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Business Combination Series

IFRS 3 Recognition Principles

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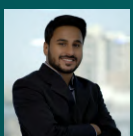

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Preface

Welcome to our 'Business Combination' series, a comprehensive exploration of the International Financial Reporting Standard that governs accounting for business combinations, IFRS 3. In this series, our objective is to provide clear guidance on IFRS 3, titled 'Business Combinations,' offering financial professionals, stakeholders, and decision-makers practical insights into the accounting rules that shape the treatment of mergers and acquisitions in the financial world.

Business combinations are transformative events with distinctive features. IFRS 3 serves as the guiding framework for recognizing and measuring assets and liabilities in these transactions. This standard has been in place for over a decade and has undergone thorough evaluations by the International Accounting Standards Board (IASB).

Each episode in this series is carefully curated to unpack the complexities of the business combination, presenting concepts in a clear and actionable manner. From the basics to advanced techniques, we will explore various aspects of deal structures, delving into real-world case studies, tax issues, contract issues, regulatory issues, and practical applications. Our goal is to equip you with the tools and knowledge necessary to make informed financial decisions, whether you are involved in mergers and acquisitions, real estate transactions, or any other financial deal.

The research underlying this report was run by the dedicated team of Helios Financial Group M&A practice, led by Asad Khan, a partner.
Valuable perspectives and advice were offered by a distinguished panel of academic and industry experts. Including, various articles, publications, books and research materials.

The report also benefited enormously from the contributions of HFG's global network of industry experts. It drew on HFG's indepth analytical expertise, our work with leading preferred acquirer organizations, distinguished lawyers, esteemed tax advisors and our understanding of deals space around the world.

The authors would like to thank the external and internal advisers for their contributions. In addition, the authors would like to thank Ammad Ahmed and Waqas Ahmed for their help in art directing, producing, and disseminating this report.

1. This report was not commissioned or sponsored in anyway by a business, government or other institution.
2. Debra C. Jeter, Paul K. Chaney (2018), Advanced Accounting
3. Grand Thornton, Insights into IFRS 3
4. PWC Insights, Business Combinations
5. By reviewing this paper, no individual is endorsing its conclusions. All errors remain our own.

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INTRODUCTION

The acquisition method involves the acquiring company in recognizing and valuing the identifiable assets and liabilities of the acquired business at their fair values as of the acquisition date, with some exceptions. These typically include assets and liabilities that were already documented in the financial statements of the acquired company.

However, applying the acquisition method may also lead to the recognition of assets and liabilities that were not previously disclosed in the acquired company's financial statements, such as internally developed items like brand names, patents, or customer relationships. To decide which assets and liabilities to recognize and how to measure them, IFRS 3 provides principles for recognition and measurement.

The identifiable assets and liabilities acquired should meet two criteria:

1. They should belong to the acquired company as of the acquisition date.
2. They should be part of what the acquiring company has obtained.

Most of these assets and liabilities are valued at their fair values as of the acquisition date, often referred to as the 'fair value exercise.' (Note that the term 'purchase price allocation' is still commonly used to describe this process, although it may not perfectly align with the IFRS 3 accounting model).

In acknowledging these challenges, IFRS 3 allows a ‘measurement period’ of up to twelve months from the date of acquisition for the acquirer to complete the initial accounting for the business combination

APPLYING IFRS 3'S RECOGNITION PRINCIPLE

Regarding the recognition of identifiable assets acquired and liabilities assumed in a business combination, it's crucial to note that they are recognized separately from goodwill, contingent upon their alignment with IFRS 3's recognition principle at the acquisition date. It's noteworthy that these assets and liabilities may not necessarily correspond to those acknowledged in the financial statements of the acquiree.

Furthermore, effective January 1, 2022, as per IFRS 3, identifiable assets acquired, and liabilities assumed are to be recognized at the acquisition date if they satisfy the definitions of an asset or a liability as outlined in the 'Conceptual Framework for Financial Reporting' issued in 2018.

Before January 1, 2022, IFRS 3 referred to the IASB's earlier conceptual framework. Consequently, acquirers were mandated to apply the definitions of an asset and a liability, along with the supporting guidance, as laid out in the 'Framework for the Preparation and Presentation of Financial Statements,' which the IASB had adopted back in 2001.

Moreover, in order to qualify for recognition under the acquisition method, it's imperative that the identifiable assets acquired and liabilities assumed are integral to the exchange between the acquirer and the acquiree (or its previous owners) within the business combination itself. This implies the need to distinguish separate transactions negotiated concurrently with the business combination, as they warrant distinct accounting treatment apart from the combination. As an example, consider payments made or anticipated to be made to selling shareholders in exchange for future services committed to post-combination.

In practice, most of the assets and liabilities to be recognised should fall within familiar IFRS categories, such as:

- cash and cash equivalents
- inventories including work in progress
- financial assets and liabilities, including trade receivables and payables
- prepayments and other assets
- property, plant and equipment
- intangible assets
- income tax payable or receivable
- deferred tax assets and liabilities
- accruals and provisions.

An effective approach to identifying the assets and liabilities for recognition involves a two-step process:

1. Begin by assembling a pool of 'potential' identifiable assets and liabilities. These sources may include the most recent financial statements of the acquiree, internal management reports, underlying accounting records, due diligence reports, and the terms outlined in the purchase agreement.

2. Subsequently, rigorously assess these potential identifiable assets and liabilities against the recognition conditions outlined in IFRS 3. The complexity of this determination can vary; it may be straightforward for some items but demand a more comprehensive analysis for others. The forthcoming section will delve into specific assets and liabilities that frequently warrant in-depth examination.

IFRS 3'S IDENTIFIABLE ASSETS AND LIABILITIES REQUIRING SPECIFIC ATTENTION

The assets and liabilities eligible for recognition vary from one business combination to another and can exhibit significant disparities based on the industry involved. Nevertheless, there are considerations that come into play for certain types of assets and liabilities. These considerations arise due to one or more of the following factors:

1. IFRS 3 incorporates specialized guidance, which, in certain instances, represents an exception to the overarching recognition principle we previously discussed.
2. Some of these items were not originally acknowledged in the financial statements of the acquiree.

The table below provides a concise summary of examples illustrating the types of identifiable assets and liabilities that frequently demand focused consideration, with corresponding guidance available in IFRS 3:

SPECIFIC ATTENTION

Intangible assets

In order to be recognized separately from goodwill, an intangible asset should be identifiable, ie meets either the separability or the contractual-legal criteria. This identification process can be challenging and often requires judgment.

Contingent liabilities

A contingent liability is recognised if it is a present obligation that arises from past events and its fair value can be measured reliably.

Restructuring plans

A restructuring plan is recognised only if the acquiree has an obligation at the acquisition date to incur the restructuring costs. Costs the acquirer expects to incur as a result of its own post-combination decisions are not liabilities at the acquisition date and should be recognised in post-combination earnings.

Deferred taxes

The acquirer does not recognise the acquiree's historical deferred tax balances but determines new amounts based on the identifiable assets and liabilities recognised in the acquisition accounting and the requirements of IAS 12 'Income Taxes'.

Leases in which the acquiree is the lessee

The acquirer should recognise right-of-use assets and lease liabilities for leases in the business combination that have been identified in accordance with IFRS 16 'Leases'.

Employee benefits

The acquirer applies the specific requirements of IAS 19 'Employee Benefits' to determine the liabilities (or assets, if any) to be recognised for any assumed post- employment benefit plans and other post-retirement benefit plans.

Indemnification assets

If the seller agreed to contractually indemnify the acquirer for the outcome of a particular uncertainty that may affect the amount of an asset or a liability, an indemnification asset is recognised on a basis that is consistent with how the indemnified item is recognised at the acquisition date.

Reacquired rights

f 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.

Examples of other items requiring specific attention but for which no specific guidance is provided in IFRS 3 include:

SPECIFIC CONSIDERATIONS

ITEMS REQUIRING ANALYSIS	SPECIFIC CONSIDERATIONS
Acquiree's previous goodwill	The acquirer does not recognise goodwill recognised by the acquiree from a past business combination. Instead, a new goodwill amount (or gain from a bargain purchase, as the case may be) should be calculated and recognised at the acquisition date.
Liability and equity accounts	Financial instruments issued by the acquiree to third parties need to be classified as liabilities or equity instruments (or if compound instruments a split between the two classifications) based on IAS 32 'Financial Instruments: Presentation' and conditions at the acquisition date. In other words, no matter how the instruments are presented in the statement of the financial position of the acquiree, it will be presented in the financial statements of the acquirer based on the contractual terms assessed on the basis of the pertinent conditions as they exist at the acquisition date. The change of ownership could change the classification and/or trigger specific clauses in contractual agreements. Equity 'reserves' such as retained earnings and revaluation reserve are not identifiable assets or liabilities. Equity instruments of the acquiree held by non-controlling parties may affect goodwill and may require more analysis.
Deferred revenue	Deferred (unearned) and accrued revenue balances that arise from application of the acquiree's revenue recognition policies should be analysed to determine if an underlying asset or liability exists at the acquisition date and, if so, how it should be recognised in the combination. Specifically, an acquiree's contract liability (ie deferred revenue) relating to a contract with a customer, is a liability from the acquirer's perspective if the acquiree has received consideration (or the amount is due to be received) from the customer but has not satisfied the related performance obligation. In addition, sometimes a contract liability may relate to a situation where the performance obligation has been satisfied either partially or totally but revenue has not been recognised yet by the acquiree because of the variable consideration constraint.

RECOGNIZING IDENTIFIABLE INTANGIBLE ASSETS: WHAT IFRS 3 PERMITS

The separate identification of intangible assets holds paramount significance due to the finite nature of their useful lives in most cases. This entails that the acquirer must recognize an amortization expense to comply with the stipulations outlined in IAS 38 'Intangible Assets.' The individual recognition of intangible assets thus exerts a direct impact on post-combination earnings. The more intangibles with finite useful lives are identified separately from goodwill, the greater the influence on the acquirer's earnings. Consequently, IFRS 3 places significant emphasis on distinct recognition rather than amalgamating intangibles into goodwill.

However, it's imperative to recognize that identifying intangible assets is inherently more challenging and subjective in comparison to the identification of physical assets, such as inventory and property. Moreover, many intangibles recognized in a business combination may not have found a place in the acquiree's own financial statements.

The International Accounting Standards Board (IASB) has initiated efforts to address the distinct recognition of intangibles through its project titled 'Business Combinations – Disclosures, Goodwill, and Impairment.' In 2020, a Discussion Paper was released, and as of now, the IASB is deliberating whether further amendments to the existing standard are warranted.

SPECIFIC REQUIREMENTS FOR RECOGNITION

When it comes to intangible assets acquired through a business combination, their recognition, distinct from goodwill, hinges on two key criteria:

1. Adherence to IFRS 3's general recognition principle, as discussed previously.

2. Meeting the concept of 'identifiable,' which holds specific significance and is guided by the directives outlined in IAS 38. An intangible asset acquired can be considered identifiable if it satisfies either of the following criteria:

    a. 'Contractual-Legal': Originating from contractual or legal rights, regardless of whether these rights can be transferred or separated from the entity or from other rights and obligations.

    b. 'Separable': Capable of being isolated or divided from the acquiree, and subsequently, being sold, transferred, licensed, rented, or exchanged either individually or in conjunction with a related contract, identifiable asset, or liability.

APPLYING THE SPECIFIC RECOGNITION REQUIREMENTS

The identification of tangible intangible assets acquired is contingent upon various factors, including the nature of the business, its industry, and the unique circumstances surrounding the combination. To facilitate this process, it can be beneficial to break down the identification into two distinct steps:

Step 1: Identifying the Pool of 'Potential' Intangibles

Step 2: Evaluating Each Against IFRS 3's Prescribed Criteria

POTENTIAL INTANGIBLE ASSETS

The pool of potential intangible assets encompasses items devoid of physical substance and of a non-monetary nature, arising from contractual or legal rights—examples include trademarks and licenses. The detection of these assets can be rooted in a thorough analysis of relevant contracts or agreements.

On the other hand, non-contractual intangible assets, such as customer relationships and in-process research and development, often necessitate a more comprehensive examination. Potential indicators and sources of pertinent information may include:

SOURCES OF INFORMATION	POSSIBLE INDICATORS
Acquiree's Fnancial Statements and Other Internal Reports	• Some intangible assets will have been recognised in the acquiree's financial statements. Other financial statement information may also provide indirect indicators, for example: - significant marketing costs may be an indicator of the relative importance of brands, trademarks and related intangible assets - significant expenditures on research and development may indicate the existence of technology-based intangible assets - significant expenditures related to customer care may point to customer relationship assets, or - governments grants relating to specific research and development expenditure, as well as forgivable loans, which repayment is based on a royalty mechanism.
Purchase Agreement and Accompanying Documents (Licencing Agreements)	• May include references to certain trademarks, patents or other intangible assets that are established by contract or legal rights, and • May include non-compete provisions that sometimes give rise to a potential intangible asset
Due Diligence Reports	• May include information that assists in understanding the acquired business, resources and how revenues are generated.
Website Materials, Press Releases and Investor Relation Communications	• The website may contain discussions of the unique characteristics of the business which may translate into a potential intangible asset, and • Press releases and investor relation communications of both the acquiree and the acquirer may include discussions of potential intangible assets.
Industry Practice	• Results of similar business combinations may provide indicators of the types of intangible assets that are typically recognised in such situations.

DETERMINING WHETHER A POTENTIAL INTANGIBLE ASSET IS IDENTIFIABLE

Every potential intangible asset, which encompasses non-monetary items without physical substance, must undergo an assessment to ascertain its 'identifiability.' It's important to note that intangible assets stemming from contracts or agreements inherently meet this criterion.

For other potential intangible assets, the assessment revolves around 'separability.' This hinges on whether the asset can be sold or transferred independently, without necessitating the sale of the entire business. Key considerations in this evaluation include:

- This assessment is not contingent on any intention to sell, although the existence of a sales plan, if present, can demonstrate separability.
- Actual exchange transactions involving similar types of potential intangible assets or the very asset being analyzed may indicate separability, even if such transactions are infrequent and irrespective of the acquirer's involvement in them.
- The potential intangible asset need not be independently saleable to be considered separable. It could be transferred in conjunction with a related contract, identifiable asset, or liability. However, if separation is only feasible as part of a larger transaction, a judgment call is required to discern whether the potential sale pertains to the entire business or only a segment of it.
- The terms outlined in the purchase agreement or related agreements may impose restrictions on the transfer of specific intangible assets. For instance, confidentiality agreements might prohibit the transfer of customer information.
- The legal and regulatory landscape can also be a determining factor, as it may impede the transfer of intangible assets in the absence of underlying contractual or legal rights.

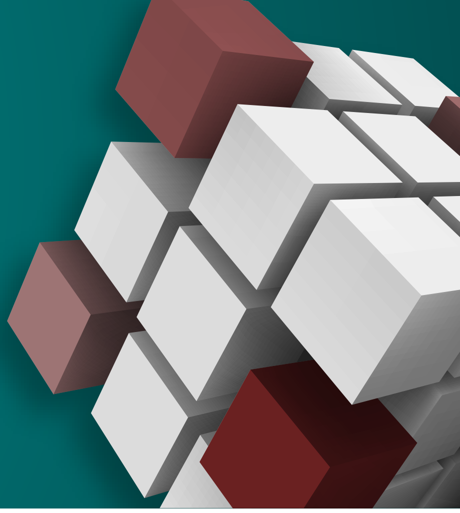
IFRS 3 offers additional examples of intangible assets that conform to either the separability or contractual-legal criteria. Furthermore, within IFRS 3's Illustrative Examples, you can find a compilation of prevalent types of identifiable intangible assets often acquired in a business combination, as summarized below. It's important to note that this list is not exhaustive

IFRS 3 offers additional examples of intangible assets that conform to either the separability or contractual-legal criteria. Furthermore, within IFRS 3's Illustrative Examples, you can find a compilation of prevalent types of identifiable intangible assets often acquired in a business combination, as summarized below. It's important to note that this list is not exhaustive:

* *These items are usually considered as identifiable intangible assets because they meet the separability criterion. All other items usually satisfy the contractual-legal criterion.*

EXAMPLE INTANGIBLE ASSETS

ARTISTIC-RELATED INTANGIBLE ASSETS	• Plays, operas and ballets • Books, magazines, newspapers and other literary works • Musical works such as compositions, song lyrics and advertising jingles • Pictures and photographs • Video and audio-visual material, including films, music videos and television programmes.
CONTRACT-BASED INTANGIBLE ASSETS	• Advertising, construction, management, service or supply contracts • Licensing, royalty and standstill agreements • Lease agreements • Construction permits • Franchise agreements • Operating and broadcasting rights • Use rights such as drilling, water, air, mineral, timber- cutting and route authorities • Servicing contracts such as mortgage servicing contracts • employment contracts that are beneficial contracts from the perspective of the employer because the pricing of those contracts is below the current market value.
MARKETING-RELATED INTANGIBLE ASSETS	• Trademarks, trade names, service marks, collective marks and certification marks • Internet domain names • Trade dress (unique colour, shape or package design) • Non-compete agreements.
CUSTOMER-RELATED INTANGIBLE ASSETS	• Customer lists* • Order or production backlog • Customer contracts and the related customer relationships • Non-contractual customer relationships*
TECHNOLOGY-BASED INTANGIBLE ASSETS	• Patented technology • Computer software and mask works • Unpatented technology* • Databases* • Trade secrets such as secret formulas, processes or recipes.



ITEMS NOT MEETING IFRS 3's RECOGNITION CONDITIONS

Within numerous business combinations, the acquirer may come across other assets or resources that hold value for the acquired business.

However, it's important to note that not all of these items meet IFRS 3's recognition criteria, as exemplified below:

SITUATIONS

Assembled workforce

An assembled workforce denotes an existing group of employees that enables the acquirer to continue operating the acquired business from the acquisition date. Nonetheless, it does not qualify as identifiable. IAS 38 additionally underscores that there is typically insufficient control over the economic benefits stemming from the assembled workforce.

Given that an assembled workforce constitutes a collective of employees rather than an individual worker, it does not emanate from contractual or legal rights. While individual employees may have employment contracts with the employer, the collective workforce as a whole lacks such a contract.

Furthermore, an assembled workforce is not separable, either as individual employees or in conjunction with a related contract, identifiable asset, or liability. Attempting to sell, transfer, license, rent, or otherwise exchange an assembled workforce would invariably disrupt the acquirer's business operations.

Potential Contracts

Potential contracts, despite the value attributed to them by the acquirer (reflected in goodwill), pertain to contracts that the acquiree is negotiating with potential new customers as of the acquisition date. These potential contracts do not qualify as assets at the acquisition date.

Consequently, the acquirer should refrain from reclassifying the value of these contracts from goodwill for events occurring post-acquisition. This includes the separate recognition of an intangible asset.

Synergies

Synergies, as a rule, do not satisfy the criteria for identifiability, as they do not hinge on contractual or other legal rights. Furthermore, they are typically indivisible from the acquired entity.

Synergies are categorized as one of the components of goodwill and should be encompassed within it.

Market Share, Market Potential, Monopoly Situations or Similar 'Strategic Values'

Elements such as market share, market potential, or the potential for a monopoly position, while significant in augmenting the value of marketing-related or technology-driven intangible assets, do not qualify as controllable future economic benefits. These attributes are beyond the control of the acquirer.

High Credit Rating or Going Concern

Values ascribed to a high credit rating or indications of the acquired entity's ability to operate as a going concern are not considered controllable future economic benefits. These attributes can indeed be valuable but are subject to various external factors beyond the acquirer's control.

Contingent Assets

Values ascribed to a high credit rating or indications of the acquired entity's ability to operate as a going concern are not considered controllable future economic benefits. These attributes can indeed be valuable but are subject to various external factors beyond the acquirer's control.

CLASSIFICATION AND DESIGNATION OF IDENTIFIABLE ASSETS ACQUIRED AND LIABILITIES ASSUMED UNDER IFRS 3

The accounting treatment of identifiable assets and liabilities acquired hinges on their classification and designation, a process that is influenced by contractual terms and prevailing economic conditions at the acquisition date. This assessment also takes into consideration various factors, including:

- The acquirer's operational and accounting policies.
- The future strategic intentions of the business.
- Other relevant contextual factors.

It's worth noting that the acquirer's classifications and designations may differ from those employed by the acquiree prior to the combination.

IFRS 3 provides a non-exhaustive list of examples illustrating the classification or designation of acquired assets and liabilities, encompassing:

- The classification of specific financial assets and liabilities in accordance with IFRS 9 'Financial Instruments.'
- The designation of a derivative instrument as a hedging instrument under IFRS 9.
- The assessment of whether an embedded derivative should be separated from the host contract, a determination reliant on the classification of the host contract in accordance with IFRS 9.

The scope of this requirement is potentially extensive, often requiring the evaluation of numerous items. In practice, financial instruments, including classification under IAS 39 or IFRS 9, assessment of embedded derivatives, and hedge accounting, typically emerge as the most significant areas of consideration. Special attention must be directed towards the acquiree's hedge accounting designations (if applicable). The acquirer cannot simply continue with the acquiree's original designations in their post-combination financial statements. New designations are necessary if the acquirer intends to apply hedge accounting, though these new designations may be subject to increased hedge ineffectiveness, as the acquired hedging instruments (usually derivatives) may no longer align 'at market.'

IFRS 3 introduces an exception to the general principle regarding leases, particularly for lease contracts in which the acquiree serves as the lessor in accordance with IFRS 16 'Leases.' In such cases, the acquirer classifies leases based on the contractual terms and other pertinent factors as of the inception of the contracts.

Notably, IFRS 3 currently extends this exception to the classification of contracts as insurance contracts (under IFRS 4 'Insurance Contracts'). Similar to leases, these contracts are classified based on the contractual terms and other factors existing at the inception of the contracts. However, it's important to highlight that once IFRS 4 is replaced by IFRS 17 'Insurance Contracts,' this classification exception will be eliminated, necessitating the application of a new measurement exception, which is discussed in detail in our article 'Insights into IFRS 3 – Specific Recognition and Measurement Provisions.

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CONCLUSION

In conclusion, understanding the recognition principles outlined in IFRS 3 is essential for anyone involved in mergers and acquisitions, as these principles govern the accounting treatment of identifiable assets and liabilities acquired during a business combination. In this Part 1 of our 'Insights into IFRS 3' series, we have highlighted the key points related to recognition and measurement principles as set out in IFRS 3.

The recognition of identifiable assets and liabilities acquired involves evaluating whether they meet the criteria specified in the standard and recognizing them at their fair values as of the acquisition date. It's important to note that these assets and liabilities may not necessarily correspond to those acknowledged in the financial statements of the acquiree.

Furthermore, the introduction of the 'Conceptual Framework for Financial Reporting' in 2018 has had an impact on the recognition of assets and liabilities, as they are now to be recognized if they satisfy the definitions of an asset or a liability as outlined in the new framework.

The process of identifying these assets and liabilities involves a two-step approach: first, assembling a pool of potential identifiable assets and liabilities, and second, assessing each against the recognition conditions specified in IFRS 3. Certain assets and liabilities, such as intangible assets, restructuring plans, and contingent liabilities, often require focused consideration due to their unique characteristics.

Identifying intangible assets separately from goodwill is of paramount significance because it directly impacts post-combination earnings. However, recognizing intangibles is inherently challenging, and the IASB has initiated efforts to address this issue.

Finally, it's crucial to classify and designate identifiable assets and liabilities acquired based on their contractual terms and prevailing economic conditions at the acquisition date. This assessment considers various factors, including the acquirer's operational and accounting policies and future strategic intentions. The classification and designation process is an area of extensive evaluation, particularly for financial instruments.

In summary, IFRS 3's recognition principles are complex but critical for financial professionals dealing with business combinations. A thorough understanding of these principles is essential to ensure compliance and accurate financial reporting in the context of mergers and acquisitions. As we continue with our 'Insights into IFRS 3' series, we will delve deeper into the specifics of measurement and other key aspects of the standard.

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Endnotes

1. Debra C. Jeter, Paul K. Chaney (2018), Advanced Accounting
2. Grand Thornton, Insights into IFRS 3
3. PWC Insights, Business Combinations
4. Based on HFG's own consultative experience of working with clients on Mergers & Acquisitions.
5. By reviewing this paper, no individual is endorsing its conclusions. All errors remain our own.

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