EFFECTS OF IFRS 9, 15 AND 16 ON BUSINESS COMBINATION ACCOUNTING

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Summary

IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* are effective for periods beginning on or after 1 January 2018 and IFRS 16 *Leases* is effective as of 1 January 2019. These three new standards have broad impacts to entities in many industries, affecting financial position and financial performance along with financial metrics, gearing and KPIs.

IFRS 9, 15 and 16 may also affect business combinations that have occurred prior to the date of adoption of the new standards, as well as business combinations occurring after their respective effective dates. While fair value is the default measurement basis for assets and liabilities acquired in a business combination in the scope of IFRS 3, certain exemptions exist, which modify this requirement in certain cases. IFRS 3 *Business Combinations* was consequentially amended in certain respects to address specific areas affected by the three new standards.

Additionally, IFRS 9, 15 and 16 affect business combinations regardless of any consequential amendments as the basis for recording fundamental transactions have changed.

This IFRB illustrates certain areas that entities should consider both in the context of their adoptions of IFRS 9, 15 and 16, but also for future business combinations and how accounting may differ from past business combinations. For further information on IFRS 9, 15 and 16, please refer to BDO's IFRS In Practice publication series.

STATUS

Not applicable

EFFECTIVE DATE

Not applicable

ACCOUNTING IMPACT

Potentially significant changes to business combinations due to other changes in IFRS.

Considerations for Business Combinations Occurring Prior to Effective Dates of IFRS 9, 15 and 16

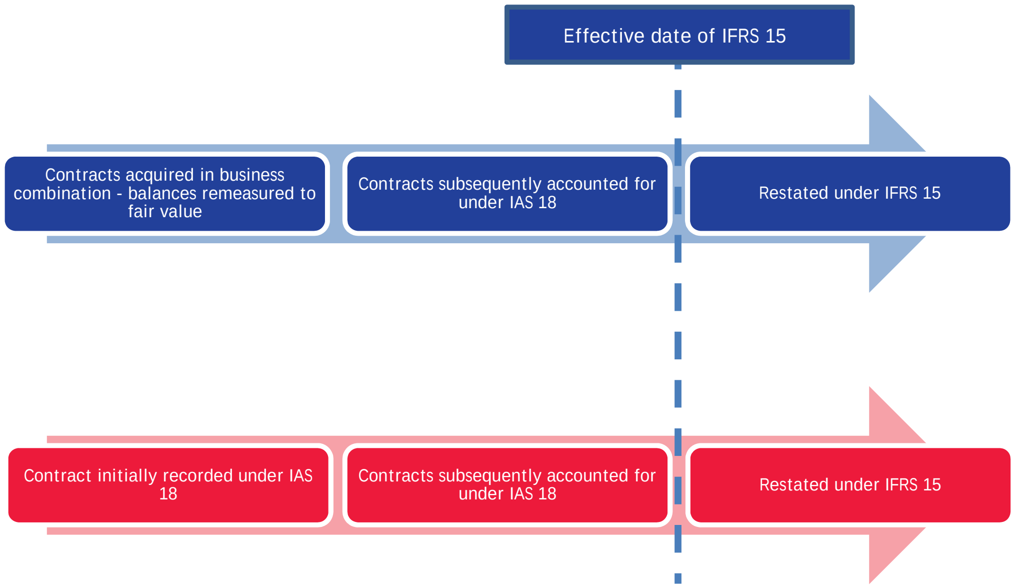
For business combinations that occurred prior to the effective dates of the new standards, the general transition requirements of each applicable standard apply. However, there are special considerations to keep in mind for balances that arose from business combinations prior to the transition dates. The following sections discuss specific issues relating to IFRS 15 and 16. The transitional provisions of IFRS 9 are comprehensive and address most issues that may arise relating to business combinations occurring prior to the effective date of IFRS 9. Please refer to BDO's IFRS 9 In Practice publication for further discussion of the transition provisions of IFRS 9.

<u>Revenue Contracts Acquired Prior to Effective Date of IFRS 15</u>

If an entity acquired a business prior to the effective date of IFRS 15, it would apply IFRS 3 to the transaction and recognise most assets and liabilities acquired at their fair values. In doing so, differences will arise between the carrying value of assets and liabilities and their fair values on acquisition. For example, the fair value of deferred revenue originally determined under IAS 18 *Revenue* (the predecessor standard to IFRS 15) would have been remeasured at fair value under IFRS 3.

If any contracts come forward into the effective date of IFRS 15 (or the comparative period when the full retrospective approach is used), then the transitional provisions of IFRS 15 will be applied to such balances.

This process of multiple remeasurements to a contract can be illustrated as follows, with the acquirer's steps in accounting for the contracts represented in blue and the acquiree's represented in red:



Assuming that both the acquirer and acquiree prepare IFRS compliant financial statements, then the entities may have to account for the contracts under three different bases over the contracts' lives:

1. Under IAS 18 in the records of the acquiree;
2. Remeasured to fair value under IFRS 3 and then subsequently accounted for under IAS 18 in the records of the acquirer; and
3. Under IFRS 15 in the records of both the acquiree and acquirer.

The underlying calculations required to perform this restatement will differ from other contracts not previously acquired in a past business combination, therefore, such contracts will have to be segregated into discrete populations apart from other contracts. It may also be challenging to reconcile the consolidated accounts

Off-Market Lease Contracts Acquired Prior to Effective Date of IFRS 16

Under IFRS 3, favourable operating lease contracts were recognised as distinct intangible assets (or liabilities for unfavourable leases) in a business combination, as the underlying lease contract was not recognised 'on balance sheet' prior to IFRS 16. Favourable leases could arise if acquirees held operating leases in desirable locations or had long-term contracts with fixed payments that were considered to be at below market rates at the time of the acquisition, or vice versa for unfavourable leases.

The transitional provisions of IFRS 16 (paragraph C19) require any asset or liability relating to favourable or unfavourable lease terms for an operating lease acquired in a business combination to be derecognised and adjusted to the carrying value of the associated right-of-use asset. This is consistent with the guidance discussed further below where off-market lease contracts are no longer discretely recognised apart from the primary measurement of the lease contract (i.e. the right-of-use asset itself), as nearly all leases are recognised 'on balance sheet' under IFRS 16.

Considerations for Business Combinations Occurring Subsequent to Effective Dates of IFRS 9, 15 and 16

Classification of Financial Assets under IFRS 9

The classification of financial assets under IFRS 9 occurs at their initial recognition. For financial assets acquired in a business combination, initial recognition occurs at the time of the business combination. The contractual cash flow test (i.e. assessing whether a debt instrument gives rise to solely payments of principal and interest), assessing the business model in which a financial asset is used and the fair value option are all available at the time financial assets are initially recognised by the acquirer in a business combination. This may result in different classification and will affect measurement of financial assets from the perspective of the acquirer and the acquiree.

Staging Provisions of Expected Credit Loss Requirements

For financial assets acquired in a business combination that are subject to the expected credit loss ('ECL') requirements of IFRS 9 (e.g. debt instruments measured at amortised cost or fair value through other comprehensive income), entities may have to segregate those financial assets acquired in a business combination from those originated by the entity and its subsidiaries. This is due to the staging provisions of IFRS 9's ECL requirements, where financial assets subject to ECL are categorised into 'buckets':

- Stage 1: financial assets that have not had a significant increase in credit risk since initial recognition;
- Stage 2: financial assets that have had a significant increase in credit risk since initial recognition;
- Stage 3: credit-impaired financial assets.

The staging drives the measurement and disclosure requirements in the ECL model. Since the relative change in credit risk since initial recognition is the mechanism for migration between these stages, 'initial recognition' must be considered carefully. For an acquirer, 'initial recognition' is the date of the business combination.

For example, Entity A is a lending entity that acquired Entity B on 1 January 2020. Entity B has several portfolios of loans measured at amortised cost, which are categorised into stages 1 – 3 based on the relative movement in credit risk since they were originated by Entity B. From the perspective of Entity A, all such financial assets must be categorised into stage 1 at the time of the business combination occurring, except for acquired loans that were in stage 3 from the perspective of Entity B at the time of the business combination. These loans are purchased or originated credit-impaired financial assets ('POCI' assets) since they are credit impaired at the time that Entity A acquires them.

This will result in several significant implications, which may be complex to address in financial reporting systems:

1. Entity A's assessment of the staging of these loans will differ from Entity B's;
2. In order to address the staging provisions, Entity A will need to develop policies and procedures to measure the relative movement in credit risk since the date of the business combination;
3. The ongoing ECL required on the instruments may therefore differ as staging may differ (e.g. a 12-month ECL may be required for Entity A, but a lifetime ECL may be required for B);
4. POCI assets will need to follow the specific guidance in IFRS 9, which requires a credit-adjusted effective interest rate to be used. This builds expected credit losses into the effective interest rate of the instrument, which may be complex to calculate and not easily achieved with current accounting systems and processes.

There are also significant implications on the presentation of financial assets subject to ECL.

<u>Presentation of Expected Credit Losses</u>

Like most assets acquired in a business combination, financial assets acquired in a business combination that are subject to the ECL requirements of IFRS 9 are initially recorded at their fair value as at the date of the business combination. While ECL is a forward-looking measure with some similarities to fair value measurement, the concepts are not identical. Therefore, the net carrying value of financial assets may differ from their fair value.

For example, continuing on from the example noted in the previous section, assume a particular financial asset subject to ECL that is owned by Entity B prior to the business combination had a gross carrying value of 100 CU ('currency units'). It also has a corresponding 20 CU ECL recorded against it, representing the lifetime ECL of the financial asset, as it is classified as a stage 2 financial asset. At the time of the business combination, Entity A determines its fair value to be 78 CU (note that the fair value of a financial asset may be more or less than the gross carrying value less ECL depending on a number of factors). No separate valuation allowance is recorded in the purchase price allocation by Entity A (IFRS 3.B41), as the fair value of the financial asset incorporates uncertainty regarding credit risk. The difference in classification and measurement of the financial asset from the perspective of Entity B and Entity A's consolidated records as at the time of the business combination can be demonstrated as follows:

	Entity A	Entity B
Gross carrying value	78	100
ECL balance	<u>Nil</u>	<u>20</u>
Net carrying value	78	80
Stage in ECL methodology	Stage 1 – 12-month ECL	Stage 2 – lifetime ECL

This results in not only the carrying value differing upon the completion of the business combination, but also the measurement of the ECL balance and the staging of the financial asset in the ECL guidance. Addressing these differences from a systems and process standpoint may be complex, especially if Entity A and B are required to maintain distinct financial records for reasons such as local jurisdictional regulation.

<u>Accounting for Contracts with Satisfied Performance Obligations and Interaction with IFRS 9 and IFRS 15</u>

Entities that acquire entities with who completed contracts for which revenue recognition remains outstanding will have to carefully examine the contractual terms of contracts.

Consider Entity Y that acquires Entity Z. Entity Z has a contract to develop a website for a customer in the scope of IFRS 15, where revenue is based on the number of website visits over the next 5 years. As at the time Entity Z is acquired, Entity Z has satisfied its performance obligation as the website is developed and no deliverables remain, however, revenue has not been entirely recognised for the contract, due to the variable amount of the transaction price being constrained (IFRS 15, paragraph 56). Therefore, despite the fact that Entity Z has satisfied all the performance obligations identified in the contract, revenue will continue to be recognised as the variable consideration constraint is 'released' over the 5 year period.

When Entity Y acquires Entity Z, it accounts for the contract acquired using IFRS 3. As discussed above, this would include measuring the outstanding performance obligations at their fair value, however, no such performance obligations exist, as

Entity Z satisfied them all prior to the date of the business combination. In substance, Entity Y has acquired a stream of future cash flows that will vary depending on website traffic, with no obligation to perform any activities associated with the contract.

At the time of the acquisition, Entity Y must measure an asset relating to the stream of future cash flows that are expected to be received. This may be achieved by determining a best estimate of the cash flows to be received and applying an appropriate discount rate. To subsequently measure the asset acquired by Entity Y in the business combination, Y must consider the nature of the asset it received in the business combination. As the cash flows do not require Entity Y to provide any goods or services, from the perspective of the acquirer, the contract is a financial asset in the scope of IFRS 9, not a contract with a customer in the scope of IFRS 15.

As such, the financial asset must be classified based on the requirements of IFRS 9. As the financial asset's cash flows vary depending on the next 5 years of website traffic, the financial asset would not satisfy the contractual cash flow test under IFRS 9, and would therefore be mandatorily classified as at fair value through profit or loss. As such, the contract is therefore initially recorded at fair value by Entity Y and subsequently measured at fair value through profit or loss.

Since the financial asset is not on the scope of IFRS 15, movements in the financial asset's carrying value will be recorded in profit or loss, but they would not be classified as revenue under IFRS 15. They would be presented with other fair value movements in financial assets classified as fair value through profit or loss.

This results in significantly different financial reporting outcomes in the consolidated accounts of Entity Y compared to Entity Z. As the uncertainty surrounding the amount of cash is resolved, Entity Z will record revenue under IFRS 15, subject to the variable consideration constraint. Entity Y will record income arising from financial instruments, which is not 'top line' revenue, and is also subject to different measurement guidance (fair value measurement under IFRS 9 and IFRS 13 vs. variable consideration subject to the variable consideration constraint under IFRS 15).

<u>Resetting Discount Rates in Contracts with Significant Financing Components</u>

IFRS 15 requires that the transaction price of contracts be adjusted when a contract contains the benefit of a significant financing component to either the customer or the entity itself. This would result in the adjustment of the transaction price and the presentation of finance income when the benefit of financing is to the customer or the presentation of finance expense when the benefit of financing is to the entity itself.

The discount rate used to adjust the transaction price and subsequently used to calculate finance income or expense is determined at the inception of the contract, but it must be re-assessed by an acquirer in a business combination. As has been noted earlier, contract assets and contract liabilities will be recognised at their fair value in a business combination. Inherent in this will be the determination of a discount rate based on the guidance in IFRS 13, which is a market participant based rate.

In subsequently accounting for the contract, from the perspective of the acquirer, a discount rate as determined using the principles of IFRS 15 will be used to subsequently measure the contract. The effect of this difference in accounting between the acquirer and the acquiree would be especially apparent in long-term contracts with over time revenue recognition, such as certain long-term construction contracts.

<u>Measurement of Lease Contracts for Lessees</u>

As noted in the earlier section, since almost all lease contracts will be recorded 'on balance sheet' under IFRS 16, leases acquired in business combinations will require specific measurement considerations. Leases liabilities will be recorded based on the present value of the remaining lease payments, with a corresponding right-of-use asset (adjusted for favourable or unfavourable terms compared to market rates at the date of the business combination). This measurement requirement has several key points to consider:

1. While IFRS 3 will no longer result in separate intangibles being recognised for favourable lease terms, entities must still identify when lease contracts have favourable or unfavourable terms, as these will result in an adjustment to the carrying amounts of right-of-use assets.
2. The lease liability and corresponding right-of-use asset being 'reset' to equal one another (assuming no adjustment to the right-of-use asset for favourable or unfavourable terms) at the time of the business combination may create significant differences between acquirer and acquiree records, since the acquiree's amortisation tables may differ substantially. This is because the acquired leases are treated as if they are new leases as at the date of the business combination, including the option to expense low value or short-term leases (based on the remaining term as at the date of the business combination).
3. While lease liabilities are similar to financial liabilities within the scope of IFRS 9, IFRS 3 directs entities to measure leases based on the requirements of IFRS 16. Therefore, lease liabilities and right-of-use assets are not measured at their respective fair values, unlike many other assets and liabilities acquired in a business combination.

Contingent Consideration Payable

For business combinations occurring both prior to and after the effective dates of IFRS 9, 15 and 16, the business impact on contingent consideration payable must be considered.

Contingent Consideration Payable (continued)

It is common for acquirers to pay a fee to the seller of a business, which is contingent on the future operations and profitability of the acquired entity. This fee may be a multiple of net income, earnings before interest, tax, depreciation and amortisation ('EBITDA'), or some other metric.

IFRS 9, 15 and 16 may have significant impacts on the calculation of items such as net income and EBITDA, which may impact the amount of contingent consideration payable. For business combinations that occurred prior to the effective dates of IFRS 9, 15 and 16, the terms of the agreements must be analysed to determine whether the basis of accounting to determine the contingent amount is based on a 'frozen' set of accounting policies, or whether they are updated to reflect changes arising from IFRS 9, 15 and 16.

For business combinations occurring subsequent to the effective dates of the new standards, entities must be aware of the impact the new standards will have on these metrics. For example, if entities have historically used a multiplier of EBITDA in contingent consideration agreements, the effects of IFRS 16 on EBITDA must be considered.

More Information on the Effects of IFRS 9, 15 and 16

For further information on IFRS 9, 15 and 16, please refer to BDO's IFRS In Practice publication series.

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