for liabilities that would have to be accounted for after the acquisition date by applying IAS 37 or IFRIC 21.
- 13 EFRAG also assesses that the additional exception explained in paragraph 11 above would solve the issue with liabilities that would have to be accounted for after the acquisition date by applying IAS 37 or IFRIC 21.
- 14 EFRAG accordingly assesses that the Amendments would not result in information that could impede the relevance of information provided in IFRS financial statements. Therefore, EFRAG assesses that the Amendments would satisfy the relevance criterion.

Reliability

- 15 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.
- 16 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.
- 17 As noted above in paragraph 8, updating the reference in paragraph 11 of IFRS 3 to the 2018 Conceptual Framework could have resulted in Day 2 gains or losses. Such gains or losses would not reflect any economic gain or loss and would thus not result in a faithful representation. However, as noted in paragraphs 12-13 above, EFRAG assesses that updating the reference to the 2018 Conceptual Framework together with the additional exception to the general recognition guidance in IFRS 3 will result in Day 2 gains or losses not being a significant problem in practice. EFRAG therefore assesses that the Amendments will not impede the reliability of the information provided.
- 18 On the contrary, EFRAG assesses that updating the reference in paragraph 11 of IFRS 3 to the 2018 Conceptual Framework could be beneficial and enhance the reliability of the information provided. It would provide clarity of the Standards to refer to one version only of the Conceptual Framework (the most recent version approved by the IASB). Updating the reference EFRAG, could thus prevent the confusion that could otherwise result from having more than one version of the Conceptual Framework in use.
- 19 Such confusion could have led to errors. The Amendments thus enhances reliability in this respect.
- 20 This is also the case with the clarification that an acquirer should not recognise contingent assets acquired in a business combination. This clarification could similarly reduce the chances of errors and could accordingly enhance reliability.
- 21 EFRAG's overall assessment is therefore that the Amendments would satisfy the reliability criterion.

Comparability

- 22 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.
- 23 EFRAG has considered whether the Amendments result in transactions that are:

- (a) economically similar being accounted for differently; or
 - (b) transactions that are economically different being accounted for as if they are similar.
- 24 Generally, EFRAG assesses that updating and aligning references in IFRS Standards to the same Conceptual Framework—in this case the 2018 Conceptual—promotes consistency in financial reporting. Having only one version of the Conceptual Framework in use would promote that economically similar transactions being accounted for similarly and that transactions that are economically different being accounted for as if they are different.
- 25 In addition, the clarification included in the Amendments that an acquirer should not recognise contingent assets acquired in a business combination, would promote the consistency between entities by removing any diversity in practice, in how they account for a business combination.
- 26 EFRAG’s overall assessment is therefore that the Amendments satisfy the comparability criterion.

Understandability

- 27 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.
- 28 Although there are a number of aspects related to the notion of ‘understandability’, EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.
- 29 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex. In this regard, EFRAG notes that the information resulting from the Amendments would be unchanged from the information currently provided. Accordingly, in EFRAG’s view, the Amendments do not introduce any new complexity that may impair understandability. Therefore, EFRAG’s overall assessment is that the Amendments satisfy the understandability criterion in all material respects.

Prudence

- 30 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.
- 31 The Amendments do not significantly affect recognition and measurement of assets and liabilities recognised in a business combination, compared to the current requirements. EFRAG has therefore concluded that they raise no issues in relation to prudence as defined above.

True and Fair View Principle

- 32 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:
- (a) does not lead to unavoidable distortions or significant omissions in the representation of that entity’s assets, liabilities, financial position and profit or loss; and
 - (b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity’s assets, liabilities, financial position and profit or loss.

- 33 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS Standards. In particular, the Amendments would not introduce any significant Day 2 gains or losses. Accordingly, EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.
- 34 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

- 35 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

- 1 EFRAG considered whether it would be conducive to the European public good to endorse the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:
 - (a) Whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS Standards as a whole;
 - (b) The costs and benefits associated with the Amendments; and
 - (c) Whether the Amendments could have an adverse effect to the European economy, including financial stability and economic growth.
- 2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

- 3 EFRAG notes that the Amendments are designed to:
 - (a) Update and align the references to the *Conceptual Framework* in Standards to promote consistency in financial reporting and avoid the confusion that could result from having more than one version of the *Conceptual Framework* in use.
 - (b) Clarify current guidance.
- 4 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's initial analysis of the costs and benefits of the Amendments

- 5 EFRAG first considered the extent of the work to be undertaken for assessing costs and benefits. For some Standards or Interpretations, it might be necessary to carry out some extensive work, in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.
- 6 The approach EFRAG has adopted in this case is thus to provide its initial analysis of the costs and benefits of the Amendments and to consult on the results of those initial assessments, and to finalise its assessment in light of the comments received.

Cost for preparers

- 7 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.
- 8 EFRAG assesses that there would be some one-off costs related to familiarisation with the new requirements. Although EFRAG assesses that the Amendments will not result in any significant change in accounting practice, entities will need to assess whether this will be the case and there would accordingly be some one-off costs related to this activity and related activities such as changing accounting policy

documentation. EFRAG assesses that these costs will be low. In this regard, EFRAG notes that the Amendments should not be applied to previous business combinations.

- 9 EFRAG assesses that there would be some ongoing costs savings from updating the reference in paragraph 11 of IFRS 3 to the 2018 Conceptual Framework. These cost savings occur from only having one version of the Conceptual Framework in use.
- 10 Overall, EFRAG's assessment is accordingly that the Amendments are likely to result in moderate cost savings for preparers over time.

Costs for users

- 11 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.
- 12 EFRAG assesses that the Amendments will not have any significant impact on financial statements. Accordingly, EFRAG's assessment is that implementation of the Amendments will not result in increased costs to users; that is, it is likely to be cost neutral.

Benefits for preparers and users

- 13 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.
- 14 As noted in paragraph 9 above, EFRAG assesses that preparers are likely benefit from only having one version of the Conceptual Framework in use. In addition, preparers are likely to benefit from the clearer guidance resulting from making explicit that an acquirer should not recognise contingent assets acquired in a business combination.
- 15 Overall, EFRAG's assessment is that users are likely to benefit from the Amendments as the Amendments would enhance reliability and comparability of information as described above in Appendix 2 and therefore will enhance their analysis.

Conclusion on the costs and benefits of the Amendments

- 16 EFRAG's overall assessment is that the overall benefits for users and preparers related to only having one version of the Conceptual Framework in use and having explicit guidance on contingent assets acquired in a business combination would outweigh the one-off costs for preparers explained in paragraph 8 above.

Conclusion

- 17 EFRAG believes that the Amendments will generally bring improved financial reporting when compared to having different versions of the Conceptual Framework in use. As such, their endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.
- 18 EFRAG has not identified any adverse effect to the European economy, including financial stability and economic growth that could result from the Amendments.
- 19 Furthermore, EFRAG has not identified any other factors that would mean endorsement is not conducive to the public good.
- 20 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that endorsing the Amendments is conducive to the European public good.