Raymond Chabot Grant Thornton

IFRS Adviser Alert

Insights into IFRS 3 – Recognition and measurement principles

December 2022

Executive summary

The Grant Thornton International IFRS team has published three *Insights into IFRS 3*:

- *Recognition principle;*
- *How should the identifiable assets and liabilities be measured?*
- *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 one is unique. IFRS 3 *Business Combinations* contains the requirements for these transactions, which are challenging in practice. The standard itself has been in place for more than 10 years now and has undergone a post-implementation review by the IASB. It is one of the most referred to standards currently issued.

The *Insights into IFRS 3* series summarizes 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.

The next three publications in the *Insights into IFRS 3* series discuss the recognition and measurement principles:

- *Recognition principle;*
- *How should the identifiable assets and liabilities be measured?*
- *Specific recognition and measurement provisions.*

Resources

The publications mentioned above follow this *IFRS Adviser Alert*.

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Insights into IFRS 3

Recognition principle

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. IFRS 3 'Business Combinations' contains the requirements for these transactions, which can be challenging in practice. The Standard itself has now been in place for more than ten years and has undergone a comprehensive post implementation review by the International Accounting Standards Board (IASB).

Our 'Insights into IFRS 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. This article explains the recognition principles set out in IFRS 3.

Overview of IFRS 3's recognition and measurement principles

The acquisition method requires the acquirer, to recognise and measure the acquiree's identifiable assets acquired and liabilities assumed at their acquisition-date fair values, subject to some exceptions. These assets and liabilities usually include assets and liabilities already reported in the acquiree's financial statements. Applying the acquisition method may, however, also result in recognising assets and liabilities that were not previously reported in the acquiree's financial statements for instance a brand name, a patent or a customer relationship, as the acquiree developed them internally. IFRS 3's recognition and measurement principles should be applied to determine which assets and liabilities to recognise and how they should be measured. The identifiable assets acquired and liabilities assumed should consist of those that:

- belong to the acquiree at the date of acquisition, and
- form part of what has been acquired by the acquirer.

Most, but not quite all, of these assets and liabilities are measured at fair value at the acquisition date – the so called 'fair value exercise'. (The term 'purchase price allocation' is still frequently used to describe this process although it does not perfectly align with the IFRS 3 accounting model).

This fair value exercise is usually a complex and time-consuming step in accounting for a business combination. Many entities engage outside specialists in the valuation area to provide assistance. In most cases this step requires a good knowledge of the business acquired, careful analysis, extensive use of estimates and management judgement in a number of areas.

Refer to our article '**Insights into IFRS 3 – How should the identifiable assets and liabilities be measured?**' for more details on the fair value exercise.

Practical insight – The identification exercise

The objective of this exercise is to identify the main items for which the acquirer made the decision to purchase the business. Establishing the core reasons for making the purchase should help to identify the intangible assets acquired, that is, what did the acquirer get in return for the consideration paid and what they were willing to pay for? For example, was it to gain access to a specific technology, to acquire a trademark with a market share (this is usually associated with a technology, a know-how or a process)?

In an acknowledgement of 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. This is discussed in more detail in our article **'Insights into IFRS 3 – Accounting after the acquisition date'**.

The following three articles in our 'Insights into IFRS 3' series discuss the key activities an acquirer needs to undertake in this step and provides examples to illustrate IFRS 3's requirements:

Requirement	Article
Recognise identifiable assets acquired and liabilities assumed	This article
Measure identifiable assets acquired and liabilities assumed	**Insights into IFRS 3 – How should the identifiable assets and liabilities be measured?**
Apply specific recognition and measurement provisions	**Insights into IFRS 3 – Specific recognition and measurement provisions**
Classify or designate identifiable assets acquired and liabilities assumed	This article

Applying IFRS 3's recognition principle

Identifiable assets acquired and liabilities assumed in a business combination are recognised (separately from goodwill) if, and only if, they meet IFRS 3's recognition principle at the acquisition date. These assets and liabilities may not be the same as those recognised in the acquiree's own financial statements.

IFRS 3's recognition conditions:
IFRS 3 states from 1 January 2022 at the latest, identifiable assets acquired and liabilities assumed are recognised at the acquisition date if they meet the following definitions of an asset or a liability included in the 'Conceptual Framework for Financial Reporting' issued in 2018:

Asset	Liability
Present economic resource controlled by the entity as a result of past events	Present obligation of the entity to transfer an economic resource as a result of past events

Prior to 1 January 2022, IFRS 3 referred to the IASB's previous conceptual framework. Acquirers were therefore required to apply the definitions of an asset and a liability and supporting guidance in the 'Framework for the Preparation and Presentation of Financial Statements' adopted by the IASB in 2001.

In addition, to qualify for recognition in applying the acquisition method, the identifiable assets acquired and liabilities assumed should be part of what is exchanged between the acquirer and the acquiree (or its former owners) in the business combination (rather than being part of a separate transaction or arrangement). This requires identifying separate transactions that were negotiated at the same time as the business combinations occurred as they should be accounted for separately from the business combination. For example, payments made or expected to be made to the selling shareholders but in consideration of future services that they are committed to render post combination. Refer to our article '**Insights into IFRS 3 – Determining what is part of a business combination transaction**'.

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.

The following two step process can be helpful when identifying the assets and liabilities to recognise:

- determine the population of 'potential' identifiable assets and liabilities from sources such as the acquiree's most recent financial statements, internal management reports and underlying accounting records, due diligence reports and the purchase agreement itself, and
- evaluate these potential identifiable assets and liabilities against IFRS 3's recognition conditions. This determination can be straightforward or may require a detailed analysis depending on the nature of each item. The next section presents some assets and liabilities for which more detailed analysis is often needed.

IFRS 3's identifable assets and liabilities requiring specific attention

The identifiable assets and liabilities to be recognised are unique to each business combination and may differ extensively depending on the industry. However, specific considerations apply to some types of assets and liabilities because of one or more of the following factors:

- IFRS 3 includes specific guidance that is, in some cases, an exception to the general recognition principle discussed above
- these items were not recognised in the acquiree's own financial statements.

The following table summarises examples of the types of identifiable assets and liabilities that will often require specific attention and for which specific guidance exists in IFRS 3:

Items requiring analysis	Specific guidance
Intangible assets	In order to be recognised 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 judgement (see page 7).
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. See the section on recognising restructuring plans presented on page 11 for more details regarding the recognition principles for restructuring plans.
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.
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*	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.

* Specific guidance on these items are discussed in more detail in our article '**Insights into IFRS 3 – Specific recognition and measurement provisions**'.

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

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. This is discussed in more detail in our article **'Insights to IFRS 3 – Recognising and measuring goodwill or gain from a bargain purchase'**.
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. This is discussed in our article **'Insights into IFRS 3 – Recognising and measuring non-controlling interest'**.
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.

Recognising identifiable intangible assets: what IFRS 3 permits

It is important to identify intangible assets separately because, in most cases, their useful lives will be finite, which means an amortisation expense should be recognised by the acquirer to comply with the requirements set out in IAS 38 'Intangible Assets'. Separate recognition therefore affects post-combination earnings and the more intangibles with finite useful lives that are recognised separately from goodwill, the more their identification will affect the earnings of the acquirer. Partly for this reason, IFRS 3's approach places a strong emphasis on separate recognition rather than subsuming intangibles within goodwill.

However, identifying intangible assets is inherently more difficult and subjective than identifying physical assets such as inventory and property. In addition, many intangibles recognised in a business combination may not have been recognised in the acquiree's own financial statements. The IASB has started looking at a solution to the separation recognition of intangibles as part of its project entitled 'Business Combinations – Disclosures, Goodwill and Impairment'. A Discussion Paper was issued in 2020 and at the time of writing the IASB is deciding if further changes to the existing standard are required.

Specific recognition requirements

Intangible assets acquired in a business combination are recognised separately from goodwill if they:

- meet IFRS 3's general recognition principle (see above), and
- are identifiable.

Identifiable has a specific meaning in this context and is based on guidance set out in IAS 38. An acquired intangible asset is identifiable if it meets either of the following criteria:

'Identifiable'		
Contractual-legal		**Separable**
Arising from contractual or legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.	OR	Capable of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, identifiable asset or liability.

Applying the specific recognition requirements

The identifiable intangible assets acquired will depend on the nature of the business, its industry and other specific facts and circumstances of the combination. It is useful to divide the identification process into two steps:

Step 1	Identify the population of 'potential' intangibles
Step 2	Assess each against IFRS 3's specific criteria

Potential intangible assets

Potential intangible assets, items that are non-monetary without physical substance, arising from contractual or legal rights, such as trademarks and licences, may be detected based on analysis of applicable contracts or agreements.

Non-contractual intangible assets, such as customer relationships and in-process research and development, can require more analysis. Possible indicators and information sources include:

Sources of Information	Possible indicators
Acquiree's financial 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

Each potential intangible asset (ie a non-monetary item without physical substance) should be assessed to determine if it is 'identifiable'. As noted, intangible assets arising from contracts or agreements will always meet this test.

For other potential intangible assets an assessment of 'separability' is required. This is based on whether the item can be sold or otherwise transferred, without selling the entire business. Examples of these considerations are as follows:

- it is a hypothetical assessment and is not dependent on any intention to sell (although a sale plan, if one exists, demonstrates separability)
- actual exchange transactions for the type of potential intangible assets being analysed or a similar type indicate separability, even if those transactions are infrequent and regardless of whether the acquirer is involved in them
- in order to be separable, the potential intangible asset need not be saleable on its own. It could be transferred in combination with a related contract, identifiable asset or liability. However, if separation is only possible as part of a larger transaction, judgement is required to determine whether the potential sale is of the entire business or only part of it
- the terms of the purchase agreement or related agreements may prohibit the transfer of certain intangible assets (eg confidentiality agreements prohibiting transfer of customer information), and
- the legal and regulatory environment may prevent the transfer of intangible assets without underlying contractual or legal rights.

Example 1 – Database used in a supporting activity

Entity Q acquired Entity R, a retailer. Entity R owns a database, used in managing its loyalty scheme, which captures information on customer demographics, preferences, relationship history and past buying patterns. The database can either be sold or licensed. However, Entity R has no intention to do so because it will negatively impact its operations.

Analysis

In this situation, the database does not arise from a contractual or legal right. Thus, an assessment of its separability is required. The database and content were generated from one of Entity R's supporting activities (ie management of the loyalty scheme) and could be transferred independently of the rest of the business. The actual intention not to transfer the database does not affect the assessment. The separability criterion is met and the database is recognised as an intangible asset in the business combination.

Note – the intention not to use the database should not affect its recognition as a identifiable intangible asset, nor should it affect its measurement (ie fair value). This is covered in our article '**Insights into IFRS 3 – How should the identifiable assets and liabilities be measured?**'

Example 2 – Complementary intangible assets

Entity X acquired the food manufacturing division of Entity Y, which includes a registered trademark for a certain product and an associated secret recipe for the product. Access to the secret recipe is required to enable the product to be manufactured and reasonable steps are taken to maintain its secrecy. The recipe is not protected by legal rights.

Analysis

The trademark is recognised as a separate intangible asset – as this is based on a legal right.

The secret recipe is not covered by the trademark registration and is not otherwise protected by legal rights. Its separability is therefore assessed. It is probably not feasible to transfer the recipe without the trademark, or vice versa, and the value of the trademark may rely upon the recipe itself. It is however likely to be feasible to transfer the recipe and trademark together without transferring the entire business. If so, the secret recipe meets the separability criterion and is recognised as a separate intangible asset. However, the recipe may be grouped with the trademark for presentation and measurement purposes if their useful lives are similar.

IFRS 3 provides other examples of intangible assets that meet either the separability or the contractual-legal criterion. In addition, IFRS 3's Illustrative Examples provide a list of the common types of identifiable intangible assets that may be acquired in a business combination and these have been summarised below. This list is not exhaustive.

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.

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

IFRS 3's guidance on recognising restructuring plans

An acquirer recognises liabilities for restructuring or exit activities acquired in a business combination only if they meet the definition of a liability at the acquisition date, as follows:

- recognising a restructuring provision as part of the acquiree's liabilities requires that the acquiree has a constructive obligation to restructure at the acquisition date. This may only arise when the acquiree has developed a detailed formal plan for the restructuring and either raised a valid expectation with those affected that it will carry out the restructuring by publicly announcing details of the plan or demonstrating that it has begun implementing the plan. Such a liability is recognised when it becomes probable that an outflow of resources embodying economic benefits will be required to settle the obligation
- a restructuring plan that is contingent on the business combination being consummated is not a liability of the acquiree at the acquisition date
- similarly, a restructuring that the acquirer arranges to be implemented by the acquiree within the context of the business combination is not a liability of the acquiree at the acquisition date.

Although the standard no longer contains the explicit requirements relating to restructuring plans, the Basis for Conclusions clearly indicates that the requirements for recognising liabilities associated with restructuring or exit activities remain the same.

Items not meeting IFRS 3's recognition conditions

In many business combinations, the acquirer will detect other items or resources that are valuable to the acquired business. However, not all of them meet IFRS 3's recognition conditions, for example:

Assembled workforce	• An assembled workforce is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. It is not considered to be identifiable. IAS 38 also points out that there is usually insufficient control over the economic benefits that may result from the assembled workforce. • Because an assembled workforce is a collection of employees rather than an individual employee, it does not arise from contractual or legal rights. Although individual employees might have employment contracts with the employer, the collection of employees, as a whole, does not have such a contract. • In addition, an assembled workforce is not separable, either as individual employees or together with a related contract, identifiable asset or liability. An assembled workforce cannot be sold, transferred, licensed, rented or otherwise exchanged without causing disruption to the acquirer's business.
Potential contracts	• Potential contracts are not assets at the acquisition date even though the acquirer attributes value to those contracts (via goodwill) the acquiree is negotiating with prospective new customers at the acquisition date. The acquirer should not subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date for instance by separately recognising an intangible asset.
Synergies	• Synergies are usually not identifiable as they do not depend on contractual or other legal rights and they are usually not capable of being separated from the acquired entity. They are identified as one of the component of goodwill and should be subsumed in it.
Market share, market potential, monopoly situations or similar 'strategic values'	• A robust position in the market may enhance the value of identifiable marketing-related or technology-driven intangible assets. However, the acquiree's market share or market condition is not a controllable future economic benefit.
High credit rating or going concern	• Value is sometimes attributed to a high credit rating or other indicators of the sustained ability of the acquiree to operate as a going concern. However, these values are not controllable future economic benefits.
Contingent assets	• A contingent asset represents a possible asset that arises from past events, and whose existence will be confirmed only by the occurrence or non occurrence of one or more uncertain future events not in control of the entity. An acquirer does not recognise a contingent asset at the acquisition date as it does not meet the definition of an asset in accordance with the Conceptual Framework for Financial Reporting.

IFRS 3's requirement to classify or designate identifiable assets acquired and liabilities assumed

The accounting for identifiable assets and liabilities depends on how they are classified and designated. The acquisition method requires the acquirer to classify and designate acquired assets and liabilities based on contractual terms and economic conditions at the acquisition date. This also takes into account:

- the acquirer's operating or accounting policies
- the intentions of the business going forward, and
- other pertinent conditions.

Therefore, the acquirer's classifications and designations may differ from those of the acquiree before the combination.

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

- classification of particular financial assets and liabilities in accordance with IFRS 9 'Financial Instruments'
- designation of a derivative instrument as a hedging instrument in accordance with IFRS 9, and
- assessment of whether an embedded derivative should be separated from the host contract, which will be dependent on the classification of the host contract in accordance with IFRS 9.

The scope of this requirement is potentially broad and a large number of items may need to be assessed. In practice, the most significant area is often financial instruments, including classification in accordance with IAS 39 or IFRS 9, assessment of embedded derivatives and hedge accounting. Particular attention may need to be paid to the acquiree's hedge accounting designations (if any). The acquiree's original designations cannot be continued in the acquirer's post-combination financial statements. New designations are therefore required if the acquirer wishes to apply hedge accounting. These new designations may be susceptible to greater hedge ineffectiveness because the acquired hedging instruments (derivatives in most cases) are probably no longer 'at market'.

IFRS 3 provides an exception to this general principle concerning leases, this is for the classification of a lease contract in which the acquiree is the lessor as either an operating lease or a finance lease in accordance with IFRS 16 'Leases'. In this situation, the acquirer classifies leases on the basis of the contractual terms and other factors that existed at the inception of the contracts.

IFRS 3 also currently provides this same exception for the classification of contracts as insurance contracts (under IFRS 4 'Insurance Contracts'). Similar to leases the acquirer classifies these contracts on the basis of the contractual terms and other factors that existed at the inception of the contracts. When IFRS 4 is replaced by IFRS 17 'Insurance Contracts' this exception on classification will be removed and a new measurement exception will have to be applied. This new measurement exception is presented in our article '**Insights into IFRS 3 – Specific recognition and measurement provisions**'.

How we can help

We hope you find the information in this article helpful in giving you some insight into IFRS 3. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

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Insights into IFRS 3

How should the identifiable assets and liabilities be measured?

Business combinations are infrequent transactions that are unique for each occurrence. IFRS 3 'Business Combinations' contains the requirements and despite being fairly stable in the ten years since its been released, still provides challenges when accounting for these transactions in practice.

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

This article sets out the definition and underlying principles of fair value, gives a brief overview of permissible valuation techniques and presents IFRS 3's specific guidance on fair value measurement.

IFRS 3's measurement principle

The identifiable assets acquired and liabilities assumed in a business combination are measured in accordance with the general measurement principle in IFRS 3 which states they should be measured at their acquisition-date fair values. However, there are a few exceptions to this measurement principle, which are discussed in our article '**Insights into IFRS 3 – Specific recognition and measurement provisions**'.

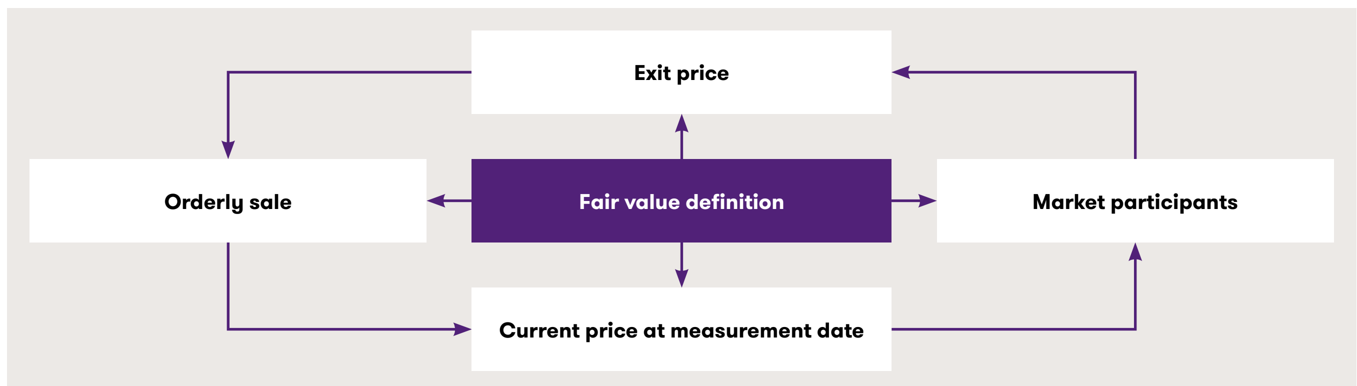
If an identifiable asset or liability has a quoted price in an active market (for example, listed shares), this price should be used as fair value. However, few assets and even fewer liabilities have such quoted prices. So in many cases, fair value then needs to be estimated using a valuation technique. As a result estimating fair values can be a complex exercise requiring considerable management judgement and many acquirers engage professional valuation specialists to assist in this stage of the process.

Fair value is defined in IFRS 13 'Fair Value Measurement' as follows:

Fair value definition:

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

A number of concepts are embodied in this definition. Firstly, it clarifies fair value is an 'exit' price – for example it refers to the transfer of a liability rather than settlement. Secondly, it assumes an orderly sale or transfer (ie not a forced transaction or a distressed sale). Thirdly, there is an explicit reference to 'market participants', emphasising fair value is a market-based concept and not an entity specific value. Finally, IFRS 13 clarifies fair value is a current price at the measurement date (eg the acquisition date in a business combination).



Fair value estimates have a pervasive effect on business combination accounting. Aside from measuring identifiable assets acquired and liabilities assumed, the acquisition method uses fair value to measure:

- consideration transferred
- any previously held interest in the acquiree
- any present ownership interests in the acquiree retained by non-selling shareholders, referred to in IFRS 3 as non-controlling interests (NCI), but only if that measurement method (ie fair value) is elected for those interests that entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. Refer to our article '**Insights into IFRS 3 – Recognising and measuring non-controlling interest**' for more details.

IFRS 3 defines fair value (consistently with IFRS 13) but does not provide detailed guidance on the valuation methodology and instead refers to IFRS 13 for valuation models and techniques. IFRS 3 does however include limited guidance on some specific situations (see page 4).

With respect to IFRS 13, the Standard notes there are three widely used 'families' of valuation techniques (see the following) that can be grouped into three broad approaches and states entities should use valuation techniques consistent with one or more of them to measure fair value:

Approach	Valuation technique
Market approach	Uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business.
Income approach	Converts future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. The fair value measurement reflects current market expectations about those future amounts. For example, present value techniques, option pricing models or the multi-period excess earnings method.
Cost approach	Reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

The complexity of the valuation depends on the asset or liability in question and management judgement is required to not only select the most appropriate valuation technique but also to determine all relevant inputs and material assumptions. Some valuations require specialist expertise and may need to engage a valuation professional. Whether or not a valuation professional is engaged, management's involvement in the process and in developing assumptions should be commensurate with its overall responsibility for preparing the financial statements.

The valuation techniques are commonly used as follows:

Name	Market approach	Income approach	Cost approach
Business	Yes	Yes	No
Property	Yes	Yes	Certain specialised buildings
Tangible assets	Yes	Yes	Certain specialised machinery
Intangible assets	Depending on asset and data availability	Yes	Some non-core intangible assets
Other financial assets and liabilities*	Yes	Yes	No

*Certain financial assets and liabilities have specific treatment under IFRS which may differ from this

Whichever technique is used, the resulting valuation should be consistent with the definition and underlying concepts of fair value. The acquirer should ensure the valuation:

- has an objective to estimate the price that would be paid or received in a hypothetical sale or transfer to other market participants (ie potential buyers and sellers)
- uses techniques and assumptions that are consistent with how other market participants would determine fair value
- does not take account of factors that are specific to the actual acquirer, such as the acquirer's intended use of an asset or synergies that would not be available to other market participants
- reflects conditions at the acquisition date
- prioritises observable market inputs when available, and
- incorporates IFRS 3's specific guidance, as applicable.

For more information on IFRS 13's guidance on fair value measurement, please refer to our article '**Insights into IFRS 13 Fair Value Measurement**'

IFRS 3's specific guidance on fair value measurement

IFRS 3 provides guidance on the determination of fair value in specific situations, as follows:

Assets	Specific IFRS 3 guidance on fair value measurement
Assets with uncertain cash flows (valuation allowances)	The acquisition-date fair value of assets such as receivables and loans should reflect the effects of uncertainty about future cash flows. A separate valuation allowance should not be recognised.
Assets subject to operating leases – acquiree is the lessor	If the acquiree is the lessor (of say a building), when measuring the acquisition date fair value of the lessor's underlying asset, the terms of the operating lease are taken into account. No separate asset or liability is recognised on acquisition even if the operating lease terms are either favourable or unfavourable when compared with market terms.
Assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them	Fair value should be determined in accordance with the asset's expected use by market participants (highest and best use) and should not be affected by the acquirer's intended use of the asset.

The following examples illustrate some of the concepts of fair value:

Example 1 – Fair value and buyer intentions
Entity A acquires a competitor, Entity B. The identifiable assets of Entity B include its trade name, under which Entity B's products are marketed to its customers. Entity A plans to discontinue any marketing support to the acquired trade name and migrate Entity B's customers to its own products. Entity A intends to retain the trade name to prevent competitor access to Entity B's products. Two valuations of the acquired trade name were determined: 1) estimated market value derived from other recent market transactions and 2) a lower value-in-use calculation based on the plan to discontinue its use.

Analysis
In this situation, the fair value of the acquired trade name is based on the price that could be obtained in an orderly, arm's length transaction with other market participants. The higher valuation based on evidence of the estimated market value derived from other recent market transactions should be used and the acquirer's plan to discontinue the use of the trade name should not affect the valuation.

Matters to consider after the acquisition date
This type of asset is commonly referred to as a defensive intangible asset. The value of a defensive intangible asset is expected to diminish over a period of time resulting mainly from the lack of marketing support and exposure. For this reason, the immediate impairment of the asset may not be appropriate. Determining the useful life of the asset, however, can be difficult. Since there is no intention to use the trade name, the useful life may then be viewed as the period of time for which holding the trade name will be effective in discouraging competition. It is expected this would be a fairly short period, as the value of an unsupported trade name diminishes rather quickly.

Example 2 – Identifying comparable market transaction
An acquirer is determining the fair value of the acquiree's parcel of land in an industrial park. An analysis of recent sales in similar locations indicated a diversity in transaction prices per unit of area. Further analysis identified some 'outlier' prices related to: (i) a sale of land by a company in liquidation; (ii) a sale between related parties; and (iii) a sale to a developer of a property for which planning consent for conversion to residential use has been obtained.

Analysis
In this situation, judgement will be required to identify those recent market transactions that are relevant from a fair value perspective. A liquidation sale may be a distress sale rather than a willing seller. A related party sale may not be at arm's length. The price the developer paid is likely to reflect the planning consent and the highest and best use of that specific property. Further analysis is required to assess whether possible alternative uses (including, if applicable, the likelihood of planning consent) would be taken into account by market participants in agreeing a price for the acquired property.

Guidance on fair value measurement of specific items

Inventory

Fair value of inventory acquired in a business combination is often different from the carrying amount of the same inventory in the acquiree's books at the date of acquisition. This is because fair value represents an exit price, ie a price that a market participant would receive to sell the inventory in its principal (or most advantageous) market, instead of a 'historical cost' concept.

The complexity of the calculation of the amount of the adjustment to make to the carrying amount of the inventory usually depends on the nature of the inventory acquired and the industry in which the acquiree operates:

Nature of inventory	Fair value measurement
Raw materials	Usually determined using current replacement cost.
Work-in-progress	Usually determined as the estimated selling price of the related finished goods in the ordinary course of business, less: • the estimated costs of completion • the estimated costs necessary to make the sale, and • a reasonable profit allowance for the completing and selling effort, based on the profit for similar finished goods.
Finished goods	Usually determined as the estimated selling price of the finished goods in the ordinary course of business less: • the estimated costs necessary to make the sale, and • a reasonable profit allowance for the acquirer's selling effort, based on the profit for similar finished goods.

The methods described above for measuring fair value of work-in-progress and finished goods aim to ensure that the fair value of the inventory acquired includes the profit generated by the selling and other efforts (manufacturing) of the acquiree before the date of acquisition as this profit does not belong to the acquirer and as such the acquirer cannot recognise it.

Deferred revenue

Deferred revenue is an obligation to transfer products or services to a customer because a payment has already been obtained (or an amount is due) from the customer. As part of a business combination transaction, an acquirer recognises deferred revenue as a part of the liabilities they assumed if the acquiree still has an obligation to provide goods or services after the date of acquisition.

As fair value is defined as an exit price, fair value of deferred revenue represents a price a market participant is willing to pay to assume the obligation to which the deferred revenue relates. As such fair value of deferred revenue is usually different from the acquiree's carrying value. Measurement of this amount can be complex and may require a significant use of judgement in certain circumstances.

A method frequently seen in practice to measure fair value of deferred revenue is called the 'build-up' or 'bottom-up' approach. Under this method, an acquirer determines the fair value of deferred revenue based on an estimate of the direct and incremental costs a market participant must incur to fulfil the performance obligation after the date of acquisition, plus a 'reasonable' profit margin for the products or services provided and a premium for any risks assumed. The 'reasonable' profit margin should consider the different types of work that a market participant would need to perform to complete any remaining performance obligation.

How we can help

We hope you find the information in this article helpful in giving you some insight into IFRS 3. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

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Insights into IFRS 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. IFRS 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 IFRS 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.

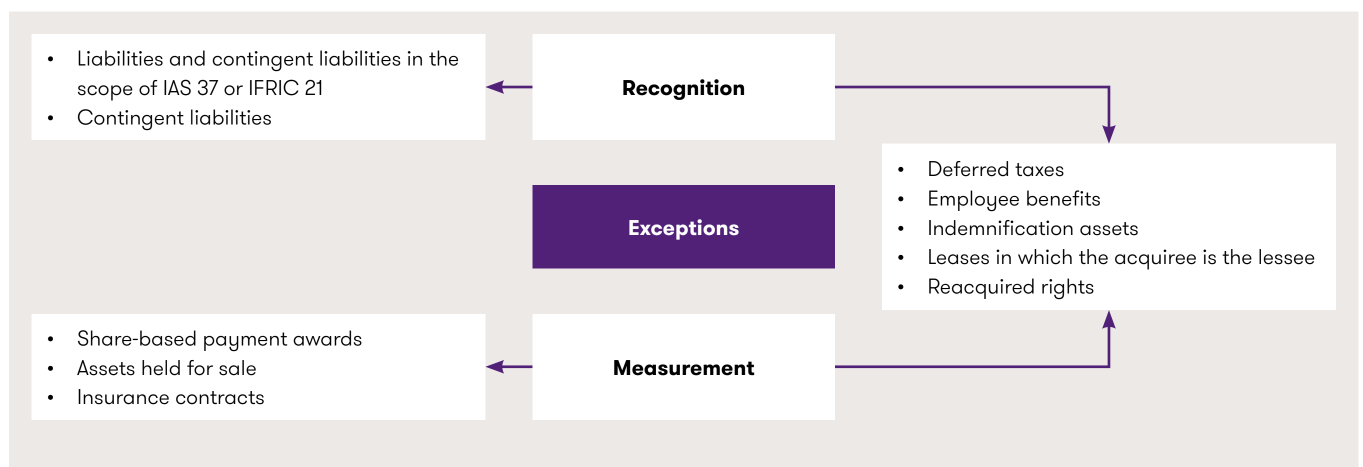
IFRS 3 has specific guidance on how some items are recognised and measured. This guidance is described as a series of exceptions to the general recognition and measurement principles (as discussed in our articles **'Insights into IFRS 3 – Recognition principle'** and **'Insights into IFRS 3 – How should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

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

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

Under IFRS 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 IFRS 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 IAS 37 or IFRIC 21

This exception applies to liabilities and contingent liabilities that would be in the scope of IAS 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 IFRS 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 IAS 37, the acquirer applies 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, 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 IFRS Standards resulted from 'Amendements 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 IFRS 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 IFRS 17 is first applied or 1 January 2023)

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

Assets held for sale

Measured at fair value less costs to sell in accordance with IFRS 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 IAS 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 IFRS 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 IFRS 16 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 (ie 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 IAS 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.

IFRS 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 licence 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 licence to operate franchised restaurants in a certain country. Entity B paid a fixed fee for this licence.

A year later, Entity A acquires Entity B. On the acquisition date, Entity A determines that the licence 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 licence. 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 IFRS 3 – Determining what is part of a business combination transaction**'.

Recognising and measuring deferred taxes when applying IFRS 3

IFRS 3 requires deferred taxes in a business combination to be recognised in accordance with IAS 12. Items to be recognised and measured in accordance with IAS 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 above 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	Description
Step 1 – Determine the recognised amounts of the assets and liabilities	See above guidance and our articles '**Insights into IFRS 3 – Recognition principle**' and '**Insights into IFRS 3 – How should the identifiable assets and liabilities be measured?**'.
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 (eg 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 the acquisition
- 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 its own.

How we can help

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