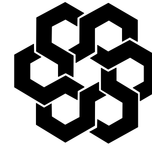

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**21 March 2007, London**
Project:	**Business Combinations II**
Subject:	**Contingent Consideration (Agenda Paper 2B)**

PURPOSE OF THE MEMO

1. This memo addresses the proposal in both the FASB's and the IASB's Business Combinations Exposure Draft (BC ED) that the acquirer measure and recognize *contingent consideration* (liabilities and equity) at fair value as of the acquisition date and subsequently. The purpose of this memo is to discuss whether the Boards want to change that proposal as a result of (a) the direction the Boards have taken with contingencies, (b) the concerns expressed by respondents to the BC ED, or (c) other potentially conflicting guidance in U.S. GAAP or IFRSs.

CONTINGENT CONSIDERATION—EXISTING GUIDANCE

Statement 141

2. Paragraphs 25–31 of Statement 141 provide the U.S. guidance for accounting for contingent consideration in a business combination. Paragraph 26 states that ”amounts of contingent consideration that are *determinable* at the date of acquisition shall be included in determining the cost of an acquired entity and recorded at that date” (*emphasis* added). Therefore, only contingent consideration whose settlement amount is *determinable* (not estimable) is recognized at the acquisition date. An example is when the contingent consideration is based on security prices such that the number of shares varies to make the contingent consideration equal that specified amount. Since the total amount of contingent consideration is determinable (the number of shares is unknown), it would be recognized at the acquisition date.

3. However, in many cases, the amount of the contingent consideration is not determinable at the acquisition date. In that case, paragraph 27 states that “the contingent consideration usually should be recorded when the contingency is resolved and consideration is issued or becomes issuable“ (that is, when the settlement amount is determinable).

4. Contingent consideration based on earnings is recognized as an additional element of cost (adjustment to goodwill) (paragraph 28, paraphrased). In contrast, contingent consideration based on security prices does not change the recorded cost of the combination (paragraph 30, paraphrased).

IFRS 3

5. Paragraph 32 of IFRS 3 requires that contingent consideration be recognized at the acquisition date “if the adjustment is *probable* and can be measured reliably.” IFRS 3 also requires that the acquirer adjust the cost of the combination:

a. For changes in the value of the contingent consideration since the acquisition date (paragraph 33, paraphrased).

b. When the contingent consideration becomes *probable* and *reliably measurable* (paragraph 34, paraphrased).

BOARDS' CONCLUSIONS DURING INITIAL DELIBERATIONS

6. The BC ED proposes that an acquirer would measure and recognize contingent consideration at fair value as of the acquisition date and classify that obligation as either a liability or equity. After initial recognition, contingent consideration classified as equity would not be remeasured. Contingent consideration classified as a liability would be remeasured to fair value (or if the contingent consideration is a liability in the scope of IAS 37, remeasured in accordance with IAS 37). Changes in the amount recognized for contingent consideration would be recognized in earnings unless the contingent consideration is a hedging instrument and Statement 133 or IAS 39 allows the changes to be recognized directly in equity or other comprehensive income.

7. The basis for the Boards' conclusion on the initial recognition of contingent consideration is as follows:

    a. The Boards concluded that not recognizing an obligation of the acquirer at the acquisition date for future contingent payments would not fairly represent the economic consideration exchanged at that date. (paragraph B75; paraphrased)

    b. While measuring the fair values of some contingent payments may be difficult, to ignore or delay recognition of obligations that are difficult to measure would cause financial reporting to be incomplete. (paragraph B78; paraphrased)

    c. The Boards considered arguments that constituents would prefer to retain the guidance in Statement 141 and IFRS 3 because of difficulties in measuring the fair value of contingent consideration at the acquisition date. Some constituents expressed concern about the increased subjectivity that they believe such measurements introduce in the financial statements and others argued that many or most contingent consideration arrangements cannot be reliably measured. However, the Boards concluded that the notion that an entity's directors and managers enter into such arrangements

without assessing and measuring the economic risk inherent in the agreement is inconsistent with prudent business practices. (paragraph B76; paraphrased)

BOARDS' DECISIONS FOR CONTINGENCIES

8. Contingent consideration and contractual contingencies are similar in the sense that (a) there is no element uncertainty because the contract provides evidence that a liability (asset) exists but (b) there is uncertainty about the timing and amount of the future payment. Because contingent consideration and contingencies are similar, the next section of the memo summarizes the Boards' decisions about contingencies.

FASB's Contingencies Guidance

9. At the February 28, 2007 meeting the FASB decided that:

   a. Contractual contingencies (assets and liabilities) should be recognized and measured at fair value as of the acquisition date.

   b. Non-contractual contingencies (assets and liabilities) should be recognized and measured at fair value as of the acquisition date if it is *more likely than not* that the contingency meets the definition of an asset or liability.

   c. After the acquisition date, contingencies should be measured at fair value and changes in fair value should be recognized in earnings (except for measurement period adjustments, which would generally be recognized as adjustments to goodwill).

IASB's Contingencies Guidance

Temporary Guidance until the IAS 37 Project Is Completed

10. The IAS 37 project will not be completed before the final business combinations standard is issued. Therefore, IFRS 3 (revised) will provide the following guidance for accounting for contingencies until the IAS 37 project is completed. When complete, IAS 37 (revised) is likely to amend the business combinations standard. In the interim, IFRS 3 (revised) will provide the following guidance:

a. Assets and liabilities for which the amount of the future economic benefits embodied in the asset or required to settle the liability are conditional on the occurrence or non-occurrence of one or more uncertain future events should be recognised if its fair value can be **measured reliably.** After initial recognition, the acquirer should measure:

   (i) Any such liabilities at the **higher of** (1) the amount initially recognized (less, when appropriate, cumulative amortization) or (2) the amount that would be recognized under IAS 37 (current settlement value when *probable* and *reliably measurable*)

   (ii) Any such assets in accordance with IAS 37 (reimbursements), IAS 38 (intangible assets at fair value), or IAS 39 (financial assets and liabilities at fair value), as appropriate.

Tentative Decisions in the IAS 37 Project

11. The IASB has been deliberating the accounting for non-financial liabilities and reimbursements as part of its IAS 37 project. To date, the IASB has decided that **if the contingency is:**

   a. **A liability** within the scope of IAS 37:

      (1) Recognize when the **definition of a liability** has been satisfied and the non-financial liability can be **measured reliably.** The IAS 37 ED provides limited guidance about when the definition of a liability is satisfied. The IASB is exploring whether it is possible to develop indicators to assist in that determination.

      (2) Measure at the amount the entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date using an expected cash flow approach. (The IASB acknowledges that its proposed measurement is similar to fair value, but has decided against labeling the proposed measurement principle fair value as part of this project.)

   b. **A reimbursement right**

      (1) Recognize a reimbursement right as an asset if the reimbursement right can be **measured reliably.**

      (2) The IAS 37 ED does not specify measurement, it only states that the *amount* recognized for the reimbursement right should not exceed the amount of the related non-financial liability. The

IASB has decided to add that guidance, but has yet to consider the nature or form of the guidance.

Staff Analysis

12. The staff believes that the Boards' decisions for contingencies support the accounting for contingent consideration that was proposed in the BC ED.

COMMENT LETTER RESPONSES

13. Some preparers, the majority of audit firms, most valuation practitioners, and users agreed that contingent consideration should be initially recognized at fair value. For example, one audit firm stated:

> We agree that contingent consideration and equity interests issued by the acquirer should be measured and recognized at acquisition-date fair value. The proposed recognition and measurement requirements are consistent with the proposed accounting objective for business combinations. [CL #20]

14. One respondent stated that it is inappropriate to look past the acquisition date to value contingent consideration because we do not look past the acquisition date to value other assets, liabilities or equity instruments in a business combination. That respondent stated:

> We agree that acquisition date fair value is the best evidence of determining fair value. We do not support looking past the acquisition date for any aspects of the consideration, for example contingent consideration. Firms are always going to get a better idea later on down the track of whether the price they paid at day 1 was too high or too low. Shifting the valuation of some, but not other, aspects of the consideration out to get the benefit of hindsight would create an inconsistent anomaly. . . . [CL #29]

15. Some stated that it is inappropriate to defer recognition of an obligation when, in many cases, contingent consideration is used as a deferred payment mechanism. Some also agreed with the Boards that when determining the purchase price, management has already estimated what it expects to pay for contingent consideration. For example, one respondent stated:

> We concur with the proposed Standard's treatment of contingent consideration. Whether contingent consideration has been put in place to take into account differences in opinion between the seller and the buyer regarding the future performance of the acquiree or actually represents a deferred payout of the acquisition price, we believe the acquiree's management team has factored such contingent consideration into its final decisions regarding purchase price. Management's decisions to consummate a business combination would have been based in larger part on projections and business models that can serve as the basis for estimating the fair value of contingent consideration at the acquisition date. We believe it is appropriate for the acquirer to include the fair value of contingent consideration in its determination of the purchase price. . . [CL #108]

16. For those who disagreed with initially recognizing contingent consideration at fair value, the alternative they suggested seemed to depend on whether the respondent applies U.S. GAAP or IFRSs. U.S. preparers generally believe the Boards should retain the accounting in Statement 141 (generally recognize when the contingency is resolved and the consideration is issued or becomes issuable and adjust goodwill). IFRS preparers and one audit firm believe the Boards should retain the accounting in IFRS 3 (recognize when probable and reliably measurable and adjust goodwill).

17. While valuation practitioners and users generally agreed with the proposed subsequent accounting for contingent consideration, the majority of preparers and audit firms disagreed that after the acquisition date, contingent consideration liabilities should be measured to fair value and that changes should be recognized in earnings.

18. The concerns expressed by respondents, mainly preparers and audit firms, about initial recognition and subsequent measurement are described in the next section of the memo. The concerns can be put in the following categories:

    a. The proposals will lead to accounting abuse (*accounting abuse*).

    b. The costs of the proposals will outweigh the benefits (*cost-benefit*).

    c. Recognizing the fair value of contingent consideration provides irrelevant information (*relevance*).

d. Contingent consideration cannot be reliably measured (*reliable measurement*).

e. Performance-based contingent consideration cannot be reliably measured (*measurement of performance-based contingent consideration*).

f. Performance-based arrangements are more like profit sharing (compensation) than contingent consideration (*classification of performance-based arrangements*).

g. Subsequent changes in the fair value of contingent consideration confirm the value of the acquiree and, therefore, should be recognized as adjustments to the purchase price (*recognize changes as adjustments to the purchase price*).

h. The proposals will lead to recognition of gains and losses that do not reflect economic reality (*counterintuitive results*).

i. Are changes in the fair value of contingent consideration measurement period adjustments (*measurement period*).

A. Accounting Abuse

19. Some respondents suggested that the proposals might motivate acquirers to overestimate the acquisition date fair value of contingent consideration so that (a) there is no income statement impact in future periods, or (b) the reversal of those liabilities results in income in future periods. For example, one respondent stated:

> We also believe that this proposed accounting will have the unintentional effect of motivating some companies to be extremely conservative in their estimates of the likelihood that a contingent consideration payment will materialize. By assigning a high probability that the liability-classified contingent consideration will be paid, an acquirer can avoid, for the most part, recording subsequent charges through the income statement if the contingency does result in a payment. Alternatively, if the contingency does not result in a payment, the liability recorded will be reversed, resulting in income to acquirer in future periods. [CL #57]

20. While that might be a consequence of the proposal, the staff believes that the Boards should not compromise on the conceptually appropriate answer for fear of abuse. If the Boards find that argument compelling, one alternative

would be to default to the accounting that is currently required by Statement 141 (recognize when the contingency is resolved and the consideration is issued or becomes issuable). But that alternative results in less relevant information and results in deferred recognition of a liability, which also could be viewed as an abuse.

21. The staff believes that the proposed disclosures also will help alleviate the issue. That is, if the Boards affirm that an acquirer be required to disclose any changes in the amount recognized for contingent consideration, the reasons for the changes, the settlement amount, and the range of possible outcomes, that will add transparency around the amounts recognized and should diminish the motivation to overstate liabilities. For example, if an entity does recognize a gain as a consequence of not meeting a performance target, a requirement to report the change in the amount recognized for contingent consideration and the reason for the change will add transparency to the gain.

B. Cost-Benefit

22. A number of respondents, generally preparers, asserted that the proposals will result in significant costs to acquirers due to the need for external valuations to value the obligation not only on the acquisition date but also subsequently. This suggests that they believe that the costs of the proposal outweigh the benefits of providing timely and relevant information.

23. With initial recognition, the staff believes that there is no significant cost to measuring the fair value of contingent consideration as of the acquisition date. In determining the purchase price for an acquisition, management generally estimates what the company will likely pay for contingent consideration. For example, one valuation practitioner stated:

> As a practical matter, although current accounting does not compel either the measurement or recognition of contingent consideration in all cases, valuation practitioners typically develop valuation models that are based on the expected case Projected Financial Information ("PFI") of the acquiree as a whole. These valuation models, which are consistent with the valuation guidance

> provided in the ED as referred to above, are derived from the projections developed by the acquirer in their assessment of the acquiree and their deal negotiations, internal evaluations and Board presentations. The expected case PFI as a whole forms the foundation for the derivation of the valuation of the underlying acquired assets and liabilities, including both the assessment of income contribution (or cost savings) and the related risk-adjusted discount rate for each identifiable acquired asset and liability. The expected case PFI is also used to estimate the fair value of the acquiree as a whole in order to assess and correlate the assumptions and respective values of the component assets and liabilities with those of the overall business. [CL #27]

24. Therefore, the staff believes the proposal to initially recognize contingent consideration at fair value should not result in significant additional costs. However, the proposal to subsequently remeasure contingent consideration to fair value in each subsequent reporting period may result in additional costs. Some respondents argued that the requirement would result in the need to obtain costly valuations at each reporting period until the contingent consideration is settled. Some suggested that a way to minimize the subsequent costs would be to require that the acquirer not remeasure the contingent consideration liability until it is settled.

25. While the proposal may result in additional costs, users told the Boards that recognizing the fair value of contingent consideration provides relevant and necessary information. The staff also believes that the suggestion to not remeasure the contingent consideration until it is settled would provide little relevant information to users about what will be paid, would result in overstating or understating a liability, and would provide no more relevant information than if $0 had been recognized as of the acquisition date.

C. Relevance

26. A number of respondents, generally preparers, asserted that recognizing the fair value of contingent consideration at the acquisition date based on an expected value approach does not provide users of financial statements with relevant information about the ultimate settlement amount of that obligation.

27. Under Statement 141 and IFRS 3, entities are generally reporting the settlement amount of contingent consideration because they generally do not recognize contingent consideration until the contingent consideration becomes *probable* (IFRS 3) or the contingency is resolved (Statement 141). While the amounts recognized under Statement 141 and IFRS 3 may not have measurement uncertainty because they generally equal the settlement amount, it is difficult to argue that the guidance in Statement 141 or IFRS 3 results in more relevant information. Users told the Boards that the information provided by Statement 141 or IFRS 3 is received too late to be useful. Users support the recognition of contingent consideration at fair value as of the acquisition date. They understand that the amount that would be recognized is not the ultimate settlement amount and that it would be an estimated amount that embeds uncertainty into the measure. However, they believe that information is better than a measure of $0.

28. The staff believes that the proposed disclosures also will help alleviate the concern that fair value is not the same as the settlement value. That is, if the Boards affirm that an acquirer must disclose the range of outcomes, the disclosure will add transparency around the amount recognized and the amounts that might be paid and should diminish the relevance concerns.

D. Reliable Measurement

29. A number of respondents, generally preparers, stated that contingent consideration is used to "bridge the gap" between what the acquirer thinks the business is worth and what the acquiree thinks the business is worth. Therefore, contingent consideration cannot be measured reliably. For example, one respondent stated that "contingent consideration mechanisms are often negotiated to bridge differing views on the fair value of a business combination. As such, we find it curious to mandate fair value accounting for something that results directly from the inability of two parties to agree on fair value. . ." (CL #42).

30. Some constituents acknowledged that acquirers typically estimate what they will have to pay for contingent consideration in determining the purchase price. However, they believe that those estimates are not sufficiently reliable for *recognizing* an amount in the financial statements. For example, one respondent stated:

> We are also concerned with the ability to reliably estimate the fair value of contingent consideration. . . . While we agree with the Board that those entering into such arrangements should have assessed and tried to measure the economic risk inherent in the contingency, we do not believe such activity does or would necessarily result in a reliable estimate of the fair value of such contingent consideration. [CL #21]

31. The staff disagrees with those constituents who believe that their estimates are not sufficiently reliable for purposes of measuring contingent consideration. In many cases, an entity will not have observable (market) inputs for developing fair value measures and will have to rely on its own assumptions. An entity relying on its own assumptions for measuring an asset or liability is not inconsistent with the fair value objective, as long as there is no contrary data available. Paragraphs C84 and C85 of the basis for conclusions to Statement 157 state the following:

> . . .the [FASB] Board affirmed its conclusion in other accounting pronouncements that unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, allowing for situations in which there might be little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same—an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs should reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability (including assumptions about risk) developed based on the best information available in the circumstances.
>
> The Board agreed that in many cases, the best information available with which to develop unobservable inputs might be the reporting entity's own data. The Board affirmed its view in Concepts Statement 7 (and other existing accounting pronouncements) that the reporting entity may use its own data to develop unobservable inputs, provided that there is no information

> reasonably available without undue cost and effort that indicates that market participants would use different assumptions in pricing the asset or liability. . . .

32. The staff notes that contingent consideration arrangements are most often financial instruments.[1] The Boards have concluded repeatedly that the appropriate measurement attribute for financial instruments is fair value. It is not clear why contingent consideration should be an exception.

33. While concerns about measurement uncertainty are understandable, the staff believes that failure to recognize contingent consideration leads to measures that are less reliable than recognizing contingent consideration at amounts that might have some degree of measurement uncertainty. That is, a measure of $0 when it is likely that an entity will have to pay some amount is not a more reliable measure than a measure based on estimates with measurement uncertainty.

34. The staff believes that an acquirer should have developed an estimate of the value of contingent consideration before agreeing to the purchase price. However, if the acquirer did not, the measurement period will allow an acquirer sufficient time (not to exceed one year) to obtain the information needed to develop a fair value estimate for contingent consideration as of the acquisition date.

E. Measurement of Performance-Based Contingent Consideration

35. A few respondents stated that performance-based contingent consideration cannot be measured reliably at the acquisition date. For example, an audit firm, stated:

> . . .Further, we agree that the fair value of contingent consideration based on security prices can be reliably measured on the acquisition date and should be part of the acquisition cost. Such consideration should subsequently be accounted for in accordance with applicable GAAP (e.g., Statement 133, IAS 39).

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[1] IAS 32 defines a *financial instrument* as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity."

> However, we believe that contingent consideration based on the acquiree's earnings levels or other performance measures (performance-based contingent consideration) should be included in the acquisition price on the date of acquisition only if payment is probable at acquisition.
>
> We believe that performance-based contingent consideration generally is not reliably measurable at the acquisition date. In our experience, such contingent consideration is often agreed to because the buyer and seller were unable to reach an agreement as to the fair value of the entity. As a consequence, we question the ability to reliably measure the fair value of such contingent consideration at the acquisition date in most cases. Rather, we believe that such amounts should be recognized as an adjustment to acquisition accounting when the amounts are probable of being paid. We acknowledge that this will require the Boards to reach agreement on a common threshold for recognition and a common treatment when it is recognized (i.e., retrospective vs. an adjustment to purchase consideration in the period of recognition). [CL #88]

36. The comment letters did not state this specifically, but some staff believe there is a potential inconsistency between the proposal to initially recognize and measure performance-based contingent consideration at fair value and the requirements of Statement 123(R) and IFRS 2 for measuring share-based payment awards with performance conditions. That is, in both Statement 123(R) and IFRS 2, the Boards concluded that:

    a. A **market condition** is included in the grant date (measurement date) fair value of a share-based payment award.

    b. A **service condition** or a **performance condition** is not included in the grant date fair value of a share-based payment award because it is not feasible to develop sufficiently reliable estimates of the probability of achieving service or performance conditions. Thus, no compensation cost is ultimately recognized if a service or performance condition is not met.

37. For example, if an entity issues a share-based payment award with only a performance condition, the entity measures the fair value of the award (fair-value-based measure) at the grant date but does not recognize compensation cost associated with that award until it is *probable* that the performance condition will be met. At the point that it becomes *probable* that the performance condition will be met, the entity begins recognizing the

compensation cost. If facts change and it is no longer probable, the entity reverses any recognized compensation cost. Thus, no compensation cost is ultimately recognized if a performance condition is not met.

38. An arrangement with only a service condition would likely be compensation not contingent consideration. However, contingent consideration arrangements could be based on either (or possibly even both) a market or a performance condition. The glossary to Statement 123(R) defines *market* and *performance conditions* as follows (the definitions are similar to the definitions in IFRS 2 so those are not repeated here):

    a. **Market condition**—A condition. . .that relates to the achievement of (a) a specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares or (b) a specified price of the issuer's shares in terms of a similar (or index of similar) equity security (securities).

    b. **Performance condition**—A condition. . .that relates to both (a) an employee's rendering service for a specified (either explicitly or implicitly) period of time and (b) achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities). Attaining a specified growth rate in return on assets, obtaining regulatory approval to a market-specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions for purposes of this Statement. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share that exceeds the average growth rate in earnings per share of other entities in the same industry is a performance condition for purposes of this Statement. A performance target might pertain either to the performance of the enterprise as a whole or to some part of the enterprise, such as a division or an individual employee.

39. The basis for conclusions to Statement 123(R) provides the basis for why the FASB decided that performance conditions should not be factored into the grant date fair value of a share-based payment award. The IASB's basis was similar. Paragraph B176–B179 of Statement 123(R) state:

> The [FASB] Board decided to maintain the distinction between performance and market conditions, in part due to

concerns about the measurability at the grant date of the expected outcomes associated with performance conditions. That is, the Board concluded that it would not be feasible to eliminate the distinction by reflecting the effects of both performance conditions and market conditions in an award's grant-date fair value and recognizing compensation for both if the requisite service is rendered. Although it would be possible, in theory, to estimate the grant-date fair value of an award with a performance condition, to do so would involve developing a probability distribution reflecting the likelihood that the entity will, for example, achieve a specified percentage increase in return on assets in a specified period of time. An entity might have little, if any, data on which to base such a probability distribution, and it would be unlikely to be able to obtain adequate pertinent information about similar awards made by similar entities. Also, the IASB proposed in ED2 a requirement to take into account the effects of performance conditions in estimating an award's fair value at the grant date. Respondents to ED2, as well as to the FASB's Invitation to Comment, generally objected to that proposal on the grounds that it would not be feasible to develop sufficiently reliable estimates of the probability of achieving performance conditions. The Board also was concerned about the potential inconsistency if the effects of performance conditions were taken into account in measuring fair value at the grant date unless the effects of service conditions were treated similarly.

The [FASB] Board also considered eliminating the different accounting for performance and market conditions by requiring recognition of no compensation cost if either type of condition is not satisfied, regardless of whether the requisite service has been rendered. However, based on discussions with members of the Options Valuation Group, the Board understands that the fair value of a share option with a market condition can be estimated at the grant date using valuation techniques developed for similar options that trade in external markets. The Board concluded that it would be inappropriate and illogical not to take advantage of relatively well-developed valuation techniques for those traded options in accounting for awards with market conditions. Therefore, this Statement continues to require recognition of compensation cost for awards with market conditions based on the fair value at the grant date, provided that the requisite service is rendered.

The [FASB] Board also notes that performance and market conditions are conceptually distinct. Including a performance condition in an award of share-based compensation requires an employee to contribute to achieving an increase in a specified measure of the entity's performance regardless of the extent to which that increase is reflected in the entity's share price. For

example, a performance condition may require an increase of 15 percent in market share over a 2-year period. But the entity's share price may not increase accordingly, and may even decrease, even though that condition is achieved.

Market conditions, on the other hand, pertain to the interaction between an entity's individual performance as reflected in its share price and changes in the environment in which it operates. For example, an award of share options with a market condition might have an exercise price that changes in accordance with (that is, is indexed to) changes in the relationship between the entity's share price and an index of the share prices of other entities in the same industry. Changes in measures of the entity's individual performance, such as achieving or not achieving a 15 percent increase in market share, will affect that award only to the extent that the increase is reflected in changes in the entity's share price relative to those of its competitors.

40. Some respondents and staff questioned whether it would be inconsistent to require initial recognition of contingent consideration based on a performance condition at fair value when the Boards have concluded that performance conditions cannot be included in the fair-value-based measure of share-based payment awards at the grant date.

41. The staff considered this potential inconsistency. Some staff believe that, conceptually a performance condition related to a share-based payment award could be factored into the measurement at the grant date. The Boards decided against the conceptual answer in Statement 123(R) and IFRS 2 because of practicability concerns. The staff believes there is a difference between contingent consideration and share-based payment awards because it easier to value the performance condition associated with the contingent consideration than with the SBP award. The difference lies in how one assesses the reasonableness of the prospective financial information ("PFI") used to value the contingent consideration subject to a performance condition versus a share-based payment award subject to a performance condition. In measuring contingent consideration, the PFI of the acquiree would be analyzed and considered. In many cases, the performance condition for contingent consideration is based on the performance of the acquiree as a

whole. This PFI could be, and often is, assessed for reasonableness based on an analysis of (a) the acquiree's historical financial performance, (b) the current and prospective outlook for the industry and the economy, and (c) other relevant factors. Whereas, for a share-based payment award, the performance condition is often tied to an individual employee's performance on a specific item (such as obtaining a predetermined number of new customers, a successful IPO, regulatory approval on a new drug, and so on), rather than the acquiree's performance as a whole. Accordingly, the staff believes that measuring a performance condition for a share-based payment award is more difficult than measuring a performance condition for contingent consideration.

42. If the Boards believe that performance-based contingent consideration cannot be measured reliably at the acquisition date, the alternative that would be consistent with IFRS 2 and Statement 123(R) would be to require an acquirer to recognize contingent consideration with:

    a. A **market condition** at fair value as of the acquisition date.

    b. A **performance condition** at fair value when it is *probable* that the performance condition will be met (similar to the requirements of Statement 123(R) and IFRS 2).

43. However, it is not clear how to account for contingent consideration under this alternative if the contingent consideration is based on both a market and a performance condition.

44. Since the staff believes that contingent consideration with a performance condition can be reasonably measured, the staff believes that it not preferable to have two different ways to account for contingent consideration depending on whether it is based on a market condition or a performance condition. It seems that having two methods could lead acquirers to structure contingent consideration arrangements based on the accounting they prefer.

F. Classification of Performance-Based Arrangements

45. Some constituents stated that contingent consideration with performance conditions are more like profit sharing than consideration. Thus, the acquirer should recognize the compensation cost over the service period rather than recognize the obligation as part of the business combination.

46. The staff believes that determining the nature of an arrangement with a performance condition depends on the facts and circumstances of the arrangement. Consider an example in which the acquirer agrees to pay the former owners of the acquiree a percentage of sales over a specified amount. If the former owners have no continuing involvement with the acquiree after it is acquired, it seems like the arrangement is contingent consideration. In contrast, if the former owners stay on as employees and the payment is forfeited if the former owners terminate employment, it seems like that arrangement is compensation expense that should be recognized over the period of service.

47. The Boards agreed to codify in the final business combinations standard the guidance in EITF Issue 95-8, "Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination." That guidance has been used extensively in U.S. practice to determine whether arrangements are contingent consideration or compensation. Respondents to the BC ED did not cite issues with that guidance other than the fact that it was paraphrased in the BC ED rather than carried forward verbatim. They would have preferred that the EITF be carried forward in its entirety so that long-standing U.S. practice would continue and not be subject to interpretation given that the words changed slightly. The staff will consider those comments in drafting.

48. The IFRIC has also been asked to provide an interpretation of how to account for puts or forwards attached to noncontrolling interests as part of a business combination. In some cases, the amounts might relate to future services, depending on the pricing of the put or forward. The staff is assessing whether

guidance can be included on these transactions and incorporated into the final standard.

G. Recognize Changes as Adjustments to the Purchase Price

49. A significant number of respondents, generally preparers and audit firms, stated that if the Boards required initial recognition of contingent consideration at fair value, that all subsequent adjustments to the fair value of contingent consideration should be recognized as an additional element of purchase price (adjustments to goodwill).[2] Users did not express concern about where the acquirer recognizes the adjustments (in income, other comprehensive income (directly in equity) or as adjustments to goodwill) as long as the adjustments are disclosed.

50. Those who suggested that changes in the fair value of contingent consideration should be recognized as adjustments to purchase price generally believe that the changes in the fair value of contingent consideration just affirms the acquisition-date fair value of the acquiree. Therefore, they believe those changes should appropriately be reflected as changes in purchase price.

51. The Boards carefully considered this argument during initial deliberations. The Boards ultimately concluded that changes in the fair value of contingent consideration do not affirm the value of the acquiree on the acquisition date. Changes that are the result of future events should not be reflected as changes to goodwill. The FASB's basis for conclusions to the BC ED states:

> The [FASB] Board also considered whether subsequent changes in the measurement of liabilities for contingent consideration should be reflected as an adjustment to the consideration transferred in the business combination (normally in goodwill). The [FASB] Board noted that the measurement objective of a business combination is to record the fair value of the acquiree

[2] One audit firm suggested that adjustments to contingent consideration be recognized in other comprehensive income (directly in equity) until paid. At that point, the other comprehensive income could be recycled into income.

> on the acquisition date and that measuring contingent consideration at its fair value at that date furthers that objective. . . . [T]he [FASB] Board concluded that except for adjustments to provisional estimates of fair values at the acquisition date, subsequent changes in the fair value of a liability for contingent consideration do not affect the acquisition-date fair value of the consideration transferred or the acquiree. Rather, the [FASB] Board believes those subsequent changes in value generally are directly related to postcombination events and changes in circumstances related to the combined entity. Thus, subsequent changes in value for postcombination events and circumstances should not affect the measurement of the consideration transferred or goodwill on the acquisition date. [Paragraphs B83 and B84]

52. Some respondents stated that recognizing changes in the value of contingent consideration as adjustments to goodwill would have the added benefit of eliminating the issue of deciding whether the adjustment is a measurement period adjustment since all adjustments would be recognized in goodwill. (This issue is discussed further in section I.) However, the staff does not believe that that reason alone is sufficient to change the proposal that was in the BC ED. The same issue exists for other assets and liabilities, but the Boards have not suggested that changes in the value of other assets and liabilities should be recognized as adjustments to goodwill. It is not clear why the Boards would want to make an exception for only contingent consideration.

H. Counterintuitive Results

53. A few respondents stated that the proposed accounting for contingent consideration would lead to counterintuitive results. For example, an audit firm stated:

> We also believe the proposed model results in financial reporting that is counterintuitive since gains would be recognized if specified milestones or events requiring the payment of contingent consideration are not met and losses would be recognized if the company is successful and the amount paid under such arrangements exceeds the estimated fair value of the liability at the acquisition date. We noted that changes in the fair value of the assets that underlie many of these contingent consideration

arrangements are not subsequently re-measured and as a result, the effect on income in future periods may relate solely to changes in the fair value of the liability for the contingent consideration arrangement. [CL #66]

54. The following examples further explain the concerns expressed by some respondents.

Example 1: Contingent Consideration Linked to the Performance of the Entity

On the acquisition date, an acquirer pays $1,000 in cash for $800 in tangible net assets. The acquirer also agrees to pay the former owners of the acquiree an additional $200 in two years if the acquiree meets certain sales targets. The acquirer believes there is a 70% chance the acquiree will meet the sales targets. The acquirer values the contingent consideration at $140 ([$200 x 70%] + [$0 x 30%]). The acquirer would recognize the following on the acquisition date:

Dr. Net assets	800
Dr. Goodwill	340
Cr. Cash	(1,000)
Cr. Contingent consideration	(140)

If the acquiree meets the sales target, the acquirer recognizes:

Dr. Contingent consideration	140
Dr. Loss	60
Cr. Cash	(200)

If the acquirer does not meet the sales target, the acquirer recognizes:

Dr. Contingent consideration	140
Cr. Gain	(140)

55. Some respondents expressed concern that it seems counterintuitive that if the acquiree meets the sales target (higher income), a *loss* is recognized. They believe it is equally counterintuitive that if the acquiree does not meet the sales target (lower income), a *gain* is recognized.

56. The staff disagrees. In this example, for simplicity, the acquirer recognizes the gain or loss all at once. However, the proposed requirement is that the acquirer recognizes changes in the fair value of contingent consideration

continuously. In the case in which the acquiree meets the sales target, in each period the acquirer would be recognizing the income from the higher sales and an offsetting expense for the increase in value of the contingent consideration. In the case in which the acquiree does not meet the sales target, the reverse would be true. While it appears counterintuitive when one looks at the gain or loss on the contingent consideration alone, the net effect makes sense. It is also possible that missing the sales targets could indicate that the acquirer should assess the acquiree for impairment. However, the result might be counterintuitive if the contingent consideration is linked to an asset or liability that is not remeasured after the acquisition date. Consider the following example:

Example 2: Contingent Consideration Linked to IPR&D

On the acquisition date, an acquirer pays $1,000 in cash for $800 in tangible net assets. The acquirer also agrees to pay the former owners of the acquiree an additional $200 if and when an acquired compound (IPR&D) that has been submitted for FDA approval receives that approval. The acquirer believes there is a 70% chance the IPR&D will receive FDA approval. The acquirer values the contingent consideration and the IPR&D at $140 as of the acquisition date ([$200 x 70%] + [$0 x 30%]). The acquirer would recognize the following on the acquisition date:

Dr. Tangible net assets	800
Dr. Goodwill	200
Dr. Intangible asset (IPR&D)	140
Cr. Cash	(1,000)
Cr. Contingent consideration	(140)

Assume that in the next reporting period the acquirer now believes that it is 85% likely FDA approval will be received. The acquirer would adjust the value of the contingent consideration liability to $170, which is an adjustment of $30 ($140 – ([$200 x 85%] + [$200 x $0])), but would not adjust the value of the IPR&D asset because it is prohibited from revaluing its intangible assets (except for measurement period adjustments, which this is not). Therefore, the acquirer would recognize the following on the acquisition date:

Dr. Expense	30
Cr. Contingent consideration	(30)

Assume that in the next reporting period the acquirer learns that its application has been rejected and the IPR&D becomes worthless. Therefore, the acquirer would recognize the following:

Dr. Contingent consideration	170
Cr. Intangible asset (IPR&D)	(140)
Cr. Gain	(30)

In contrast, assume that in the next reporting period the acquirer receives FDA approval. The acquirer would pay the contingent consideration but would not change the amount recorded for the IPR&D asset because it is not permitted to revalue the intangible asset. Therefore, the acquirer would recognize the following:

Dr. Expense	30
Dr. Contingent consideration	170
Cr. Cash	(200)

57. This result does seem counterintuitive. The FDA approval changes the value of the contingent consideration, which would be recognized based on the proposals in the BC ED. The FDA approval also changes the value of the related IPR&D asset, which is not recognized because U.S. GAAP and IFRSs do not (normally) allow intangible assets to be revalued (except for measurement period adjustments).[3] The Boards considered this type of potential inconsistency during initial deliberations. Paragraph B86 of the basis for conclusions to the FASB's BC ED states:

> The [FASB] Board accepts the consequence that recognizing the fair value of a liability in a business combination for contingent payments of consideration is likely to subsequently result in a gain if smaller or no payments are required or in a loss if greater payments are required. The [FASB] Board believes that this is a consequence of companies entering into contingent consideration arrangements whereby the underlying in the arrangement relates to future changes in the value of a specified asset or liability or net income of the acquiree after the acquisition date—that is, in the postcombination period of the acquirer (combined entity). [14]
>
> [14] The [FASB] Board also observed that liabilities for contingent payments may be related to contingencies surrounding an outcome for a particular asset or other liability. In those cases, the effects of changes in estimates of the fair value related to the liability for the contingent payment on income of the period may be offset by changes in the value of the asset or other liability. Assume, for

[3] IAS 38 does allow revaluations, but only for intangible assets for which there is an active market.

example, that after an acquisition the combined entity reaches a very favorable settlement of pending litigation of the acquiree for which it had a contingent consideration arrangement. If the combined entity is thus required to make a contingent payment to the seller of the acquiree in an amount greater than the carrying amount (fair value) of the liability to the seller, the effect of the increase in that liability and charge to income may be offset in part by the reduction to the liability to the litigation claimant and the credit to income resulting from that favorable settlement. Similarly, assume the acquirer is not required to make a contingent payment to the seller because an acquired research and development project failed to materialize into a viable product. In that case, the gain resulting from the elimination of the liability may be offset, in whole or in part, by an impairment charge to the asset acquired.

58. Some staff still question what the Boards really intended. They believe that the measurement period guidance in the BC ED is not clear.

59. The staff generally agrees that adjusting the contingent consideration but not adjusting the related IPR&D asset seems counterintuitive. Some staff members believe that the FDA approval is a subsequent event that changes the value of both the contingent consideration and the IPR&D asset. But it does not change the value **at the acquisition date.** It changes the value of the asset and contingent consideration **on the date the approval is received.** Economically, the value of both change when approval is received, but IFRSs and U.S. GAAP preclude the entity from recognizing the increase in value of the IPR&D asset. The staff members who think the assets should not be adjusted do not see why an entity should be allowed to revalue a particular intangible asset that is linked to contingent consideration but be prohibited from revaluing other intangible assets. They think that adjusting the IPR&D asset is no different from adjusting goodwill in the first example. That is, adjusting the value of the IPR&D asset implies that receiving FDA approval changes the value of the asset **at** the acquisition date. Using that logic, reaching a sales target implies that the acquiree was worth more **at** the acquisition date and, therefore, goodwill should be adjusted.

60. Some staff members believe that, in the example given above, the acquirer should adjust the value of the related IPR&D asset rather than recognize a gain or loss. They do not view the adjustment as a revaluation. They see it as an adjustment to the purchase price and the underlying asset. Their

argument is based on the view that adjusting the asset rather than recognizing a gain or loss:

a. Provides the most relevant information about the business combination

b. Is consistent with how an acquisition is likely to be recognized outside of a business combination

c. Is consistent with the principles in the BC ED, modified by the redeliberations, that the acquirer's financial statements should reflect the financial effects of all transactions and events for which the acquirer is responsible. (See paragraph 9 of July 2006 Agenda Paper 2A.)

61. Those staff members are also concerned that the BC ED does not provide clear enough guidance on adjusting acquisition date measurements. They believe that it is possible to interpret the BC ED as requiring, in the case presented above, that the asset be adjusted. If the Boards decide that this interpretation is not what was intended, the staff will ensure that the final standard reflects the Boards' intentions.

Provides the most relevant information about the business combination

62. Some staff members believe that adjusting the asset would better reflect the economics of the transaction. In the example given, the acquirer will ultimately control an asset with a value of $0 or with a value of $200. The acquirer will pay either $0 or $200. The parties could have agreed to include the asset in the business combination with no conditions attached. Presumably, the fair value would have been $140 and that would have been the amount the acquirer paid. By establishing a conditional contract, the acquirer will either pay $1,000 for net assets of $1,000 or $1,200 for net assets of $1,200. The acquirer is in the same economic position whichever way the FDA approval comes out. Put another way, the acquirer is indifferent because fair values are exchanged in both cases.

63. Other staff members disagree that recognizing an IPR&D asset at $200 better reflects the economics of the transaction. Those staff members believe that the acquirer purchased an in-process asset **at the acquisition date.** That in-process asset had a value of $140 because there is uncertainty about the outcome of the FDA approval at the acquisition date. If the acquirer had paid for the IPR&D asset outright in the business combination (no contingent consideration), presumably the acquirer would have paid $1,140 at the acquisition date and the IPR&D asset would have been recognized at $140. Therefore, the amount recognized for the IPR&D asset would be the same regardless of whether the asset was purchased outright or whether there was a contingent consideration arrangement tied to it.

Consistency with how an acquisition is likely to be recognized outside of a business combination

64. Some staff members think that adjusting the asset is consistent with the accounting for a similar asset outside of a business combination. *[Sentences omitted from observer note]*. Those staff members think that the accounting for an asset as part of a business combination should be the same as the accounting outside of a business combination.

65. Other staff members think the transactions are different because the transactions occur at different times and the acquirer is acquiring different assets. In the business combination, the acquirer purchased an in-process asset with a value of $140. If the acquirer had waited and acquired the business after FDA approval was received, then it would have paid $200 to acquire that asset and it would have recognized the asset at $200. The value of the asset is different depending on when it was purchased, its stage of completion, and whether FDA approval has been received.

Consistency with the principle that the acquirer's financial statements should reflect the financial effects of all transactions and events for which the acquirer is responsible

66. Some staff members believe that adjusting the asset is consistent with the principles in the BC ED, modified by the redeliberations, that the acquirer's financial statements should reflect the financial effects of all transactions and

events for which the acquirer is responsible. In the case of the FDA approval, it is difficult to argue that the acquirer has any control over the approval process. It is this lack of control that is likely to be the reason the acquirer enters into a conditional contract. They do not want to assume the approval risk and, therefore, they enter into a conditional agreement in which they are indifferent to the outcome.

67. Other staff members think that it is impractical to delineate between outcomes that the acquirer can control versus those it cannot. Questions will inevitably be raised about what is meant by “able to control the outcome.” Can the acquirer control performance-based targets because it presumably controls the entity and has some control over its sales and costs? Can the acquirer control market-based targets, like target share prices? That line is a little hazier since it has some control over the performance of the entity, but no control over other market factors. In the drug example, what if the acquiree had not yet applied for the FDA approval? In that case, the acquirer could control some aspects of obtaining FDA approval because it could control when the application is filed. Because of all of these questions, some staff members would not pursue a path of control in deciding whether the asset should be adjusted.

Clarifying the measurement period guidance

68. All of the staff members agree that the Boards should clarify their intent. The staff members who prefer to adjust the IPR&D asset emphasize that it is only when the consideration uncertainty relates to an **identifiable** asset or liability that an adjustment would be appropriate. That is to say, goodwill would not normally be adjusted.[4] The staff supporting a change in the final standard would use the principle and guidance the Boards decided on when redeliberating what is part of a business combination.

[4] There are exceptions. If, for example, the final consideration was subject to finalizing the most recent financial statements

I. Measurement Period

69. Some respondents stated that it is not clear from the BC ED if or when a change in the fair value of *performance-based* contingent consideration would be a measurement period adjustment (recognize the change as an adjustment to goodwill). For example, one audit firm stated:

> However, if the Boards decide to issue Statements based on the proposed model, we believe that additional guidance should be provided on the interaction of performance-based contingent consideration and the measurement period. The proposed standard defines the measurement period as "the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized at the acquisition date in accounting for a business combination." The measurement period ends as soon as the acquirer receives all the necessary information that existed at the acquisition date or learns information is not obtainable. However, the measurement period does not exceed one year. The proposed standard is unclear whether changes in the estimated fair value of performance-based contingent consideration due to progress towards the performance measure are considered measurement period adjustments. As we noted earlier, contingent consideration often is agreed to because the buyer and seller are unable to reach an agreement as to the fair value of the entity. We believe that the resolution of a performance contingency confirms the value that existed at the acquisition date and therefore should be recognized as an adjustment to acquisition accounting. [CL #88]

70. Some staff members raised similar questions. That is, they believe the BC ED is not clear about whether changes in the fair value of contingent consideration (either performance-based or security price-based) could be a measurement period adjustment or whether those changes are always the result of changes in fact and circumstance after the acquisition date.

71. Paragraph 64 of the BC ED states that "during the measurement period, the acquirer shall adjust the provisional amounts recognized at the acquisition date to reflect any new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date." The question is whether changes in fair value of contingent consideration reflect new

information about facts and circumstances that existed at the acquisition date or whether the changes result from changes in circumstance.

Example 3: Performance-Based Contingent Consideration and the Measurement Period

On the acquisition date, an acquirer pays $1,000 in cash for $800 in tangible net assets. The acquirer also agrees to pay the former owners of the acquiree an additional $200 in one year if the acquiree meets certain sales targets. The acquirer believes there is a 70% chance the acquiree will meet the sales targets. The acquirer values the contingent consideration at $140 ([$200 x 70%] + [$0 x 30%]). The acquirer would recognize the following on the acquisition date:

Dr. Net assets	800
Dr. Goodwill	340
Cr. Cash	(1,000)
Cr. Contingent consideration	(140)

Six months after the acquisition date, the acquirer believes it is 85% likely that the sales target will be met. The acquirer would adjust the value of the contingent consideration liability to $170, which is an adjustment of $30 ($140 – ([$200 x 85%] + [$200 x $0])). The question is whether the debit should be recognized as a loss or as an adjustment to purchase price (goodwill).

Dr. ????	30
Cr. Contingent consideration	(30)

72. Some constituents believe that in this example, the debit should be to the purchase price (goodwill). They believe that the adjustment only confirms the value that existed at the acquisition date. As such, they believe that the adjustment is not the result of changes in circumstance. They believe the adjustment is the result of new information about facts and circumstances that existed as of the acquisition date.

73. The staff believes that the Boards intended such an adjustment to be recognized as a loss. That is, the staff believes that the Boards thought that:

   a. A change in the value of contingent consideration that is based on future earnings is *not* a measurement period adjustment.

b. Future earnings is a change in circumstance that changes the value of the entity. It does not confirm that value of the entity at the acquisition date.

c. The change in the value of the entity leads to the change in the value of the contingent consideration.

74. If the Boards believe something different, the staff would like to receive that feedback. Either way, the staff believes that the application of the measurement period to contingent consideration should be clarified in the final BC standard.

Example 4: Contingent Consideration Linked to IPR&D

On the acquisition date, an acquirer pays $1,000 in cash for $800 in tangible net assets. The acquirer also agrees to pay the former owners of the acquiree an additional $200 if and when an acquired compound (IPR&D) meets FDA approval. The acquirer believes there is a 70% chance the IPR&D will receive FDA approval. The acquirer values the contingent consideration and the IPR&D at $140 as of the acquisition date ([$200 x 70%] + [$0 x 30%]). The acquirer would recognize the following on the acquisition date:

Dr. Tangible net assets	800
Dr. Goodwill	200
Dr. Intangible asset (IPR&D)	140
Cr. Cash	(1,000)
Cr. Contingent consideration	(140)

Three months later, the acquirer receives FDA approval and the acquirer pays the contingent consideration. The question is whether the receipt of approval within the measurement period is a measurement period adjustment (that is, should the debit should be recognized as a loss or as an adjustment to purchase price (goodwill)).

Dr. ????	60
Dr. Contingent consideration	140
Cr. Cash	(200)

75. Some staff members believe that the measurement period guidance in the BC ED is not clear. *[Sentence omitted from observer note].*

76. Paragraph 64 of the BC ED states that it is appropriate to adjust acquisition date fair values for facts and circumstances that, if known, would have

affected the measurement at that date. *[Sentences omitted from observer note].*

77. *[Paragraph omitted from observer note]*

78. *[Sentence omitted from observer note].* We would, therefore, like the Boards to clarify their intent so that it can be made clear in the final business combinations standard.

79. One respondent suggested a practical way to address concerns about whether a change in the fair value of contingent consideration is a measurement period adjustment. That respondent stated:

> Considering the difficulties, we suggest that goodwill could be adjusted as a counterpart of any change in the measurement of contingent consideration during the measurement period. Beyond the measurement period, we agree with the Board's proposal that remeasurements should be recognized in profit or loss. [CL #149]

80. The staff notes that recognizing all changes in the value of contingent consideration during the measurement period as adjustments to goodwill would eliminate the issue of deciding whether the adjustment is a measurement period adjustment. However, the same difficulties arise with determining whether an adjustment to the value of other assets and liabilities is a measurement period adjustment. It is not clear how contingent consideration is different and why an exception should be made only for it.

Staff Recommendations

81. The staff recommends that the Boards affirm the accounting for contingent consideration that was proposed in the BC ED. As such, the staff recommends that the Boards affirm that an acquirer would:

    a. Measure and recognize contingent consideration at fair value as of the acquisition date (or if the contingent consideration is a liability that falls within the scope of IAS 37, measure in accordance with IAS 37 (a current settlement value)).

b. Classify contingent consideration as either a liability or equity as of the acquisition date.

c. After initial recognition:

   (1) Contingent consideration classified as equity would not be remeasured.

   (2) Contingent consideration classified as a liability would be remeasured to fair value(or if the contingent consideration is a liability that falls within the scope of IAS 37, measure in accordance with IAS 37 (a current settlement value)).

   (3) Changes in the amount recognized for contingent consideration liabilities would be recognized in earnings unless the contingent consideration is a hedging instrument and Statement 133 or IAS 39 allows the changes to be recognized directly in equity/other comprehensive income.

Question 1: Do the Boards agree with the staff's recommendation?

82. The staff recommends that the Boards clarify their intent with regard to the measurement period. That is, are subsequent events—like receiving FDA approval or meeting future performance-based or market-based targets—measurement period adjustments?

83. The staff also recommends that the Boards clarify whether they believe it would be appropriate in Example 2 to adjust the IPR&D asset for changes in fair value of the related contingent consideration. That is, do they agree with those members of the staff who believe that if consideration uncertainty relates to an **identifiable** asset or liability, adjusting that asset or liability would be appropriate. Therefore, goodwill would not normally be adjusted.

Question 2: What did the Boards intend?

TERMINOLOGY

84. Some staff members suggest that references to *contingent consideration* overcomplicate the proposal and associate the measurement of consideration with the IAS 37 project. Those staff members think that the references in the

proposal to consideration being measured at fair value provide a simple and sufficient description of consideration that adequately covers contingent payments. Those staff members, therefore, would avoid referring to *contingent consideration.* The final standard need only refer to additional consideration that is conditional upon specified events. The IASB is eliminating the terms *contingent asset* and *contingent liability* from its guidance and the FASB may do the same if it reconsiders the guidance in Statement 5. Therefore, it might be prudent to replace the term *contingent consideration* now. There is no element uncertainty in relation to adjustments to the consideration that are conditional on specified events or outcomes.

***Question 3: Do the Boards want to eliminate the term* contingent consideration?**

DISCLOSURES

85. The BC ED proposes that an acquirer disclose:

a. The acquisition date fair value of any contingent consideration (paragraph 72(f)(3)).

b. The maximum potential amount of future payments (undiscounted) the acquirer could be required to make under the terms of the acquisition agreement. If there is no limitation on the maximum potential amount of future payments, that fact should be disclosed (paragraph 72(h)).

c. A reconciliation of contingent consideration that is required to be remeasured to fair value after initial recognition, showing separately the changes in fair value during the reporting period and amounts paid or otherwise settled (paragraph 76(b)).

86. Respondents did not comment on the proposed disclosures for contingent consideration. At the FASB's February 28 Board meeting, the FASB discussed contingency disclosures. The FASB decided:

a. For contingencies acquired or assumed in a business combination, the acquirer should disclose the nature of the contingency, the amount recognized as of the acquisition date, if any, and an

estimate of the range of outcomes (undiscounted) or a statement that an estimate of the range cannot be made.

b. To eliminate the detailed rollforward for contingencies that was proposed in the BC ED and instead require that in periods after the business combination, the acquirer should disclose changes in the amounts recognized for the contingencies, changes in the range of outcomes (undiscounted), and the reasons for the changes. The FASB decided to eliminate the rollforward for purposes of simplicity.

87. The staff recommends that:

a. The Boards affirm that an acquirer disclose the amount of contingent consideration recognized on the acquisition date.

b. The Boards affirm that an acquirer disclose the range of potential payments (undiscounted).

c. The Boards affirm that if there is no limitation on the maximum potential amount of future payments, the acquirer disclose that fact.

d. That, instead of the rollforward, the acquirer be required to disclose changes in the amounts recognized for the contingent consideration, changes in the range of outcomes (undiscounted), and the reasons for the changes.

88. At the FASB's February 28 Board meeting, the FASB noted that the disclosure in paragraph 32 of Statement 157 would apply to contingencies. That paragraph requires that for assets and liabilities measured at fair value on a recurring basis, an entity disclose (a) the level in the hierarchy in which the fair value measurement falls, (b) a reconciliation of the assets and liabilities measured using significant unobservable inputs (Level 3), and (c) annual disclosure of valuation techniques. If the Boards affirm that contingent consideration should be subsequently measured to fair value, then paragraph 32 of Statement 157 would apply to contingent consideration as well. However, the IASB does not have an equivalent to Statement 157. Therefore, does IASB want to require annual disclosure of the valuation techniques used to measure contingent consideration at fair value?

Question 4: Do the Boards agree with the proposed disclosures?

Question 5: Does the IASB also want to require annual disclosure of the valuation techniques used to measure contingent consideration?