Project	**Annual Improvements – 2009–2011 cycle**
Topic	**IFRS 3 *Business Combinations* – Regrouping and consistency of contingent consideration guidance**

Introduction

1. Guidance on contingent consideration is currently included in more than one IFRS. This may give rise to divergent application practices.
2. At its meeting in February 2010, the Board asked the IFRS Interpretations Committee (the Interpretations Committee) to provide a recommendation on how to present the guidance on contingent consideration within one standard.
3. The Interpretations Committee discussed the issue at its meeting in July 2010. Its recommendation is presented in this paper.

Purpose of this paper

4. The purpose of this paper is to ask the Board whether it approves an annual improvement to IFRS 3 *Business Combinations* that would clarify the accounting for contingent consideration arising from business combinations.
5. This paper:
   (a) provides background information and explains the issue;
   (b) makes a recommendation for

(i) a proposed amendment to IFRS 3 as presented in Appendix A,

(ii) an assessment of the proposed amendment against the criteria for inclusion in *Annual Improvements*;

(c) asks the Board whether they agree with the recommendation.

Background information and issue raised

6. A review of the existing IFRS guidance on the accounting for contingent consideration arising from a business combination provides for the following comments:

(a) 'Contingent consideration' is only mentioned in IFRS 3 and is <u>defined</u> with reference to the acquisition of a business.

(b) Paragraph 40 of IFRS 3 specifies <u>classification</u> requirements for contingent consideration with reference to different standards depending on the nature of the contingent consideration.

(c) Paragraph 58 of IFRS 3 provides guidance for <u>subsequent measurement</u> requirements for contingent consideration with reference to different standards. A consistency issue arises in that, for example, a contingent consideration that is a financial liability classified as at <u>amortised cost</u> in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* would be required to be accounted for <u>at fair value</u> by paragraph 58 of IFRS 3. Appendix B to this paper provides a table that summarises the existing accounting requirements and references.

(d) Paragraph B64 of IFRS 3 requires <u>disclosures</u> for contingent consideration. However, due to the references to other IFRSs included in paragraph 58 of IFRS 3, some constituents are unclear whether other IFRSs disclosure requirements apply in addition to the requirements in paragraph B64.

7. Given the references to multiple standards to account for contingent consideration, constituents express concerns on the lack of clarity in IFRS 3.

8. At the IFRS Interpretations Committee meeting in July 2010, the Interpretations Committee agreed with the staff proposal to recommend that the Board add this issue to the 2009–2011 *Annual Improvements* cycle[1].

Staff analysis

Recognition, classification and initial measurement

9. The staff notes that paragraph 40 of IFRS 3 brings about consistency issues on classification when contingent consideration is a financial instrument that falls within the scope of IAS 39. The inconsistency arises from the interaction between classification as a result of applying paragraph 40 of IFRS 3 combined with IAS 39 and subsequent measurement requirements in paragraph 58 of IFRS 3.

10. The followings are two ways of dealing with this inconsistency and highlight consequences for each:

    (a) Approach A: require that contingent consideration is classified following the guidance in IAS 39 / IFRS 9. Following this approach would result in some contingent consideration balances being classified as at amortised cost, but this would conflict with the requirement in paragraph 58 of IFRS 3 for such balances to be subsequently measured at fair value.

    (b) Approach B: do not allow contingent consideration balances to be classified in accordance with IAS 39 / IFRS 9. This would remove the inconsistency arising from the interaction of classification and subsequent measurement requirements highlighted in paragraph 6(c) above.

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[1] Consequently the Committee recommended that the Board remove inconsistencies in classification, measurement and disclosures relating to contingent consideration associated with business combinations by deleting references to other IFRSs in paragraphs 40 and 58 of IFRS 3 as part of *Annual Improvements*. The Committee also recommended that the Board make consequential amendments to IAS 39 *Financial Instruments: Recognition and Measurement*, to IFRS 7 *Financial Instruments: Disclosures* and to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

11. The staff believes that removing classification requirements for contingent consideration that is a financial instrument from paragraph 40 of IFRS 3 would simplify initial recognition and subsequent accounting. Therefore the staff recommends paragraph 40 of IFRS 3 be amended to reflect approach B. The staff notes that the proposed change to paragraph 40 of IFRS 3 does not alter the existing requirement to classify the contingent consideration as a liability or as equity in accordance with IAS 32 *Financial Instruments: Presentation*.

Subsequent measurement

Subsequent measurement - contingent consideration that is a <u>financial instrument</u> – paragraph 58(b)(i)

12. Paragraph 58(b)(i) requires that contingent consideration that is a financial instrument within the scope of IAS 39/IFRS 9 be accounted for at fair value, with the resulting gains or losses recognised either in profit or loss or in other comprehensive income (OCI).

13. The staff believes that this requirement is a departure from the requirements in IAS 39/IFRS 9 that provide for some instruments (eg loans, receivables, financial liabilities) to be accounted for at amortised cost. As a consequence, the measurement requirements in IFRS 3 are not fully consistent with those in IAS 39/IFRS 9.

14. The staff lists two paths forward to remove the inconsistency highlighted above:

    (a) View A: require that all contingent consideration that is a financial instrument within the scope of IAS 39/IFRS 9 be measured at fair value through profit or loss.

    (b) View B: require that all contingent consideration that is a financial instrument within the scope of IAS 39/IFRS 9 follow the measurement provisions set out in IAS 39/IFRS 9.

15. Under view A references to IAS 39/IFRS 9 would need to be removed from IFRS 3. The staff is aware that requiring the resulting gain or loss to be recognised through profit or loss only is a change from what is currently required in paragraph 58(b)(i) of IFRS 3 (ie either profit or loss or OCI). However, the staff believes this proposal would improve comparability and would simplify the accounting by requiring a single accounting treatment for all contingent consideration arising from business combinations. In addition, this proposal is consistent with removing the references to IAS 39/IFRS 9.

16. Under view B the guidance in IFRS 3 would need to be amended to permit this accounting. In addition, the staff believes that this view would lead to a major change in subsequent measurement of contingent consideration arising from business combinations.

17. The staff notes that view A is consistent with the principle in IFRS 3 for measuring consideration transferred at fair value. The staff also believes this is consistent with the Board's intent to measure contingent consideration regardless of its nature.

18. In the light of the above findings, the staff believes that view A would best address the perceived conflict between the existing guidance in the different standards.

Subsequent measurement - contingent consideration that is <u>not a financial instrument</u> – paragraph 58(b)(ii)

19. The staff notes that the first part of paragraph 58 of IFRS 3 refers to changes in <u>fair value</u> for contingent consideration irrespective of its nature. In addition, the second part of paragraph 58 of IFRS 3 requires accounting be in accordance with other IFRSs.

20. The staff believes it is inconsistent in the same paragraph to:

    (a) mention changes in fair value of an item, and

    (b) require this item be measured in accordance with standards that do not require fair value as a measurement basis.

21. The staff is of the opinion that similarly to the analysis for contingent consideration that is a financial instrument, two paths forward exist:

    (a) View 1: specifically require fair value measurement for items that are contingent consideration, delete reference to applicable IFRSs and acknowledge in the Basis for Conclusions that fair value measurement requirement departs from the 'normal' accounting that would apply if these items were not contingent consideration, or

    (b) View 2: change the accounting for contingent consideration to retain relevant individual measurement principles in other IFRSs.

22. The staff recommends a path that ensures consistency with the requirements in IFRS 3 and in particular the solution in subparagraph 21(a) above.

Disclosures

23. The staff notes that paragraph B64 of IFRS 3 provides guidance with respect to required disclosures.

24. The staff also notes that paragraph 58 of IFRS 3 provides guidance for the accounting for contingent consideration by reference to applicable IFRSs. Some believe that when contingent consideration is in the scope of a relevant IFRS it should be subject to all the disclosure requirements of that IFRS in addition to the requirements in paragraph B64 of IFRS 3.

25. The staff is of the opinion that the information provided in accordance with paragraph B64 is useful and sufficient information. This is also illustrated by Illustrative Example IE72 where disclosures on contingent consideration do not show disclosure requirements from other applicable IFRSs.

26. Therefore the staff believes that for contingent consideration that is a financial instrument the disclosures in IFRS 7 *Financial Instruments: Disclosures* do not need to be given.

Conclusion

27. The review of existing guidance shows:

    (a) the extent to which guidance to account for contingent consideration is included in more than one IFRS, and

    (b) inconsistencies in classification, measurement and disclosure requirements, that could be removed either by:

        (i) deleting references to other IFRSs within IFRS 3, or

        (ii) changing the accounting requirements.

28. The staff believes that removing inconsistencies by deleting references to other IFRSs within the guidance provided in IFRS 3 would meet the set objective of regrouping guidance as well as enhancing the quality of the standards while not changing the accounting principle in IFRS 3.

Annual Improvements criteria assessment

Assessment against current criteria

29. The existing criteria for deciding of the inclusion in the 2009-2011 *Annual Improvements* cycle are that the change is non-urgent and necessary.

30. The staff notes that the current wording of paragraphs 40 and 58 contains inconsistent guidance as to the accounting for contingent consideration arising from business combinations.

31. While improving consistency, the proposed amendment does not change an existing principle or introduce a new principle. Therefore, the staff believes that

the proposed improvement meets the existing criteria for inclusion in the 2009-2011 *Annual Improvements*.

Assessment against the proposed new criteria

32. The IFRS Foundation has exposed for public comments proposed enhanced criteria as part of an amendment to the Due Process Handbook. The comment period ends 30 November 2010.

33. The staff proposes an assessment of the inclusion of the issue against the proposed enhanced criteria reproduced in full below:

   (a) The proposed amendment has one or both of the following characteristics:

      (i) clarifying—the proposed amendment would improve IFRSs by:

      - clarifying unclear wording in existing IFRSs, or
      - providing guidance where an absence of guidance is causing concern.

      A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.

      (ii) correcting—the proposed amendment would improve IFRSs by:

      - resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or
      - addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.

      A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.

   (b) The proposed amendment has a narrow and well-defined purpose, ie the consequences of the proposed change have been considered sufficiently and identified.

   (c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach agreement on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.

(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a pressing need to make the amendment sooner than the project would.

34. In the staff's opinion, the issue satisfies the above proposed *Annual Improvements* criteria:

(a) In the staff's opinion, the change proposed is a correction that improves IFRSs by resolving a conflict between perceived diverging requirements in IFRS 3 and other IFRSs, namely IAS 39/IFRS 9 and IAS 37. The correction does not change the current principles but clarifies the Board's intent when providing for the required accounting treatment.

(b) In the staff's opinion, the change proposed is limited to contingent consideration that arises from business combinations therefore it has a narrow and well-defined purpose.

(c) The staff thinks that since the Interpretations Committee reached a conclusion on a timely basis on the issue, it is likely that the Board will also reach a conclusion on a timely basis.

(d) There is no current or planned Board project to review the accounting of contingent consideration arising from business combinations.

Transition provisions

35. The staff believes that the effects of the proposed changes should be accounted for prospectively from the date the improvement is effective in order to avoid unduly burdensome changes.

Consequential amendments

Consequential amendment to IAS 37 Provisions, Contingent Liabilities and Contingent Assets

36. The staff believes that no consequential amendment to IAS 37 is needed. The scope in paragraph 1 of IAS 37 already excludes provisions, contingent liabilities and contingent assets covered by “another Standard”. As mentioned above, IFRS 3 explicitly covers all contingent consideration arising from business combinations.

Consequential amendment to IAS 39/IFRS 9 Financial Instruments

37. IFRS 9 *Financial Instruments* explicitly refers to the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. Therefore the staff believes that a consequential amendment to IAS 39 only is needed that excludes from its scope contingent consideration to which IFRS 3 *Business Combinations* applies. The staff notes that prior to the publication of IFRS 3 revised in 2008, the scope of IAS 39 excluded contingent consideration (former subparagraph 2(f) deleted when IFRS 3 revised 2008 was issued).

38. The scope exception in IAS 39 in respect of contingent consideration arising from business combinations was deleted by the revision to IFRS 3 in 2008 in order to allow contingent consideration to be accounted for in accordance with IFRS 3. The staff’s and the Interpretations Committee’s recommendations in this paper remain consistent with the Board’s original intent.

Consequential amendment to IFRS 7 Financial Instruments: Disclosures

39. The staff believes that IFRS 7 *Financial Instruments: Disclosures* needs be amended as a consequence of the proposed changes to IFRS 3 so that IFRS 7 disclosures do not apply to contingent consideration to which IFRS 3 applies.

Recommendation

40. The Interpretations Committee recommends that the Board amend paragraphs 40 and 58 of IFRS 3 through the *Annual Improvements* project to remove references to other IFRSs. In addition, paragraph 58(b) of IFRS 3 would be amended to require that resulting gains and losses from changes in fair value be recognised in profit or loss.

41. The proposed amendment wording is included in Appendix A.

Questions to the Board

42. The Interpretations Committee discussed this issue and agreed to recommend that the Board should include this issue in the *Annual Improvements* 2009-2011 cycle.

Question 1 – Committee recommendation on the need for the amendment
Does the Board agree with the Interpretations Committee recommendation to amend IFRS 3 as proposed in paragraph 40?

Question 2 – Staff assessment of the proposed amendment against the criteria for inclusion in the *Annual Improvements*
Does the Board agree with the inclusion of the proposed amendment to IFRS 3 in the *Annual Improvements* cycle for 2009-2011?

Question 3 – Wording for the proposed amendment
Does the Board agree with the wording for the proposed amendment as set out in Appendix A?

Appendix A - Drafting for proposed amendment

This appendix includes drafting of the proposed amendment. It is based on the text included in the most recently issued standards (including the *Improvements to IFRSs* issued in May 2010). New text is underlined and deleted text is struck through.

Proposed amendments to IFRS 3 *Business Combinations* (as revised in 2008)

Paragraphs 40 and 58 are amended. Paragraph 64D is added. Paragraph B64 is reproduced in part for ease of reference and paragraph B64A is added. New text is underlined and deleted text is struck through.

The acquisition method

Consideration transferred

Contingent consideration

40 The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity on the basis of the definitions of an equity instrument and a financial liability in paragraph 11 of IAS 32 *Financial Instruments: Presentation*~~, or other applicable IFRSs~~. Contingent consideration that is a financial instrument in accordance with the definitions in IAS 32 is not in the scope of IAS 39 or IFRS 9 and shall follow the requirements in this standard. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met. Paragraph 58 provides guidance on the subsequent accounting for contingent consideration.

Subsequent measurement and accounting

Contingent consideration

58 Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with paragraphs 45–49. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

(a) Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.

(b) Other c~~C~~ontingent consideration~~ classified as an asset or a liability that:~~

~~(i) is a financial instrument and is within the scope of IAS 39~~ shall be measured at fair value at each reporting date, with any resulting gain or loss recognised ~~either~~ in profit or loss for the period~~ or in other comprehensive income in accordance with that IFRS~~.

~~(ii) is not within the scope of IFRS 9 or IAS 39 shall be accounted for in accordance with IAS 37 or other IFRSs as appropriate.~~

Effective date and transition

Effective date

64D *Improvements to IFRSs* issued in [date] amended paragraphs 40 and 58 and added paragraph B64A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2012. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. Application should be prospective from the date the amendments are effective.

Appendix B

Application guidance

Disclosures (application of paragraphs 59 and 61)

B64 To meet the objective in paragraph 59, the acquirer shall disclose the following information for each business combination that occurs during the reporting period:

(a) …

(g) for contingent consideration arrangements and indemnification assets:

(i) the amount recognised as of the acquisition date;

(ii) a description of the arrangement and the basis for determining the amount of the payment; and

(iii) an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

B64A For contingent consideration, an entity shall not apply the disclosure requirements set out in IFRS 7 *Financial Instruments: Disclosures.*

Basis for Conclusions on proposed amendments to IFRS 3 *Business Combinations* (as revised in 2008)

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

Accounting for contingent consideration

BC1 The Board proposes to clarify the accounting for contingent consideration arising from business combinations. The Board noted that requirements on classification in paragraph 40 of IFRS 3 are inconsistent with requirements on subsequent measurement in paragraph 58 of IFRS 3 for contingent consideration that is a financial instrument within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* when compared with the accounting requirements of IAS 39. Because paragraph 40 of IFRS 3 refers to 'other applicable IFRSs' a contingent consideration that is a financial liability might be classified as at amortised cost. This would conflict with the requirement in paragraph 58 of IFRS 3 that such contingent consideration be subsequently measured at fair value. Therefore, the Board proposes to delete the reference to 'other applicable IFRSs' in paragraph 40 of IFRS 3. The reference to paragraph 11 of IAS 32 *Financial Instruments: Presentation* would remain because such distinction is relevant for the subsequent measurement requirements in paragraph 58(a) of IFRS 3, ie no re-measurement for contingent consideration classified as equity. The proposed amendment entails a consequential amendment to IAS 39 to exclude contingent consideration from its scope.

BC2 As a consequence of not requiring classification of contingent consideration that is a financial instrument in accordance with IAS 39, the Board proposes to delete the option in paragraph 58(b) of IFRS 3 to recognise the resulting gain or loss from changes in fair value through other comprehensive income. All changes in the fair value of the financial instrument would therefore be recognised in profit or loss.

BC3 The Board also noted that the subsequent measurement requirements in paragraph 58(b) of IFRS 3 for contingent consideration that is not a financial instrument conflict with the measurement in other applicable IFRSs. The conflict lies in that paragraph 58(b) of IFRS 3 refers to changes in fair value of contingent consideration and requires contingent consideration be measured in accordance with standards that do not require fair value as a measurement basis. Therefore the Board proposes to delete the reference to 'IAS 37 or other IFRSs as appropriate' from paragraph 58(b) of IFRS 3. The proposal therefore maintains fair value as the subsequent measurement basis for all contingent consideration to which IFRS 3 applies. The Board acknowledges this is a change from the accounting that would apply if these items were not contingent consideration. However, the Board believes that this increases consistency with the principle in IFRS 3 for measuring consideration transferred at fair value.

BC4 In addition, the Board proposes to clarify that the information provided in accordance with paragraph B64 of IFRS 3 is useful and sufficient information. Disclosures in IFRS 7 *Financial Instruments: Disclosures* should not need to be given for contingent consideration that is a financial instrument. The proposed amendment entails a consequential amendment to IFRS 7 to exclude contingent consideration from its scope.

Appendix to proposed amendments to IFRS 3 Amendments to other IFRSs

IFRS 7 *Financial Instruments: Disclosures*

Paragraph 3 is amended and paragraph 44L is added (new text is underlined).

Scope

3 This IFRS shall be applied by all entities to all types of financial instruments, except:

(a) …

<u>(g) contingent consideration to which IFRS 3 *Business Combinations* applies.</u>

Effective date and transition

<u>44L *Improvements to IFRSs* issued in [date] amended paragraph 3. An entity shall apply those amendments for annual periods beginning on or after 1 January 2012. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. Application should be prospective from the date the amendments are effective.</u>

IAS 39 *Financial Instruments: Recognition and Measurement*

Paragraph 2 is amended and paragraph 108D is added (new text is underlined).

Scope

2 This Standard shall be applied by all entities to all types of financial instruments, except:

(a) …

(f) [deleted]

<u>(i) contingent consideration to which IFRS 3 *Business Combinations* applies.</u>

Effective date and transition

<u>108D *Improvements to IFRSs* issued in [date] amended paragraph 2. An entity shall apply those amendments for annual periods beginning on or after 1 January 2012. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. Application should be prospective from the date the amendments are effective.</u>

Appendix B - Subsequent measurement - overview

The staff notes that subsequent measurement requirements are also included in more than one IFRS.

For a clear overview, the table below summarises the existing requirements and references:

Nature of adjustments	When do they occur?	Applicable IFRSs	Measurement and presentation requirements
Measurement period adjustments[2]	During the measurement period	IFRS 3.45-49	Fair value re-measurement. Adjustments booked against goodwill. Restatement of comparative information.
	After the measurement period	IFRS 3.50 IAS 8.41-49	Accounting for errors. Fair value re-measurement. Adjustments booked to profit or loss for the relevant period. Restatement of comparative information.
Non measurement period adjustments	Any time from the date of acquisition	Contingent consideration classified as equity IFRS 3.58(a)	No re-measurement. Subsequent settlement accounted for within equity.
		Contingent consideration classified as a financial instrument IFRS 3.58(b)(i) IAS 39/IFRS 9	Fair value re-measurement. Resulting gain or loss in ✓ P&L, or ✓ OCI. Appropriate disclosures from IFRS 7.
		Other contingent consideration IFRS 3.58(b)(ii) IAS 37 Other IFRSs	Measurement: ✓ best estimate, or ✓ in accordance with appropriate IFRSs. Appropriate disclosures from IAS 37 or other IFRSs.

2 Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with paragraphs 45–49 of IFRS 3. The accounting requirements for measurement period adjustments are not changed by the proposed amendment.