IASB Meeting Agenda reference **13C**

Staff Paper Date **June, 2009**

Project	**Annual Improvements Process**
Topic	**Contingent consideration of an Acquiree ("pre-existing contingent consideration")**

Introduction

1. The FASB has issued FSP FAS 141(R)-1 on 1 April 2009 and amended the recognition and measurement of contingencies in a business combination. We will update the comparison of IFRS 3 and SFAS 141(R) in Appendix A of IFRS 3 accordingly (see Appendix E of this agenda paper).

2. The FASB also concluded that contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination are recognised initially at fair value and measured subsequently in accordance with the guidance for contingent consideration arrangements in SFAS 141(R).

3. The IASB has been asked to clarify the treatment of contingent consideration of an acquiree that an acquirer assumes in a business combination (this agenda paper refers to those arrangements as "pre-existing contingent consideration" or "PCC").

Issue: How should an entity account for pre-existing contingent consideration according to IFRSs?

4. In May 2009 the Board discussed this issue but did not make any decision. The Board asked the staff to come back with a more detailed analysis and a firm staff recommendation with examples to explain how the accounting differs from each other under the following views:
View 1: Although PCC does not meet the definition of contingent consideration, it retains its nature in the subsequent acquisition. Accordingly, it should be accounted for in the same way as any contingent consideration in the subsequent

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business combination.

View 2: PCC does not meet the definition of contingent consideration in the subsequent business combination. Therefore, it should be accounted for as part of the acquired identifiable assets and liabilities in the subsequent acquisition.

Summary of staff recommendation

5. The staff recommends that the Board adopts **view 2** and does not add this issue to the annual improvements project.

Staff Analysis

6. The staff has organised the paper into three parts:

   (a) Does PCC meet the definition of contingent consideration in a subsequent business combination?

   (b) Does PCC retain its nature as contingent consideration in a subsequent business combination?

   (c) Consequences of adopting view 1 – to account for PCC as contingent consideration in a subsequent business combination (we will discuss only if the Board adopts View 1)

   A flowchart to illustrate the thought process is included in Appendix A.

Does PCC meet the definition of contingent consideration in a subsequent business combination?

7. The staff believes that pre-existing contingent consideration does not meet the definition of contingent consideration in a subsequent business combination and cannot be analogised as such.

8. IFRS 3 (as issued in 2008) defines contingent consideration as "….an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met." (IFRS 3 Appendix A)

9. Using the illustrative example in Appendix B of this paper, we believe that only the consideration paid by Entity A (the acquirer) to the owner of Entity B (the acquiree) in exchange for control of Entity B is contingent consideration. Entity C is not the acquiree in the current acquisition and therefore pre-existing consideration paid to its former owners is not consideration of this business combination.

Question 1
Does the Board agree with the staff's view that pre-existing contingent consideration does not meet the definition of contingent consideration in IFRS 3?

Does the nature of PCC retain as contingent consideration in a subsequent business combination?

10. There are two views:

    View 1 (alternative view): Although PCC does not meet the definition of contingent consideration, it retains its nature in the subsequent business combination. Accordingly it should be accounted for in the same way as contingent consideration of the subsequent business combination

    View 2 (staff recommendation): PCC does not meet the definition of contingent consideration and is accounted for as a part of the acquired identifiable assets and liabilities of the acquiree in the subsequent business combination. Therefore, we recommend not to amend IFRS 3 as it will in effect establish an exception to the principle that in a business combination the acquirer recognises the identifiable assets and liabilities of the acquiree. If the Board agrees with view 2, we will include an additional item in the non-mandatory section of IFRS 3 – Comparison of IFRS 3 (as revised in 2008) and SFAS 141(R) (included in Appendix D for the Board's information)

11. We note that in most situations it will not matter whether pre-existing contingent consideration is treated as part of the identifiable assets and liabilities of the acquiree or as contingent consideration. This is because most contingent consideration obligations are financial instruments within the scope of IAS 39. The only potential accounting difference exists for non-financial contingent consideration that would be in the scope of IAS 37, which, in our view, is not common.

12. We also note that the accounting requirements for non-financial contingent consideration and contingencies are not converged between IFRS and US GAAP. Accordingly, differences between the IFRS and US GAAP treatment of contingent consideration that is classified as a non-financial liability will persist regardless of whether the pre-existing contingent consideration is treated as contingent consideration or as identifiable assets or liabilities of the acquiree.

13. A comparison of the accounting treatments of pre-existing contingent consideration as identifiable assets or liabilities or contingent consideration and with that of US GAAP is summarised below and is explained in the illustrative example (Appendix B):

Pre-existing Contingent Consideration	**Treated as Contingent Consideration (View1)**	**Treated as Identifiable Assets or Liabilities of Acquiree (View2)**	**US GAAP**	**Different or same?**
Financial				
Initial measurement	At fair value (IFRS 3.39)	At fair value (IFRS 3.18)	At fair value (FAS 141R.24A)	Same
Subsequent measurement	At fair value (IFRS 3.58)	At fair value	At fair value (FAS 141R.65b)	Same
Non-financial				
Initial measurement	At fair value (IFRS 3.39)	At fair value (IFRS 3.18)	At fair value	Same
Subsequent measurement	In accordance with IAS 37 (IFRS 3.58(b)(ii))	At the higher of: (a) the amount that would be recognised in accordance with IAS 37; and (b) the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue. (IFRS 3.56)	At fair value	Different

Questions 2
Does the Board agree with the staff recommendation **(View 2)** to account for the PCC as a part of the acquired identifiable assets and liabilities of the acquiree in the subsequent business combination and not to amend the standard?

Consequence of Adopting View1

Amendments

14. If the Board supports View 1 (PCC is accounted for in the same way as a contingent consideration in the subsequent business combination), we believe that the Board should provide guidance on the measurement of pre-existing contingent consideration in the standard, similar to that provided for the other items listed in paragraph 54 of IFRS 3.

Transition

15. In addition, we ask the Board to clarify the accounting of pre-existing contingent consideration that arose before the adoption of the revised standard. There are two alternatives:

    View 1(a): the contingent consideration is accounted for in accordance with IFRS 3 (as issued in 2004). This means that subsequent changes in the value of the contingent consideration are recognised as adjustments to goodwill.

    View 1(b): the contingent consideration is accounted for in accordance with IFRS 3 (as issued in 2008). This means that subsequent changes in the value of the contingent consideration are recognised as profit or loss. US GAAP has adopted this view.

16. **We note that there are conceptual difficulties with both options.** If the Board adopts view 1(a), it would have a consistent accounting treatment for all pre-existing contingent consideration. In May 2009 the Board decided that contingent consideration arising before the effective date of IFRS 3R (ie. "pre-adoption contingent consideration") should be accounted for in accordance with IFRS 3 (as issued in 2004). View 1(a) would introduce the same principle for pre-existing contingent consideration of the acquiree.

17. However, the goodwill of the previous business combination of the acquiree is not carried over in the subsequent business combination of the acquirer (as it is not part of the identifiable assets and liabilities). The only goodwill will be that recorded by the acquirer for the subsequent business combination. Therefore, the adjustment to goodwill would not be made to the original goodwill arising from the previous business combination but to the new goodwill recorded by the acquirer in the subsequent business combination.

18. If the Board should adopt view 1(b), it would create an exception from last month's decision on pre-adoption contingent consideration. However, this will be consistent to the accounting treatment for other assets and liabilities of the acquiree to be accounted for under the revised standard and converged in wording to the US GAAP (although the accounting treatment for non-financial contingent consideration would still be different as explained above).

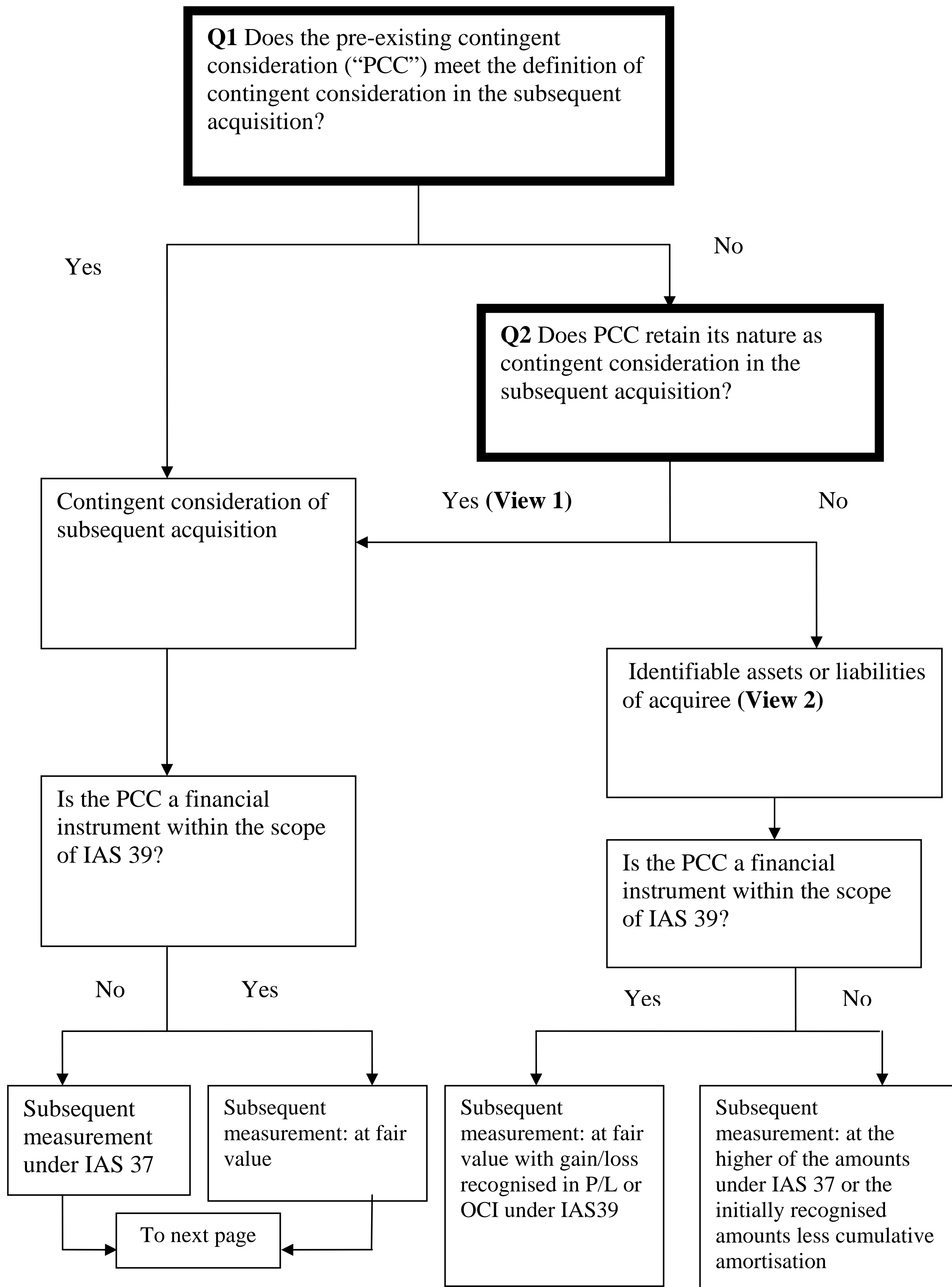
Question 3

If the Board supports View 1, i.e. to account for PCC in the same way as contingent consideration of the subsequent business combination, does the Board agree with the draft of proposed amendments to IFRS 3 in Appendix C?

Question 4

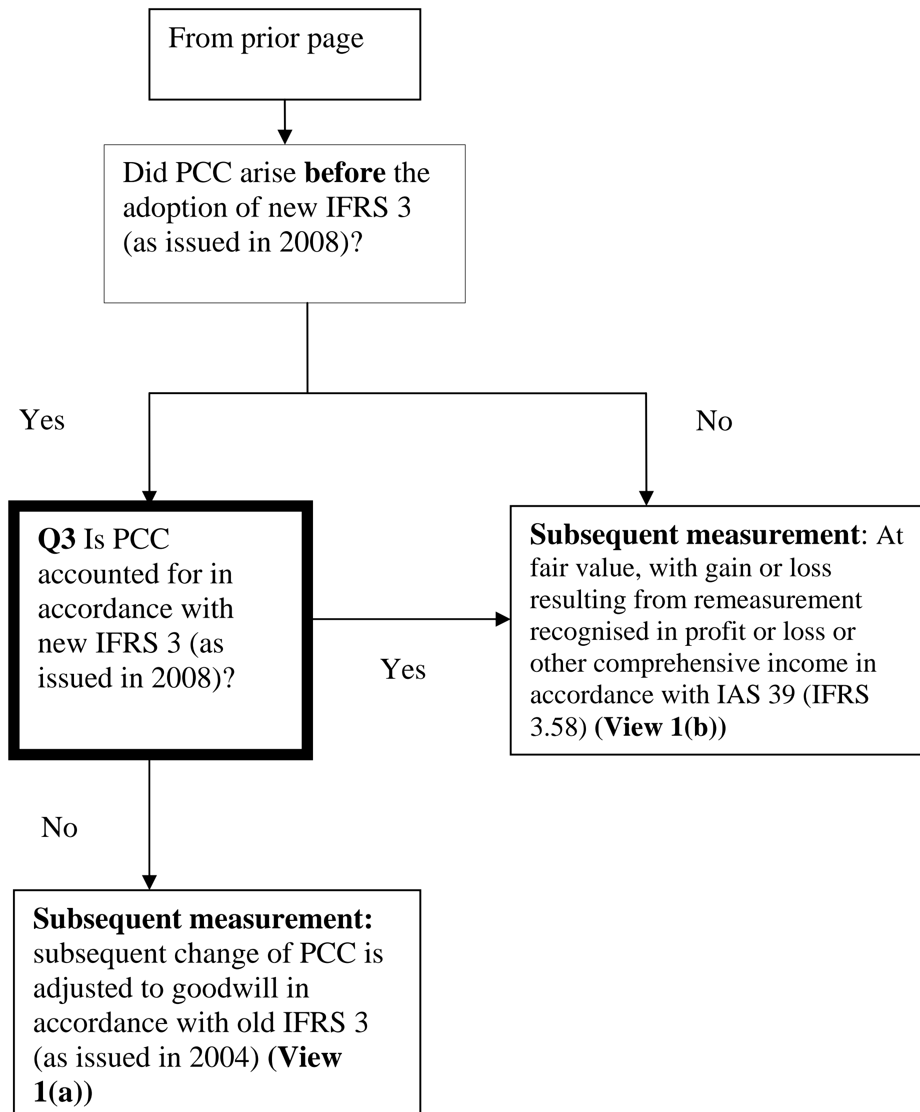
Does the Board support view 1(a), i.e. to account for the subsequent changes in the value of the pre-existing PCC as adjustments to goodwill in accordance with IFRS 3 (as issued in 2004) or view 1(b), i.e. to account for the subsequent changes in the value of the pre-existing PCC as adjustments to profit or loss in accordance with IFRS 3 (as issued in 2008)?

Appendix A – Decision tree in this paper



Note: Only subsequent measurement is shown on the chart as the initial measurement is the same under View 1 and View 2

Appendix A – Decision tree in this paper (continued)



Appendix B– Illustrative Example

B1. The following example illustrates the different views. The difference in accounting emerges when liability is non-financial liability and highlighted in the example below.

> Example 1
>
> Entity B acquires Entity C in August 2009 (after the effective date of IFRS 3 R). Entity B has a contingent consideration arrangement with the former owners of Entity C.
>
> Entity A acquires Entity B in a business combination on 31 March 2010. The contingent consideration arrangement with Entity C has not been settled when Entity A acquires Entity B. The fair value of the contingent consideration is 100 on 31 March 2010.
>
> On 31 December 2010, there has been decrease in the amounts of the pre-existing contingent consideration by 20 in accordance with IAS 37 since 31 March 2010.

B2. The following table illustrates the accounting outcome and the differences between View 1 and View 2. At 31 March 2010, there are differences in total assets and total consideration between View 1 and View 2. View 2 identifies liabilities of 100. However, the amount of goodwill recorded is not affected.

At 31 March 2010

	View 1(Treating PCC as contingent consideration of Entity A)	note	View 2 (Treating PCC as a part of the identified liability)	note
	CU		CU	
Consideration				
Cash	300	1	300	1
Contingent consideration arrangement	100	5	---	
Total consideration	400		300	
Allocation of assets and liabilities				
Recognised amounts of identifiable assets acquired and liabilities assumed				
Identifiable assets	300	2	300	2
Identifiable liabilities	---		(100)	5
Goodwill	100	3	100	4
Total assets	400		300	

Note
1. It is assumed that Entity A paid cash of 300 as a consideration.
2. It is assumed that identified assets were 300.
3. Total consideration 400 – Identifiable assets 300 = Goodwill 100
4. Total consideration 300 – (Identifiable assets 300 –identified liability 100) = Goodwill 100
5. Fair value of the contingent consideration on 31 March 2010.

B3. At 31 December 2010, there has been decrease in the amounts of the pre-existing contingent consideration by 20 in accordance with IAS 37 since 31 March 2010. The following table illustrates the accounting entries under both View1 and View2. Under View 1, the pre-existing contingent consideration was measured subsequently in accordance with IAS 37 (IFRS 3.54 and 58). Therefore, this change is recognised in profit or loss. Under View 2, , no journal entry is recognised as the amounts at initial recognition (100) is higher than the amount that would be recognised in accordance with IAS 37 (80) in accordance with IFRS 3.56.

At 31 December 2010

View 1 (Treating PCC as contingent consideration of Entity A)	View 2 (Treating PCC as a part of the identified liability)
In Entity A's consolidated financial statements Dr) Contingent consideration liability 20 Cr) Profit or loss 20	In Entity A's consolidated financial statements No Entry (because the amounts at initial recognition is higher than the amount that would be recognised in accordance with IAS 37)

Appendix C– Proposed amendments to IFRS 3 under View 1 (the alternative view to the staff recommendation)

[Omitted from observer note]

Appendix D – Proposed amendments to IFRS 3 under View 2 (the staff recommendation)

[Omitted from observer note]

Appendix E - Proposed Amendments in response to the amendment in FSP FAS 141(R)-1

[Omitted from observer note]