IFRS Interpretation Committee
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

July 10th, 2023

Subject: enquiry to the Interpretation Committee

Dear Madam, Sir,

I am writing to you to address a remaining harmful difficulty for those affected, to implement properly the provisions of IFRS 3.B.55.a about contingent payments, since the 2013 agenda decision made by the Interpretations Committee.

You will find here-after the issue and the rationale followed we would be grateful the IFRS Interpretations Committee to address.

1 The matter

1.1 The fact pattern

The Company ("Co") carries out every year several business combinations by taking over small and medium entities in its areas of business that become 100% subsidiaries. These entities are privately-owned by their founders and managers at the time of their acquisition by Co.

When acquiring a business, the main concern of Co's management is to achieve the appropriate transfer of knowledge to the new management team, especially the relationships with key-customers, vendors and employees, and then, the current stream of revenue and profitability of the acquirees.

For this purpose, Co requires in the share purchase agreement ("SPA") the sellers-managers to hand over the business to the new managers appointed by Co. The related duty of the sellers is limited to staying during a limited period of time ("the hand-over period"), often on a part-time basis, to manage this transfer of knowledge and relationships.

The SPA and labour or service contract signed together between Co and the sellers-managers provide for the following terms and provisions:

- The sellers-managers are compensated at a level that is comparable to other top management executives for their services during the hand-over period;
- Their duty is limited to providing hand-over services, excluding for instance business development;
- The earnout payment is contingent to reaching a specific level of normative EBITDA (that is actual EBITDA at the time of acquisition) and to the continued employment of the sellers-managers during the whole hand-over period (on a "good/bad leaver" basis)

Currently, the earnout payments made by Co are qualified as a post-acquisition compensation and are expensed in the consolidated income statement of the Group, on the basis of the current interpretation of IFRS3.B55.a by the IFRS IC[1]. In this context, Co has faced harmful effects where it cannot implement a condition of presence to achieve safely its hand-over process.

1.2 Business cases

To illustrate the pattern, we provide here-below two recent business cases encountered by Co.

Business case #1 (figures in thousand CU)

Purchase price: 17.000

- Fixed price: 14.000
- Earnout: 3.000

Annual compensation: 150 (on a full time basis)
Trigger of the earnout: 50% of the normative EBITDA
Hand-over period: 9 months
Earnout represents 121% of the FY22's EBITDA

Business case #2 (figures in thousand CU)

Purchase price: 22.000

- Fixed price: 19.000
- Earnout: 3.000

Annual compensation: 88 (corresponding to a quarter-time basis)
Trigger of the earnout: 100% of the normative EBITDA
Hand-over period: 2 years
Earnout represents 75% of the FY22's EBITDA

[1] IFRIC *Update*, January 2013, Agenda Decision, 'IFRS 3 *Business Combinations—Continuing employment*'

1.3 Questions proposed for the Interpretation Committee's consideration

1. **Does the January 2013 agenda decision[2] allows for an "in-substance" analysis of the contingent payment as it has been suggested by some respondents to the IFRS3 PIR in 2015?[3]**

   An analysis of the substance of the transaction leads to split the accounting of the contingent payment between its "service" component if any, and its "additional consideration for the business combination" component.

   Split accounting is of widespread use in IFRS to reflect the substance of transactions. For example, to account for hybrid contracts (IAS32 and IFRS 9) or for service contracts that contain a lease (IFRS 16).

   The "service component" would be measured at its fair value, on the basis of IFRS 13 rules and guidance. Markets rates may be obtained by reference to the compensation granted to comparable key-managers.

   The "additional consideration for the business combination" component will be equal to the remaining portion of the payment, after deducting the amount of the service component.

2. **Should a good and bad leaver provision be regarded as an "automatic forfeiture"?**

   According to the IFRS IC Agenda Decision[4], *"payments to an employee that are forfeited upon termination of employment are remuneration for post-combination services"*.

   In the SPAs signed by Co, the condition of presence associated with the earnout payment is based on a "good and bad leaver" provision.

   Bad leaving / good leaving provisions are designed to manage the early leaving of the manager-seller. It is not intended to compensate a service but rather to secure the hand-over process.

   The bad leaving of the sellers (before the end of the hand-over period) triggers the forfeiture of the earnout payment by Co (the acquirer). The good leaving (before the of the hand-over period) permits the sellers to earn the contingent payment. The good leaving is subject to either the observance of specific conditions (death, disability), or the agreement of Co.

   Thus, a bad leaver that "slams the door" will harm the hand-over and consequently the business, leading to trigger a kind of penalty or indemnification (that is the forfeiture of the payment). Good leaving will trigger the payment of the contingent consideration.

   At the end of the day, there is not an automatic forfeiture, as in the case of a good leaving, the payment is due.

---

[2] *"the Interpretations Committee observed that an arrangement in which contingent payments are automatically forfeited if employment terminates would lead to a conclusion that the arrangement is compensation for post-combination services rather than additional consideration for an acquisition,* ***unless the service condition is not substantive****"* [emphasis added].

[3] For instance Comment letter issued by the French standard setter ("Autorité des Normes Comptables") to the IASB, in June 2014 , p.17 (Question 9).

[4] IFRIC *Update*, January 2013, Agenda Decision, 'IFRS 3 Business Combinations—Continuing employment'

2 Current practice

[A brief description of current or emerging accounting practices, outlining the alternatives, and referring to the applicable requirements in IFRS Accounting Standards.]

Current practice is led by the authority of the IFRIC's January 2013 agenda decision. The earnout payments contingent to the continued employment of the sellers are systematically accounted for as an expense, regardless of the substance of the transaction.

3 Reasons for the Interpretations Committee to address the matter

3.1 Does the matter have widespread effect and does it, or is it expected to, have a material effect on those affected?

Yes, many Issuers and Preparers are facing difficulties, including in Europe, to get alternative solutions to the condition of presence in order to secure their hand-over process.

The accounting of those contingent payments as an expense has a material effect on the financial statements. For instance, this expense currently counts for 11% of Co's consolidated operating income, whereas the contribution of the related acquired entities to this consolidated operating income is of 32%.

This issue has been raised by many respondents, including several European standards setters (such as United-Kingdom and France among others), to the Agenda Consultation about the IFRS 3 post-implementation review. Following the IFRS3 PIR, the IASB's staff agreed to further investigate this issue: *"However, depending on the feedback received from the 2015 Agenda Consultation, we could start working on this issue; for example, by investigating in which circumstances these payments should be considered as consideration transferred in the acquisition."*[5]. But considering this topic as of "low priority", the staff did not add it to the IASB Work Plan 2017-2021.

3.2 Is it necessary to add or change requirements in IFRS Accounting Standards to improve financial reporting—that is, do the principles and requirements in the Accounting Standards not provide an adequate basis for an entity to determine the required accounting?

As described above, we believe that the "conclusive language" in paragraph IFRS3.B55.a could be shifted to a more conditional wording so that it remains as an indicator. Additional guidance from IFRS IC to provide for an "in-substance" analysis of the payments contingent to the continued employment of the seller would be a valuable input.

3.3 Can the matter be resolved efficiently within the confines of the existing Accounting Standards and the Conceptual Framework for Financial Reporting?

Yes, even if the IFRS IC may have to consider a narrow-scope amendment of IFRS3.B55.a.

[5] Report and Feedback Statement on the Post-implementation review of IFRS 3, p.26 (June 2015)

3.4 Is the matter sufficiently narrow in scope that the IASB or the Interpretations Committee can address it in an efficient manner, but not so narrow that it is not cost-effective for the IASB or the Interpretations Committee and stakeholders to undertake the due process required to change an Accounting Standard?

The current accounting treatment of contingent payments linked to a condition of presence has material adverse effects on the financial statements, regardless the substance of the transaction.

We believe a narrow-scope amendment targeting IFRS3.B55.a would be an efficient manner to solve this issue, unless the IFRS IC assesses an Agenda Decision based on the substance of the transaction would be a sufficient way to do it.