IFRS 3 and IAS 39: Transaction Price Allocation

Extract, IFRS Discussion Group Report on Meeting – September 13, 2016

IFRS 3 *Business Combinations* provides specific guidance on how to allocate the cost of acquisition when an entity acquires a group of assets that does not constitute a business. Paragraph 2(b) of IFRS 3 indicates that the cost of acquisition should be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of acquisition.

However, a potential conflict arises when the group of assets acquired include financial instruments. Paragraph 43 of IAS 39 *Financial Instruments: Recognition and Measurement* generally requires an entity to measure individual financial instruments at fair value. Paragraphs AG64 and AG76 of IAS 39 also provide guidance on whether the difference between the transaction price and the fair value of the individual financial instruments at the date of acquisition should be recognized as an immediate gain or loss.

Fact Pattern

An entity acquires a group of assets, including both financial instruments and non-financial items, which do not meet the definition of a business under IFRS 3. While the transaction price represents the fair value of the group of assets, there is a difference between the sum of the fair values of the net identifiable assets acquired and consideration paid. The entity has assessed that there are no other identifiable assets or liabilities causing the difference.

Issue: How should the total cost of purchase be allocated to individual assets and liabilities when the group of assets acquired is not a business and includes both financial instruments and non-financial items?

View A – IFRS 3 and IAS 39 both apply.

Under this view, the entity should first follow IFRS 3 to allocate the acquisition price to each of the identifiable assets and liabilities in the bundle based on relative fair value and then apply paragraph AG76 of IAS 39 to determine the fair value of each individual financial instrument. To the extent that a difference exists, a day one gain or loss should be recognized if the fair value of the financial instrument meets the observability conditions in paragraph AG76(a) of IAS 39.

Proponents of this view note that there are no initial measurement scope exceptions in IAS 39 for financial instruments recognized in a bundled purchase.

View B – IAS 39 takes precedence.

Proponents of this view note that IAS 39 takes precedence over IFRS 3 because it is the more specific standard that pertains to the initial recognition and measurement of a financial asset or liability. Further, there is no scope exclusion in IAS 39 for the initial measurement of financial assets or liabilities acquired as part of a bundle.

There are three views under View B on how to apply IAS 39 first.

View B1 – Measure those financial instruments whose fair value meets the observability conditions at fair value.

Under this view, the entity should first measure only the financial instruments that have an observable fair value at that fair value and then allocate the residual to the remaining identifiable assets based on relative fair value. This approach results in no day one gain or loss recognition.

View B2 – Measure those financial instruments subsequently measured at fair value.

Under this view, the entity should first measure those financial instruments that will be subsequently measured at fair value and then allocate the residual to the remaining identifiable assets based on relative fair value, including financial instruments recognized at amortized cost. The catch-up recognition of any day one gains or losses is avoided through subsequent measurement at fair value. However, if a residual value is allocated to a financial instrument not subsequently measured at fair value (for example, a debt instrument held at amortized cost) that meets the observability condition in paragraph AG76 of IAS 39, a day one gain or loss would be recognized.

View B3 – Measure all financial instruments at fair value.

Under this view, the entity should first measure all financial instruments at fair value and then allocate the residual to the remaining identifiable non-financial assets based on relative fair value. This approach results in no day one gain or loss recognition.

View C – IFRS 3 takes precedence.

Under this view, the entity should allocate the acquisition price based on a relative fair value basis with no application of the initial measurement requirements of IAS 39. The entity would apply the subsequent measurement guidance in IAS 39, and any financial instruments that are classified at fair value through profit or loss, or available for sale, would be remeasured on day two, resulting in a gain or loss recognized through profit or loss, or other comprehensive income.

Proponents of this view note that IFRS 3 specifically deals with the purchase of a group of assets. In contrast, IAS 39 does not specifically address the acquisition of financial instruments as part of a bundle.

View D – Different views may be appropriate depending on facts and circumstances.

Proponents of this view note that absent any specific guidance over which standard takes precedence, different interpretations are possible and may depend on the specific facts and circumstances.

The Group's Discussion

Some Group members observed that paragraph 2(b) in IFRS 3 is problematic as guidance on the acquisition of an asset (or group of assets) that does not constitute a business is included in the scoping paragraph. This paragraph states the following:

> IFRS 3 does not apply to "the acquisition of an asset or a group of assets that does not constitute a *business*. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, *intangible assets* in IAS 38 *Intangible Assets*) and liabilities assumed. The cost of the group shall be allocated

to the individual identifiable assets and liabilities on the basis of their relative *fair values* at the date of purchase. Such a transaction or event does not give rise to goodwill."

Most Group members supported the idea that IAS 39 takes precedence over IFRS 3, and the view that financial instruments are accounted for at fair value and any residual is allocated to the remaining identifiable non-financial assets based on the relative fair value (View B3). Group members thought that this view is most defensible because it does not create any day one gains or losses and it is the common approach seen in practice.

A few Group members thought it would be difficult to rule out Views A and B1 in the absence of specific guidance that addresses the fact pattern. However, one Group member indicated that it would be difficult to support View A because it would lead to a day one gain or loss when there is no objective evidence that one has occurred.

Most Group members ruled out the approach of fair valuing those financial instruments subsequently measured at fair value and allocating the residual to the remaining identifiable assets based on relative fair values (View B2), and allocating the acquisition price on a relative fair value basis with no application of the initial measurement requirements of IAS 39 (View C). Group members indicated that both these views are difficult to support.

Some Group members also could support that determining whether IFRS 3 or IAS 39 takes precedence in allocating the transaction price depends on an entity's individual facts and circumstances (View D). One Group member highlighted that the motives of the relevant parties in a transaction can have a significant effect on the negotiated transaction price, which may not be indicative of the fair value of the underlying net assets of a transaction. For example, if a seller is motivated to sell a portfolio of financial instruments to meet certain regulatory requirements, the seller may negotiate a price that is lower than the fair value to expedite the transaction.

An additional consideration regarding the treatment of transaction costs was also discussed. Group members supported the view that it is reasonable to first allocate the acquisition price, excluding transaction costs, and then allocate transaction costs based on the relevant guidance of other standards.

Group members observed that there was some support for four of the six views and guidance to eliminate this diversity would be helpful. As a result, the Group recommended that the issue be discussed with the AcSB to determine whether it should be raised to the IASB or IFRS Interpretations Committee.

(For a full understanding of the discussions and views expressed, listen to the audio clip).