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Insights into PFRS 3

Specific recognition and measurement provisions

Mergers and acquisitions (business combinations) can have a fundamental impact on the acquirer's operations, resources and strategies. For most entities such transactions are infrequent, and each is unique. PFRS 3, *Business Combinations*, sets out the accounting requirements for these transactions, which can be challenging to apply in practice. The standard itself has been in place for more than ten years now and has undergone a post implementation review by the International Accounting Standards Board (IASB). It is one of the most referred to Standards currently on issue.

Our 'Insights into PFRS 3' series summarises the key areas of the standard, highlighting aspects that are more difficult to interpret and revisiting the most relevant features that could impact your business.

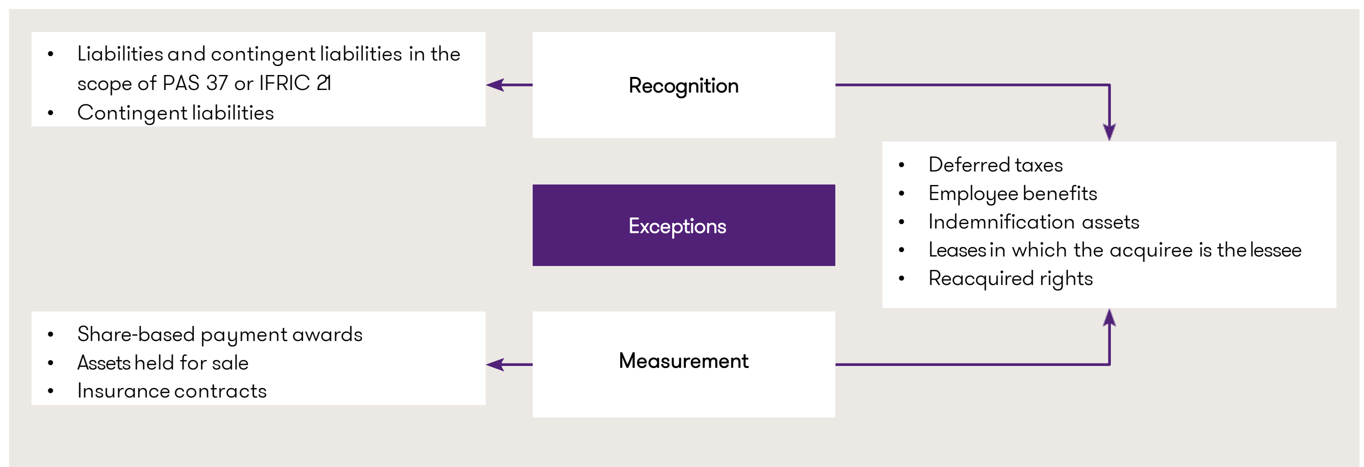
PFRS 3 has specific guidance on how some items are recognized and measured. This guidance is described as a series of exceptions to the general recognition and measurement principles (as discussed in our articles '<u>Insights into PFRS 3 – Recognition principle</u>' and '<u>Insights into PFRS 3 – How should the identifiable assets and liabilities be measured?</u>' respectively).

This article summarises this specific guidance and provides examples to illustrate its application.

Identifiable assets and liabilities subject to specific PFRS 3 guidance (exceptions)

Under PFRS 3, the general recognition principle is that the identifiable assets acquired and liabilities assumed should meet the definition of assets and liabilities in accordance with the 2018 issued Conceptual Framework for Financial Reporting (Conceptual Framework) at the acquisition date. However, some recognition and measurement exceptions have been included for particular types of assets acquired and liabilities assumed.

The diagram below summarises those assets and liabilities covered by PFRS 3's limited exceptions:



The specific recognition and measurement requirements for the above items are presented in the following pages of this article.

Recognition exceptions

Liabilities and contingent liabilities in the scope of PAS 37 or IFRIC 21

This exception applies to liabilities and contingent liabilities that would be in the scope of PAS 37, *Provisions, Contingent Liabilities and Contingent Assets* or IFRIC 21, *Levies*, as if they were incurred separately rather than part of the business combination. This has been included because PFRS 3 refers to the definition of liability in the new Conceptual Framework, which, if applied at the date of acquisition, could create a day 2 gain (see note below). Accordingly:

- for a provision or contingent liability that would be within the scope of PAS 37, the acquirer applies PAS 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, the acquirer applies IFRIC 21 to determine whether the obligating event that gives rise to a liability to pay the levy has occurred by the acquisition date.
- if the present obligation then identified meets the definition of a contingent liability, then the contingent liabilities recognition exception applies.

This exception applies from 1 January 2022, although it can be adopted early if at the same time (or earlier) an entity also applies all the amendments to PFRS standards resulted from 'Amendments to References to the Conceptual Framework' issued in March 2018.

Note: For example, applying the definition of a liability in the Conceptual Framework and not IFRIC 21 may result in recognising (at the acquisition date) a liability to pay a levy that would not be recognised subsequently when applying IFRIC 21 (which would have created a day 2 gain). Applying IFRIC 21, an entity recognises a liability to pay a levy only when it conducts the activity that triggers the payment of the levy, whereas applying the Conceptual Framework, an entity recognises a liability when it conducts an earlier activity.

Contingent liabilities

A contingent liability assumed in a business combination is recognised at the acquisition date:

- only if it is a present obligation that arises from past events and its fair value can be measured reliably, and
- even if an outflow of economic benefits is not probable (uncertainty is considered in the determination of fair value).

Other contingent liabilities are not recognised.

NB: Contingent assets acquired in a business combination are not recognised.

Example 1– Possible obligation arising from a lawsuit

Entity X purchased 100% of Entity Y. Entity Y is being sued over an alleged breach of a brand licensing agreement. As of the acquisition date, Entity Y's management denies the breach and believes that the claim is unjustified. This is consistent with the view of its legal advisers which indicated that there is only a small chance (of approximately 10%) that a court of law would uphold the claim.

Analysis

This is an example of a 'possible obligation'. Entity Y assesses that it has no present obligation at the acquisition date as the available evidence indicates that the alleged breach did not happen. Accordingly, Entity X does not record a separate liability for the lawsuit.

Example 2 – Liability arising from a lawsuit

Entity A purchased 100% interest of Entity B. Entity B is being sued over a personal injury allegedly caused by a faulty product. The claimant is suing for CU1 million in damages. The acquiree's management acknowledge that the product was faulty and may have caused injury. However, they strongly dispute the level of damages being claimed. The entity has concluded there is a low probability of paying the full CU1 million of damages, and the legal experts assessed the risk of cash outflows to be between 10% and 25%.

Analysis

Based on the available evidence, this is an example of a present obligation, which is consequently recognised as a contingent liability and measured at fair value. Entity A will need to estimate the fair value of the liability which may involve weighting possible outcomes within the expected range using their associated probabilities (expected value approach). On the basis of the above fact pattern, the fair value of such an obligation would therefore be estimated between CU100,000 and CU250,000.

Measurement exceptions

Share-based payment awards

Measured in accordance with PFRS 2, *Share-based Payment*, which refers to there being a market-based measure. This means vesting conditions, such as service conditions and performance conditions (but other than market conditions), should not be taken into account when estimating the 'fair value' of the shares or share options granted as part of the award.

Insurance contracts (exception applicable to business combinations with an acquisition date after the earlier of when PFRS 17 is first applied or 1 January 2023)

A group of contracts within the scope of PFRS 17, *Insurance Contracts*, acquired in a business combination, and any assets for insurance acquisition cash flows as defined in PFRS 17, is measured as a liability or asset in accordance with PFRS 17 at the acquisition date.

Assets held for sale

Measured at fair value less costs to sell in accordance with PFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.

Note: A non-current asset (or disposal group) is classified as held for sale at the acquisition date only if the sale is expected to be completed within one year from the acquisition, and it is highly probable that any other criteria not met at the acquisition date will be met within a short period following the acquisition (usually within three months). The other criteria being (i) the asset is available for immediate sale in its present condition, (ii) the appropriate level of management is committed to a plan to sell the asset, and (iii) an active programme to locate a buyer and complete the plan has been initiated.

Recognition and measurement exceptions

Deferred taxes

Deferred tax balances are recognised if related to temporary differences and loss carry-forwards at the acquisition date of the acquiree or if they arise as a result of the acquisition. They are measured in accordance with PAS 12, *Income Taxes*. Refer to more details on page 8.

Leases in which the acquiree is the lessee

For leases where the acquiree is the lessee, the acquirer recognises right-of-use assets and lease liabilities in accordance with PFRS 16, *Leases*.

The acquirer is not required to recognise right-of-use assets and lease liabilities for leases for which:

- the lease term as defined in PFRS16 is less than 12 months from the acquisition date (short-term lease), or
- the underlying asset is of low value (low value lease).

The lease liability is measured at the present value of the remaining lease payments as if the acquired lease were a new lease at the acquisition date. The right-of-use asset is measured at an amount equal to the related lease liability, but adjusted to reflect favourable or unfavourable terms of the lease compared to market terms.

Indemnification assets

Indemnification assets are assets arising from the acquiree's former owners contractually indemnifying the acquirer for a particular uncertainty. The indemnification asset is measured and recognised on the same basis as the related/indemnified item (i.e., at the same time and for an amount that is measured consistently with how the indemnified item is measured), subject to the contractual provisions or any collectability considerations. If the indemnified item is not recognised as a contingent liability at the acquisition date because its fair value is not reliably measurable, then, no indemnification asset is recognised at that date.

Employee benefits

Employee benefits are recognised and measured in accordance with PAS 19, *Employee Benefits*.

Post-employment benefits and other long-term benefits are measured using actuarial assumptions as at the acquisition date. Those assumptions should be determined as at the acquisition date on the basis of the conditions existing at that date.

Any previous actuarial gains or losses recognised in other comprehensive income in the acquiree's statement of financial position before the business combination takes place are not part of the business combination and should not be carried forward post business combination.

Any net plan asset related to post-employment benefits and other long-term benefits recognised is limited to the extent that it will be available to either the acquirer or the acquiree, as the case may be, as refunds from the plan or a reduction of future contributions.

The effect of any settlement or curtailment is recognised in the measurement of the obligation only if it occurred before the acquisition date and if the decision to do a settlement or curtailment is not the decision of the acquirer. Any acquiree's curtailment/settlement initiated at the request of the acquirer before the business combination is completed should not be part of the combination. Alternatively, any amendment to the acquiree's post-employment benefit plan conditioned to the business combination is a post combination event that should affect the acquirer post combination financial statements. Even if it is expected that the acquiree's employees will benefit from the acquirer's post-employment plan as from the acquisition date, this should not be taken into account when measuring the acquiree's defined benefit obligation at the acquisition date.

Reacquired rights

Fair value is determined based on remaining contractual term of the related contract without attributing value to possible renewals. Refer to more details on page 7.

If the acquirer previously granted a right to the acquiree to use the acquirer's intellectual property or other asset (such as a trade name or licensed technology), a separate 'reacquired right' intangible asset is recognised even if the underlying asset was not previously reported.

Example 3 – Indemnification asset

Entity W acquires Entity X from Entity Y. The purchase price is CU1,000. Entity X has a contingent liability in respect of litigation with a third party. Entity Y agrees to reimburse Entity W on a euro for euro basis, any amount resulting from the outcome of the covered contingency, up to a maximum of CU100. Entity W's management concluded that this is a present obligation and the fair value of the liability at the acquisition date is determined to be CU45.

Analysis

In this situation, Entity W will recognise a contingent liability of CU45. Since the indemnification relates to a liability that is recognised at the acquisition date and measured at its fair value at that date, Entity W recognises an indemnification asset at the acquisition date and measures that asset at its fair value. Therefore, an indemnification asset is recognised for CU45, consistently with how the covered contingent liability has been measured and recognised less any valuation allowance if necessary.

PFRS 3's specific guidance for reacquired rights

Reacquired rights

In a business combination, the acquirer may reacquire a right it had previously granted to the acquiree to use an acquirer's asset. Such a reacquired right is an identifiable asset recognised separately, irrespective of whether the underlying asset was previously capitalised in the acquirer's financial statements. For example, the acquirer may have previously granted the acquiree the right to use its trade name or a license to use its technology. The business combination then results in the acquirer reacquiring this right, even if it continues in legal existence and will be used in the acquiree's business in the future.

Example 4 – Reacquired rights

Entity A is in the fast-food industry and has granted Entity B an exclusive 5-year license to operate franchised restaurants in a certain country. Entity B paid a fixed fee for this license.

A year later, Entity A acquires Entity B. On the acquisition date, Entity A determines that the license agreement reflects current market terms.

Analysis

With the business combination, Entity A now controls Entity B and effectively reacquires control of the rights conveyed by the license. Entity A recognises a separate intangible asset for this reacquired right as part of the business combination.

Example 5 – Reacquired rights

A franchisor acquires a franchisee where the franchisor has granted a licensing agreement to use the tradename of the franchisor for a contractual period of five years with options to renew the agreement.

Analysis

If a fair value approach were applied, market participants would generally reflect expected renewals of the term of the licensing agreement to the fair value of the right that is acquired and would take into account that expectation in determining the cashflows computed in the fair value.

In the case of a reacquired right (here the reacquired license), the potential renewal of the contractual term after the business combination is not part of what was acquired in the business combination and the reacquired right is considered as having a definite life. Therefore, determining the fair value of such a reacquired right should be consistent with how its useful life based on the remaining contractual term has been determined.

If the terms of the contract that gives rise to the reacquired right are either favourable or unfavourable compared to current market terms, the acquirer recognises a gain or loss on the acquisition date, separately from the business combination for the effective settlement of the pre-existing relationship. This latter aspect is discussed in our article 'Insights into PFRS 3 – Determining what is part of a business combination transaction'.

Recognising and measuring deferred taxes when applying PFRS 3

PFRS 3 requires deferred taxes in a business combination to be recognised in accordance with PAS 12. Items to be recognised and measured in accordance with PAS 12 are as follows:

- any deferred tax asset or liability arising from the assets acquired and liabilities assumed in the business combination, and
- potential tax effects of temporary differences, carry forwards and income tax uncertainties of the acquiree that exist at acquisition date or that arise as a result of the combination.

When applying the said requirements, the acquirer does not recognise the historical deferred tax balances recorded in the acquiree's own financial statements. Instead, a new acquisition-date exercise is performed to determine deferred tax balances to be recognised. This may require careful analysis and judgement, taking into account:

- the relevant tax laws in the jurisdiction(s) where the acquiree operates;
- the tax status of the acquiree;
- the nature of assets and liabilities recognised as part of the business combination;
- the specific tax rules that may give rise to differences between amounts recognised and the related tax bases; and,
- any tax losses carry forwards, uncertainties or other tax attributes of the acquiree.

The following table summarises the key steps in determining the appropriate deferred tax balances:

Step 1 – Determine the recognised amounts of the assets and liabilities	See above guidance and our articles '<u>Insights into PFRS 3 – Recognition principle</u>' and '<u>Insights into PFRS 3 – How should the identifiable assets and liabilities be measured?</u>'.
Step 2 – Identify the applicable tax bases, determine temporary differences and measure the deferred tax	Identify any deductible or taxable temporary differences, based on the recognised amounts of assets and liabilities in the business combination accounting, and their relevant tax bases. The specific application of the requirements will depend on the tax regime but we commonly observe that when a legal entity is acquired: • the tax bases normally reflect amounts attributed to the assets and liabilities for the purpose of the acquiree's tax filings • if an item is recognised in the business combination that was not previously recognised by the acquiree (such as some intangible assets), its tax base is often zero • for items that were recognised by the acquiree, the use of acquisition-date fair values changes the carrying amounts but will often not affect their tax bases. This creates new temporary differences or changes the amount of existing differences. Determine whether the business combination has affected the tax rate used in measuring the deferred tax. For example, if the business combination triggers an obligation for the acquiree to sell a particular asset, measuring the deferred tax at the date of the acquisition would require the acquirer to take into account the tax consequences of the disposal if different tax rates apply depending on how the carrying value of the asset is recovered.
Step 3 – Identify acquired tax benefits or other tax attributes	Determine if there are any acquired tax losses, credit carry forwards, or other relevant tax attributes (e.g., tax uncertainties) of the acquiree should be recognised as part of the business combination.

Practical insight – Deferred tax assets

Acquirer perspective

As a result of a business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer could change. Consequently, the acquirer recognises a change in the deferred tax asset in the period of the business combination. However, the acquirer does not include it as part of the accounting for the business combination.

The probability may change if the acquirer now considers it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree.

Acquiree perspective

The business combination may create new perspectives for the acquiree to use its existing tax losses because the acquiree may benefit from:

- synergies generated by theacquisition
- new distribution channel to sell its products, and
- economies of scale that will affect its future earnings and capacity to consume its tax losses.

These new factors could lead to the recognition of deferred tax assets on tax losses carry forward that were not recognised by the acquiree on itsown.

How we can help

We hope you find the information in this article helpful in giving you some insight into PFRS 3. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit www.grantthornton.com.ph/Contact.

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