Draft Comment Letter

You can submit your comments on EFRAG's draft comment letter by using the '[Express your views]' page on EFRAG's website, then open the relevant news item and click on the 'Comment publication' link at the end of the news item.

Comments should be submitted by [date].

International Accounting Standards Board
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

[XX Month 201X]

Dear Mr Hoogervorst,

Re: Exposure Draft *Reference to the* Conceptual Framework *(Proposed amendments to IFRS 3)*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Reference to the* Conceptual Framework *(Proposed amendments to IFRS 3),* issued by the IASB on 30 May 2019 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

EFRAG agrees with the proposals in the ED.

EFRAG's detailed comments and responses to the questions in the ED are set out in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact Rasmus Sommer or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix - EFRAG's responses to the questions raised in the ED

Notes to constituents – Summary of proposals in the ED

1 *IFRS 3* Business Combinations *states in paragraph 11:*

> *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 Framework for the Preparation and Presentation of Financial Statements at the acquisition date.*

2 *When issuing the revised* Conceptual Framework for Financial Reporting *in March 2018 (the '*2018 Conceptual Framework'*), the IASB updated many of the references to the* Conceptual Framework *in IFRS Standards to the revised* Conceptual Framework*. However, the reference to '*Framework for Preparation and Presentation of Financial Statements*' in paragraph 11 of IFRS 3 was not updated as the IASB was concerned this could result in unintended consequences.*

3 *In previous versions of the* Conceptual Framework*, a liability was defined as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits". The* 2018 Conceptual Framework *defines a liability as "a present obligation of the entity to transfer an economic resource as a result of past events". In the supporting guidance it is mentioned that an obligation is a duty or responsibility that an entity has no practical ability to avoid.*

4 *IFRIC 21* Levies *was not considered to be incompatible with the definition of a liability in the previous version of the Conceptual Framework. However, the definition of a liability in the 2018* Conceptual Framework *would in some cases result in levies being recognised earlier than under IFRIC 21. Under IFRIC 21, a liability should not be recognised for a levy that would be calculated by reference to its past activities if the obligation to pay remains conditional on a future activity – even if the entity has no practical ability to avoid that future activity. These requirements are thus not consistent with the guidance included in the* 2018 Conceptual Framework. *Accordingly if paragraph 11 of IFRS 3 is amended to refer to the* 2018 Conceptual Framework, *an entity might have to recognise a liability in relation to a levy in a business combination but would have to derecognise this on day 2 (resulting in an unintended day 2 gain) as the levy cannot be recognised according to IFRIC 21 which should be used when subsequently accounting for the levy. As IFRIC 21 is an interpretation of IAS 37* Provisions, Contingent Liabilities and Contingent Assets*, this issue could also arise for other obligations within the scope of IAS 37 that are conditional on an entity's future actions.*

5 *To resolve this issue, the IASB is proposing to:*

(a) *Update the reference in IFRS 3 so that it refers to the* 2018 Conceptual Framework*.*

(b) *Specify in IFRS 3 that levies within the scope of IFRIC 21 and other obligations within the scope of IAS 37 should be recognised on the acquisition of a business only if they would be identified as present obligations by an entity applying IFRIC 21 or IAS 37.*

6 *In addition, the IASB has tentatively decided to clarify that in applying the IFRS 3 recognition principle, an acquirer does not recognise contingent assets.*

Question 1

The IASB proposes to:

(a) Update IFRS 3 so it refers to the 2018 *Conceptual Framework* instead of the 1989 *Framework*.

(b) 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 should apply IAS 37 or IFRIC 21 respectively, instead of the *Conceptual Framework*, to identify the obligations it has assumed in a business combination.

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

Do you agree with these proposals? If not, why not, and what do you recommend instead?

EFRAG's response

EFRAG agrees with the proposals.

Updating IFRS 3 to refer to the 2018 Conceptual Framework

7 EFRAG supports updating IFRS 3 so that it refers to the 2018 *Conceptual Framework* instead of the 1989 *Framework*. If the reference is not updated, there would have to be two conceptual frameworks (the 2018 *Conceptual Framework* and the 1989 Framework) in issue. This would be confusing.

Adding an exception to the IFRS 3 recognition principle

8 EFRAG has considered whether the primary objective of the project of updating the reference in IFRS 3 to the 2018 *Conceptual Framework* should be to:

(a) Change the reference in IFRS 3 to the 2018 *Conceptual Framework* in a manner that would not have any unintended consequences to avoid having two conceptual frameworks in issue; or

(b) Provide more useful information in the financial statements.

9 EFRAG is of the view that the primary objective of this particular project should be to change the reference in IFRS 3 to the 2018 *Conceptual Framework* in a manner that would not have any unintended consequences. However, if it would be possible to also have more useful information in the financial statements without compromising the primary objective, that opportunity should not be missed.

10 The proposals in the ED to require an acquirer to apply IAS 37 or IFRIC 21, instead of the 2018 *Conceptual Framework*, to identify the obligations it has assumed in a business combination, would meet the primary objective. This is because it is unlikely to result in any changes in accounting. This, however, also means that the proposals would not result in more useful information.

11 EFRAG considers that more useful information could be provided if liabilities in certain circumstances are recognised earlier than under the current Standards. EFRAG has previously considered that the IFRIC 21 interpretation of IAS 37 results in a liability, under certain circumstances, is identified too late. This is because under IFRIC 21, the obligating event that gives rise to a liability is the activity that triggers the payment of the levy. For example, a coal fired power plant might have to pay a levy on 31/3 20X1, if it has been operating in the first month of 20X1, based on the amount of CO_2 it has emitted in 20X0. Under IFRIC 21, there would not be a liability for the amount of CO_2 emitted in 20X0 on 31/12 20X0, as the triggering event would

be that the plant has been operating in the first part of 20X1. EFRAG considers that it would result in more useful information if a liability is identified as of 31/12 20X0 if the entity has no practical ability to avoid paying the levy arising from its emission in 20X0.

12 The IASB seems to have a similar view. When revising the *Conceptual Framework*, the IASB specifically stated that the interpretation of IAS 37 included in IFRIC 21 results in excluding "information that many users of financial statements would find useful" (paragraph BC4.52 of the 2018 *Conceptual Framework*).

13 When the IASB revised the *Conceptual Framework*, the IASB therefore thought it would result in more useful information to consider that a present obligation to transfer an economic resource has arisen when an entity has no practical ability to avoid the future transfer.

14 The alternatives to the proposals in the ED, that would both result in an update of the reference in IFRS 3 in a manner that would not result in a day 2 gain and result in liabilities being identified when an entity has no practical ability to avoid the future transfer, would therefore be to:

(a) Amend the requirements in IAS 37 for identifying liabilities (including the requirements in IFRIC 21) to align these requirements with the 2018 *Conceptual Framework* guidance on the definition of a liability; or

(b) Include additional requirements in IFRS 3 for the subsequent measurement of liabilities accounted for after the acquisition date by applying IAS 37 or IFRIC 21.

15 The solution mentioned in paragraph 14(a) would introduce the improvement for the relevant liabilities no matter how they have arisen. However, it would take some time to amend IAS 37 and during that time the IASB would not be able to withdraw the 1989 *Framework* as the reference in paragraph 11 of IFRS 3 to the *Conceptual Framework* could not be updated without resulting in unintended consequences. Accordingly, there would have to be two conceptual frameworks in issue (for some time) and EFRAG would therefore not support such an approach.

16 The solution mentioned in paragraph 14(b) would only introduce the improvement for the relevant duties and responsibilities that are transferred to an entity as part of a business combination. This would result in some duties and responsibilities being accounted for differently depending on whether they are assumed in a business combination or not. In the first case they could be identified as liabilities while they would not be so in the latter case. This would reduce comparability. Nevertheless, it would result in more relevant information for the obligations assumed in a business combination. Because relevance is a fundamental qualitative characteristics and comparability is "only" an enhancing qualitative characteristics, EFRAG assesses that the solution mentioned in paragraph 14(b) would result in more useful information.

17 However, the Basis for Conclusions accompanying the ED notes that an approach such as the one described in paragraph 14(b) would require more time and resources than the approach suggested in the ED. It also notes that there may be calls for further requirements to help entities apply the new liability definition and supporting concepts consistently.

18 EFRAG agrees that there may be calls for further requirements to help entities apply the new liability definition and supporting concepts consistently. EFRAG has thus observed that the guidance supporting the definition of a liability in the 2018 *Conceptual Framework* is interpreted differently. In order to avoid divergence in practice and unnecessary discussions in the future on how to interpret the guidance, it would be necessary for the IASB to clarify the guidance. This could take time and

the solution mentioned in paragraph 14(b) would therefore in the short term result in the objective mentioned in paragraph 8(a) not being met.

19 EFRAG therefore assesses that it would not be possible in the short term to meet both objectives stated in paragraph 8 above. That is, it would not be possible to both update the reference in IFRS 3 in a manner that would not result in a day 2 gain and have liabilities being identified when an entity has no practical ability to avoid the future transfer.

20 EFRAG accordingly considers that in the short term it would only be possible to update the reference in IFRS 3 in a manner that would not result in any (new) unintended consequences. EFRAG assesses that the proposals in the ED would meet that objective, and EFRAG therefore agrees with the proposals.

Adding an explicit statement that an acquirer should not recognise contingent assets acquired in a business combination

21 EFRAG supports adding an explicit statement that an acquirer should not recognise contingent assets acquired in a business combination. Such a statement could clarify the Standard and hence reduce diversity in practice.

Notes to constituents – Transition and early application

22 *The ED proposes that an entity shall apply the amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after the effective date. 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.*

Question 2

Do you have any other comments on the proposals in this Exposure Draft?

EFRAG's response

If the final standard resulting from the ED is issued after 1 January 2020, EFRAG does not think that early application should only be 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.

23 The ED proposes that the changes made to IFRS 3 can be applied earlier than the effective date (to be decided) 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*. These latter amendments are effective for annual reporting periods beginning on or after 1 January 2020. Accordingly, if the amendments resulting from the ED are issued after 1 January 2020, the conditions could only be relevant if a jurisdiction would not have endorsed *Amendments to References to the* Conceptual Framework *in IFRS Standards* or would have chosen another effective date for these amendments than 1 January 2020. In those cases, EFRAG would, however, consider that the application of the amendments resulting from the ED would enhance international comparability of financial statements. Early application should therefore not be prohibited in those cases.

Question to EFRAG TEG

24 EFRAG TEG has previously discussed its answer to Question 1. Does EFRAG TEG agree with how the response has been drafted?

25 EFRAG TEG has not previously discussed its answer to Question 2. Does EFRAG TEG agree with the drafted response? Does EFRAG TEG want additional issues to be included in its answer to Question 2?

26 Does EFRAG TEG agree with the drafting of the cover letter of the initial draft comment letter?