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

Proposed amendment

1. 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").

2. An acquired business may have contingent consideration arrangements from its own prior business combinations. The FASB has issued FSP FAS 141(R)-1 *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* which states that pre-existing contingent consideration retains its nature as contingent consideration according to US GAAP and is measured in accordance with SFAS 141(R).

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

3. This paper should be read in conjunction with the agenda paper 13C – Pre-adoption Contingent Consideration.

Staff recommendation

4. The staff recommends that the Board:

   (a) address this issue in the annual improvements project; and

   (b) propose amending IFRS 3 to clarify the accounting for pre-existing contingent consideration.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

Decisions made by the Board are reported in IASB *Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

Background

5. 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)

6. IFRS 3 requires an entity to measure contingent consideration initially at its acquisition date fair value (IFRS 3.39). Contingent consideration classified as equity is not re-measured subsequently. Contingent consideration classified as an asset or a liability is measured subsequently according to other relevant IFRSs such as IAS 39 (for a financial instrument) and IAS 37.

7. FSP FAS 141(R)-1 was issued on 1 April 2009 to address application issues raised by constituents on the initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. The FSP amended the recognition and measurement of contingencies in a business combination. An extract of the FSP is attached in Appendix B. We will update the comparison of IFRS 3 and SFAS 131(R) in Appendix A of IFRS 3 accordingly (see Appendix C of this agenda paper).

8. As part of its discussion of the accounting for contingencies, the FASB also concluded that contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination retain their nature as contingent consideration and are recognised initially at fair value and measured subsequently in accordance with the guidance for contingent consideration arrangements in SFAS 141(R).

Staff Analysis

9. Staff views are divided. The following example illustrates the different views.

Entity A acquires Entity B in a business combination. Entity B has previously acquired Entity C and recorded a contingent consideration liability. The contingent consideration arrangement with Entity C has not been settled when Entity A acquires Entity B.

View 1

10. Some staff believe that pre-existing contingent consideration retains its nature as contingent consideration in a subsequent business combination.

11. The acquirer (Entity A) assumes the obligation of the acquiree (Entity B) in a business combination. IFRS 3 requires an entity to reassess all assets and liabilities acquired or assumed in a business combination.

12. Those staff acknowledge that pre-existing contingent consideration does not strictly meet the definition of contingent consideration. However, for clarity and convergence with US GAAP, they think that the Board should provide guidance for 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. Therefore, they believe that pre-existing contingent consideration should be accounted for in the same way as contingent consideration of the acquirer**.** They note that this view has also been taken in the FSP.

13. Agenda paper 13C clarifies the treatment of contingent consideration from a business combination whose acquisition date preceded the application of the revised IFRS 3. That paper recommended clarifying that such contingent consideration is accounted for in accordance with the old IFRS 3 (as issued in 2004).

Pre-existing contingent consideration arise before the adoption of the revised standard

14. The staff notes that under view 1 it is also necessary to explain that all pre-existing contingent consideration that is in the scope of IFRS 3 (as issued in 2008) should be accounted for in accordance with that standard regardless of whether the acquiree incurred the contingent consideration obligation before the effective date of IFRS 3 (as issued in 2008). This means that in the

example Entity A accounts for the pre-existing contingent consideration in accordance with the revised IFRS 3 even though Entities B and C might have entered into the contingent consideration agreement before the effective date of the revised standard.

15. These staff acknowledge that this would create an internal inconsistency between pre-adoption contingent consideration of the acquirer and that of the acquiree assumed by the acquirer if the Board also adopt the recommendation of the agenda paper 13C. However, these staff consider such a change is needed to avoid divergence with US GAAP.

16. The staff who support view 1 therefore recommend specifying the accounting of pre-existing contingent consideration by amending IFRS 3. The proposed amendments are summarised in Appendix A.

View 2

17. Other staff believe that pre-existing contingent consideration does not meet the definition of contingent consideration in IFRS 3 and cannot be analogised as such. Those staff 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 in the above example 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.

18. Those staff 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 less common.

19. A comparison of the accounting treatment of pre-existing contingent consideration as identifiable assets or liabilities or contingent consideration is summarised below:

Pre-existing Contingent Consideration	Treated as Identifiable Assets or Liabilities of Acquiree	Treated as Contingent Consideration
Financial		
Initial measurement	At fair value (IFRS 3.18)	At fair value (IFRS 3.39)
Subsequent measurement	At fair value, with gain or loss resulting from remeasurement recognised in profit or loss or other comprehensive income in accordance with IAS 39	At fair value, with gain or loss resulting from remeasurement recognised in profit or loss or other comprehensive income in accordance with IAS 39 (IFRS 3.58)
Non-financial		
Initial measurement	At fair value (IFRS 3.18)	At fair value (IFRS 3.39)
Subsequent measurement	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)	In accordance with IAS 37 (IFRS 3.58(b)(ii))

20. In addition, those staff note that the accounting treatment for non-financial contingent consideration is 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 identifiable assets or liabilities of the acquiree.

21. Therefore, those staff recommend not amending 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. They recommend adding an additional item to the comparison of IFRS 3 and SFAS 141(R) as included in Appendix A.

22. Those staff are also concerned that if the Board adopt view 1 in this paper and the staff's recommendation of the agenda paper 13C, it will create an internal inconsistency for pre-adoption contingent consideration. Because the pre-adoption contingent consideration of the acquirer will be accounted in accordance with IFRS 3 (as issued in 2004) and adjust the goodwill. However, the pre-adoption contingent consideration of the acquiree assumed by the acquirer in a business combination after the adoption of IFRS 3 (as issued in 2008) will be accounted for in accordance with that standard, with any gain or loss on revaluation of contingent consideration included in the income statement.

23. Those staff therefore recommend the Board not to provide exemption for the pre-existing contingent consideration which is also pre-adoption contingent consideration. Those staff consider that divergence with US GAAP in this respect is only transitional and will gradually phase out over time.

Question to the Board
(1) Does the Board agree to add this issue to the annual improvements project? (2) Does the Board support view 1 or view 2 in this paper?

Appendix A – Proposed amendments to IFRS 3

A1. Proposed Amendments under View 1 in the paper

Paragraph 58A and a heading are added. Paragraph 54 and 64 are amended (added text is underlined and deleted text is struck through)

54 In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable IFRSs for those items, depending on their nature. However, this IFRS provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:

(a) reacquired rights;

(b) contingent liabilities recognised as of the acquisition date;

(c) indemnification assets; ~~and~~

(d) contingent consideration~~.~~; and

(e) contingent consideration arrangements of the acquiree assumed by the acquirer as part of the business combination.

Contingent consideration arrangements of the acquiree assumed by the acquirer as part of the business combination

58A Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in paragraph 58.

Effective date

64 This IFRS shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009, except for contingent consideration arrangements of an acquiree (paragraphs 54 (e) and 58A) prior to 1 July 2009 assumed by the acquirer in a business combination. Earlier application is permitted. However, this IFRS shall be applied only at the beginning of an annual reporting period that begins on or after 30 June 2007. If an entity applies this IFRS before 1 July 2009, it shall disclose that fact and apply IAS 27 (as amended in 2008) at the same time.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

BC351A Subsequent to the publication of the amended Standard, the FASB issued FSP FAS 141(R)-1 which amended the recognition and measurement of contingencies in a business combination. The FASB also concluded that contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination retain their nature as contingent consideration and are recognised initially at fair value and measured subsequently in accordance with the guidance for contingent consideration arrangements in SFAS 141(R). Some constituents raised concerns about the lack of explicit requirements with respect to this type of contingent consideration arrangement under IFRS.

BC351B In response to those concerns, the Board proposes to amend paragraph 54 and to add 58A to require an entity to treat the contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination in the same way as contingent consideration of the acquirer.

A2. Proposed Amendments under View 2 in the paper

The following paragraphs will be added to the Implementation Guidance of IFRS 3 – Comparison of IFRS 3 (as revised in 2008) and SFAS 141(R)

Guidance	IFRS 3 (as revised in 2008)	SFAS 141(R)
Non-financial contingent consideration arrangements of an acquiree assumed by the acquirer	**Subsequent measurement** The revised IFRS 3 requires an entity to measure subsequently such contingent consideration at the higher of the amount that it would recognise in accordance with IAS 37 or the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue. [paragraph 56]	**Subsequent measurement** SFAS 141(R) requires an entity to measure subsequently such contingent consideration in accordance with paragraph 65 at fair value. The entity recognizes changes in fair value in earnings unless the contingent consideration is a hedging instrument for which FASB Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* requires the subsequent changes to be recognised in other comprehensive income. [paragraph 12]

Appendix B - extract from FSP FAS 141(R)-1

Initial Recognition and Measurement

10. Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be recognized initially at fair value in accordance with the guidance for contingent consideration arrangements in Statement 141(R).

Subsequent Measurement and Accounting

12. Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in paragraph 65 of Statement 141(R).

Contingent Consideration of an Acquiree

B21. After the issuance of Statement 141(R), constituents questioned whether contingent consideration arrangements of an acquiree assumed in a business combination (that is, the acquiree previously acquired another business and the arrangement included contingent consideration) should be accounted for as contingent consideration or in accordance with the guidance for assets and liabilities arising from contingencies in a business combination. Those constituents argued that the contingent consideration obligation of an acquiree should not be considered contingent consideration of the acquirer because the acquirer is not obligated to transfer additional assets or equity interest to the former owners of the acquiree (that is, the arrangement does not appear to meet the definition of contingent consideration in paragraph 3(f) of Statement 141(R)).

B22. The Board believes that the nature of contingent consideration does not change on subsequent acquisition of one entity by another entity (that is, although the amount of the future payments the acquirer will make is conditional on future events, the obligation to make them if the specified future events occur is unconditional). Therefore, the Board concluded that a contingent consideration arrangement of an acquiree assumed by the acquirer in a business combination should be accounted for in the same manner as a contingent consideration.

Appendix C

C1. Proposed Amendments in response to the amendment in FSP FAS 141(R)-1

The following paragraphs will be amended to the Implementation Guidance of IFRS 3 – Comparison of IFRS 3 (as revised in 2008) and SFAS 141(R) (added text is underlined)

Guidance	IFRS 3 (as revised in 2008)	SFAS 141(R)
Assets and liabilities arising from contingencies	**Initial recognition** The revised IFRS 3 requires the acquirer to recognise a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. [paragraphs 22 and 23]	**Initial recognition** Statement 141(R) requires the acquirer to recognize as of the acquisition date~~ the~~ assets acquired and liabilities assumed that arise from ~~*contractual*~~ *contingencies*~~,~~ ~~measured~~ at their acquisition-date fair values if their acquisition-date fair values can be determined during the measurement period. ~~For all other contingencies (referred to as *noncontractual contingencies*), the acquirer recognizes an asset or liability as of the acquisition date if it is **more likely than not** that the contingency gives rise to an asset or a liability as defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*.~~ If the acquisition-date fair value of an asset or a liability cannot be determined during the measurement period, the acquirer shall recognize that asset or liability at the acquisition date based on an amount determined in accordance with the following criteria: (a) information available prior to the end of the measurement period indicates that it is probable that an asset existed

		or that a liability had been incurred at the acquisition date and (b) the amount of the asset or liability can be reasonably estimated. These criteria shall be applied using the guidance provided in FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, for application of similar criteria in paragraph 8 of Statement 5. ~~Noncontractual~~ In periods subsequent to the acquisition date, contingencies that do not meet the recognition ~~threshold~~ criteria as of the acquisition date are accounted for in accordance with other GAAP, including ~~FASB~~ Statement ~~No.~~ 5, ~~*Accounting for Contingencies,*~~ as appropriate. [paragraphs 23–2~~5~~4]
Assets and liabilities arising from contingencies	**Subsequent measurement** The revised IFRS 3 carries forward the existing requirements that a contingent liability recognised in a business combination must be measured subsequently at the higher of the amount that would be recognised in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets or the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with IAS 18	**Subsequent measurement** Statement 141(R) does not provide specific subsequent measurement guidance for assets or liabilities arising from contingencies in a business combination. Statement 141(R) requires that an acquirer subsequently measure and account for assets acquired and liabilities assumed in a business combination in accordance with other applicable GAAP for those items, depending on their nature. ~~requires that an acquirer continue to report an asset or liability arising from a contractual or~~

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<td>Revenue. [paragraph 56]</td>
<td>~~noncontractual contingency that is recognized as of the acquisition date that would be in the scope of Statement 5 if not acquired or assumed in a business combination at its acquisition-date fair value until the acquirer obtains new information about the possible outcome of the contingency. The acquirer evaluates that new information and measures the asset or liability as follows:~~
~~a. A liability is measured at the **higher** of:~~
~~(1) Its acquisition-date fair value; or~~
~~(2) The amount that would be recognized if applying Statement 5.~~
~~b. An asset is measured at the **lower** of:~~
~~(1) Its acquisition-date fair value; or~~
~~(2) The best estimate of its future settlement amount.~~
[paragraph~~s~~ 6~~2~~0 ~~and 63~~]</td>
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<td>Assets and liabilities arising from contingencies</td>
<td colspan="2">**Disclosures**

SFAS 141(R)'s disclosures related to assets and liabilities arising from contingencies are slightly different from those required by the revised IFRS 3 because the IASB's disclosures are based on the requirements in IAS 37.

[the revised IFRS 3, paragraphs B64(j) and B67(c); SFAS 141(R), paragraphs 68(j) and 72(c)]

Application Guidance

SFAS 141(R) includes examples that provide~~s application~~ illustrative guidance for applying the~~ more-likely-than-not criterion for recognizing noncontractual contingencies~~ initial recognition provisions in Statement 141(R). The revised IFRS 3 does not have equivalent guidance. [Statement 141(R), paragraphs A62–A65A]</td>
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