IFRS

IASB Meeting | Agenda reference **6A**

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Project **Annual Improvements—2010–2012 cycle**

Topic **IFRS 3 *Business Combinations*—regrouping and consistency of contingent consideration guidance**

Introduction

1. The Interpretations Committee discussed improving guidance on contingent consideration in IFRS 3 *Business Combinations* at its meeting in July 2010. The Committee made a recommendation to the Board to propose an improvement through Annual Improvements.

2. The Board discussed the issue at its meeting in October 2010, at which it asked the staff to perform further analysis.

Purpose of this paper

3. This paper:

   (a) provides background information to the issue;

   (b) provides the results of outreach performed as part of the further work asked for by the Board;

   (c) makes a recommendation for

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

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(i) a proposed amendment to IFRS 3 and IAS 39 *Financial instruments: recognition and measurement* as presented in Appendix B,

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

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

Background information and issue raised

4. A review of the existing IFRS guidance on the accounting for contingent consideration arising from a business combination has led to the following issues being identified:

   (a) **Issue 1**: IFRS 3 paragraph 40 refers not only to IAS 32 *Financial Instruments: Presentation*, but also to 'other applicable IFRSs' in determining whether contingent consideration is <u>classified</u> as a liability or equity. There is uncertainty as to when 'other applicable IFRSs' would be required to determine this classification.

   (b) **Issue 2:** Paragraph 58 of IFRS 3 provides guidance for <u>subsequent measurement</u> of contingent consideration. There is an uncertainty around how paragraph 58(b)(ii) of IFRS 3 should be applied. Paragraph 58(b)(ii) of IFRS 3 requires changes in fair value of the contingent consideration to be measured in accordance with IAS 37, but IAS 37 does not prescribe fair value as its measurement basis.

   (c) **Issue 3**: Paragraph 58 of IFRS 3 provides guidance for <u>subsequent measurement</u> requirements for contingent consideration. If the contingent consideration is classified as a financial asset or financial liability, there is an inconsistency because:

(i) IFRS 3 paragraph 58(b)(i) requires contingent consideration that is a financial asset or financial liability to be measured at fair value in accordance with IFRS 9; but

(ii) IFRS 9 would, in some circumstances, allow a financial asset or financial liability to be measured at amortised cost.

(d) **Issue 4:** Paragraph B64 of IFRS 3 requires disclosures for contingent consideration. However, because of 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.

5. Appendix C to this paper provides a table that summarises the various existing accounting requirements and references with respect to subsequent measurement in a business combination.

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

7. The analysis that was first presented to the Interpretations Committee at the meeting in July 2010 was set out in agenda paper 14, which is available on the public website[1]. The interpretations Committee recommended that the Board should consider removing 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 should 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* to clarify the scope of these standards with respect to contingent consideration.

[1] http://www.ifrs.org/NR/rdonlyres/59169253-549A-4DA0-830F-AF0A80E757B2/0/1007obs14AIP.pdf

Board's directions from the meeting in October 2010

8. At its meeting in October 2010, the Board discussed the Interpretations Committee's recommendation set out in agenda paper 3B that the issue should be addressed through Annual Improvements[2].

9. We reproduce below the IASB update for the October 2010 meeting on this issue:

> […]
>
> The Board expressed concerns about the effects of the proposed changes that might go beyond an annual improvement. The Board asked for analyses of practical examples of contingent consideration that would fall under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The Board also asked the staff whether the proposed amendment was consistent with US GAAP requirements. Discussions will continue at a future meeting.

Result of outreach activities to national standard-setters

10. We carried out outreach activities to national standard-setters asking them to provide examples of business combinations with contingent consideration that would be accounted for in accordance with paragraph 58(b)(ii) of IFRS 3. Specifically, we asked for examples of contingent consideration that is not within the scope of IAS 39/IFRS 9 *Financial Instruments*.

11. We received feedback from 11 jurisdictions that represent a broad geographical diversity. The feedback received is set out in detail in Appendix A to this paper.

12. Feedback received broadly follows the following pattern:

    (a) none of the respondents objected to the proposed improvement;

    (b) in a vast majority of cases (10 out of 11 responses) constituents are not aware of examples of non-financial contingent consideration;

    (c) one constituent reported an example of contingent consideration based on a pending lawsuit against the acquiree, claiming that in such an instance

[2] http://www.ifrs.org/Meetings/IASB+19+October+2010.htm

contingent consideration would be measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*;

(d) another constituent stated that, to be considered to be outside the scope of IAS 39/IFRS 9, the settlement of a contingent consideration relating to a lawsuit would have to be in a physical item rather than in cash or shares; but the constituent also stated that he was not aware of such examples; and

(e) one constituent provided the examples of warranties or indemnities for legal disputes or tax, claiming that these examples are not within the scope of IAS 39/IFRS 9, while acknowledging that 'these arrangements would obviously need to be outside the scope of any completion accounts'.

Staff analysis

Recognition, classification and initial measurement

13. We note that paragraph 40 of IFRS 3 raises 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 (which permits subsequent measurement at amortised cost for some financial instruments) and subsequent measurement requirements in paragraph 58 of IFRS 3 (which requires subsequent measurement at fair value).

14. 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 4 above.

15. In July 2010, the staff believed that removing from paragraph 40 of IFRS 3 the requirements to classify in accordance with IAS 39/IFRS 9 contingent consideration that is a financial instrument would simplify initial recognition and subsequent accounting. Therefore, the Committee recommended in July 2010 that paragraph 40 of IFRS 3 should be amended to reflect approach B.

16. Some expressed the concern that should the requirements to classify in accordance with IAS 39/IFRS 9 be removed for a contingent consideration that is a financial instrument, an issue would arise in that an entity would not be able to classify a contingent consideration as available for sale (AFS) and subsequent changes in fair value would not therefore be recognised in OCI.

17. We note that proposing a change that would reflect view B would lead to changes that go beyond an annual improvement. Therefore, we now recommend that requirements for classifying a contingent consideration that is a financial instrument should be retained in paragraph 40 of IFRS 3 (view A).

18. We propose to deal with the conflict between the requirements in IAS 39 / IFRS 9 and in paragraph 58 of IFRS 3 for the measurement of subsequent changes in the paragraphs below.

Subsequent measurement for contingent consideration that is not a financial instrument

19. Based on the feedback received, we observe that constituents broadly consider contingent consideration as being financial instruments. This is because contingent consideration is a contractual obligation that is usually settled either in

cash or in shares between the acquirer and the vendor in accordance with the contract between the two parties for the acquisition of the business. Consequently, contingent consideration meets the definition of a financial instrument as set out in paragraph 11 of IAS 32 *Financial Instruments: Presentation*.

20. In some instances, though, more specifically in those situations where the contingent consideration relates to a pending lawsuit, some would account for the contingent consideration in accordance with IAS 37. We observe that this accounting treatment does not take into account whether settlement of the contingent consideration is in cash or shares or if it is of any other nature. Proponents of this accounting treatment believe that the contingent consideration should be accounted for in the same way as the settlement of the underlying liability.

21. We note that IFRSs currently allow such an accounting treatment only in those cases where settlement of the contingent consideration is neither in cash nor in shares. Otherwise, the contingent consideration is a contractual obligation that is to be settled in cash or shares and so it meets the definition of a financial instrument. In addition, we observe that the definitions of a financial asset and of a financial liability do not consider the nature of the underlying item that the contractual obligation relates to. In support of this analysis, we note that one of the national standard-setters states that 'the only way such a contract gives rise to a non-financial liability would be if the means of settlement failed the definition of a financial liability in paragraph 11 of IAS 32, ie the contract will be settled with something other than cash, another financial asset or a variable amount of own equity instruments.' We agree with this statement.

22. We also note that in those instances where the contingent consideration falls in the scope of IAS 37, the constituents would agree that subsequent measurement should be at fair value. Consequently, they would agree with requiring a financial instrument type of accounting rather than accounting for the liability in accordance

with IAS 37. They claim this would result in enhancing consistency in accounting for contingent consideration.

23. Given the feedback received, we believe that the Interpretations Committee's recommendation to amend paragraph 58 of IFRS 3 to clarify that subsequent accounting should be at fair value irrespective of the nature of the contingent consideration should be taken forward.

24. In addition, the conflict with IAS 39/IFRS 9 can be eliminated by requiring that the measurement of subsequent changes should follow the requirements in paragraph 58 of IFRS 3 only. Under such an approach, contingent consideration will be measured at fair value at each reporting date with changes recognised in profit or loss except for when IAS 39/IFRS 9 requires that changes in fair value are recognised in other comprehensive income.

Recognition of subsequent variations in profit or loss or in other comprehensive income (OCI)

25. In July 2010, the Interpretations Committee recommended that the Board should consider amending paragraph 58(b) of IFRS 3 to state that gains and losses resulting from changes in fair value should be recognised in profit or loss only. The purpose of that proposal was to enhance comparability by requiring a single accounting treatment for contingent consideration.

26. Some expressed the concern that such an amendment would be a departure from current requirements in accounting for those financial instruments for which subsequent measurement is recognised through OCI, for example AFS items.

27. We therefore believe that proceeding with such an amendment would go beyond an annual improvement. Consequently, we recommend that the Board should not consider amending paragraph 58(b) of IFRS 3 to require that changes in fair value should be recognised in profit or loss only.

Disclosures

28. In July 2010, the Interpretations Committee recommended that the Board should consider amending paragraph B64 of IFRS 3 to clarify that for contingent consideration that is a financial instrument, the disclosures in IFRS 7 *Financial Instruments: Disclosures* should not be required. The purpose of the proposal was to simplify disclosures relating to a contingent consideration that is a financial instrument. In addition, we note that this proposal was in the context of the broader proposed amendments described in paragraph 7 of this paper. These broader proposed amendments entailed the exclusion of contingent consideration from the scopes of IAS 39 and IFRS 7 as consequential amendments.

29. After considering the concerns expressed and given the analyses presented above with respect to the requirements for classification upon initial recognition and for the measurement and the recognition of subsequent changes, we think that contingent consideration should not be excluded from the scope of IFRS 7 and therefore the disclosures required by IFRS 7 should be given.

30. We also note that proceeding with a proposal to amend paragraph B64 of IFRS 3 to limit disclosures for contingent consideration would depart from the current disclosure requirements for financial instruments, and in particular from the requirements set out in IFRS 7. We are of the opinion that such an amendment would go beyond an annual improvement.

31. Consequently, we recommend that the Board should not consider restricting disclosure requirements for contingent consideration to those required by paragraph B64 of IFRS 3.

Consistency with US GAAP requirements

32. We note that subsequent measurement guidance for contingent consideration arising from a business combination is similar under US GAAP and in paragraph 58 of IFRS 3, except that Topic 805-30-35-1 *Contingent Consideration*

in the *FASB Accounting Standards Codification*® specifies that changes in fair value shall be recognised in earnings unless the arrangement is a hedging instrument to which Topic 815 *Derivatives and Hedging* applies. In contrast, current paragraph 58 of IFRS 3 refers to IAS 39/IFRS 9, IAS 37 and to other IFRSs.

33. US GAAP requirements are reproduced in Appendix D for ease of reference.

34. There is currently divergence between IFRS and US GAAP for the subsequent measurement of contingent consideration because:

    (a) US GAAP requires all contingent consideration to be subsequently measured at fair value with changes recognised through profit and loss unless the contingent consideration is a hedging instrument; whereas

    (b) IFRS requires contingent consideration to be subsequently measured based on the applicable IFRS which might not require subsequent measurement at fair value through profit and loss, for example, if the contingent consideration was an asset classified as AFS.

35. Consequently, we believe that our proposal would not create any new differences compared with the current requirements for subsequent measurement in paragraph 58 of IFRS 3. In addition, we note that our proposal would improve convergence, because it would clarify that subsequent measurement cannot be amortised cost.

Conclusion

36. 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, which could be removed either by:

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

(ii) changing the accounting requirements.

37. We believe that removing inconsistencies for classification and measurement purposes by deleting references to other IFRSs within the guidance provided in IFRS 3 would meet the set objective of regrouping guidance. We observe that it would serve to enhance the quality of the standards while not changing the accounting principle in IFRS 3.

38. In addition, the results of our outreach activities confirm the need to enhance consistency.

Annual Improvements criteria assessment

39. We have assessed below the issue against the Annual Improvements criteria:

(a) *The proposed amendment clarifies or corrects existing IFRSs.*

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) *The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.*

The change proposed is limited to contingent consideration that arises from business combinations, and so it has a narrow and well-defined purpose.

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

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

There is no current or planned Board project to review the accounting for contingent consideration arising from business combinations.

40. In our opinion, the issue satisfies the Annual Improvements criteria.

Transition provisions

41. We believe that the effects of the proposed changes should be accounted for prospectively to contingent consideration balances arising from all business combinations from the date on which the improvement becomes effective in order to avoid unduly burdensome changes.

Consequential amendments

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

42. We believe that no consequential amendment to IAS 37 is needed. The scope in paragraph 1(c) of IAS 37 already excludes provisions, contingent liabilities and contingent assets that are covered by 'another Standard'. Because IFRS 3 is currently the only standard that defines and mentions contingent consideration, we believe that IFRS 3 explicitly covers contingent consideration arising from business combinations that are not financial instruments.

Consequential amendment to IAS 39/IFRS 9

Background on scope exclusions in IAS 39

43. We note that prior to the publication of IFRS 3 revised in 2008, the scope of IAS 39 excluded contingent consideration. That scope exclusion 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, via the references to IAS 39.

44. We also note that IFRS 9 explicitly refers to the scope of IAS 39.

Consequences of the conclusion of our analysis

45. We note that a contingent consideration that meets the definition of a financial instrument may have a different accounting treatment under IFRS 3 than the one required in IAS 39/IFRS 9, namely for a financial instrument that is measured at amortised cost, ie not subsequently measured at fair value.

46. Consequently, we think that if the Board were to propose amending the guidance provided in paragraph 58 of IFRS 3, a partial scope exclusion in IAS 39/IFRS 9 for contingent consideration arising from a business combination would be needed. That scope exclusion would be partial in that it would only apply to the subsequent measurement provisions of contingent consideration that would have qualified for amortised cost measurement under IAS39/IFRS9.

47. In addition, we note that amending the scope of IAS 39 as described above remains consistent with the Board's original intent that the subsequent measurement of a contingent consideration that is a financial instrument should be accounted for at fair value as described in IFRS 3.

48. Because of the reference to the scope of IAS 39 in IFRS 9, we believe that amending the scope of IAS 39 is sufficient.

Staff's recommendation

49. We recommend that the Board should proceed with the proposed changes in paragraph 37 of this paper within the Annual Improvements 2010-2012 cycle.

50. The proposed amendment wording is included in Appendix B.

Questions to the Board

Question 1—Committee recommendation on the need for the amendment
Does the Board agree with the staff recommendation to amend IFRS 3 as proposed in paragraph 49 of the paper?

Question 2—Staff assessment of the proposed amendment against the criteria for inclusion in Annual Improvements
Does the Board agree with the inclusion of the proposed amendment to IFRS 3 in the Annual Improvements cycle for 2010-2012?

Question 3—Wording for the proposed amendment
If the Board agrees with the proposal to amend IFRS 3 through Annual Improvements, does the Board agree with the wording for the proposed amendment as set out in Appendix B?

Appendix A—Summary of feedback received

1. The table below summarises the responses received as part of our outreach to find practical examples of contingent consideration that would fall within the scope of IAS 37. Because we are focusing on situations that currently exist in practice and that lead to diverging accounting treatments, we chose not to reproduce situations that were reported to us as being only theoretical.

2. Some constituents expressed additional broader concerns with respect to some specific situations. Because we were focusing on the original issue raised, we chose to not reproduce these comments in the table below. We will address those broader concerns as part of the post-implementation review of IFRS 3.

Outreach to national standard-setters

3. The views expressed below are informal feedback received from national standard setters/staff from national standard setters. They do not reflect the formal views of the Boards of those organisations. The geographic breakdown for the responses is as follows:

Geographic area	Number of respondents
Africa	1
Asia/Oceania	4
Europe	4
North America	2
Total respondents	**11**

Responses provided
Responses received indicate that all the real life examples are contractual by virtue of the agreement between the buyer and the seller. Therefore, would all be financial instruments. Some additional comments were that contingent consideration based on some other future event, e.g. a pending lawsuit against the acquiree, would currently be measured in terms of IAS 37.
No practical example that is outside the scope of IAS 39 / IFRS 9. A contingent consideration within the scope of IAS 37 is only a theoretical possibility.
In terms of the specific question, our members have not seen any examples of contingent consideration that is not within the scope of IAS 39. Since, in the case of contingent consideration there is by definition a contract between a buyer and a seller, the only way such a contract gives rise to a non-financial liability would be if the means of settlement failed the definition of a financial liability in paragraph 11 of IAS 32 ie the contract will be settled with something other than cash, another financial asset or a variable amount of own equity instruments. For example, if the settlement means was a physical item such as cocoa beans. The cause of the variability in terms of the contingency itself is irrelevant to this question. So in the case of contingent consideration relating to a lawsuit, if the deal is that the buyer will pay the seller cash if the lawsuit is settled in the acquiree's favour, then this is a financial liability as per IAS 32.25, whereas if the deal is that the buyer will pay cocoa beans, then this is a non-financial liability. Our members would expect that the large majority of contingent consideration deals therefore involve financial liabilities. Having said all this, our members would agree with the basic issue in the paper that the accounting for contingent consideration post acquisition is not explained clearly in IFRS 3 and the cross references to other standards do not help in this regard. They are supportive of the proposal to deal with the matter entirely within the body of IFRS 3, with clarification that the measurement basis for contingent consideration is fair value until settlement. However, there are some concerns about the proposal that all changes in the measurement of the fair value will be recognized in profit or loss: it is clear from paragraph 42 of IFRS 13 that the fair value of a financial liability should take into account the payer's own credit risk. It is also the case in IFRS 9 para 5.7.7 that when a financial liability is

Responses provided
carried at fair value, any changes in the entity's credit risk should be reported in OCI rather than profit or loss, unless doing so increases an accounting mismatch per 5.7.8. Therefore, in requiring all movements in the FV of contingent consideration to be booked in P&L the staff should make sure that they have considered the requirements in paragraphs 5.7.7-5.7.8 of IFRS 9 and are comfortable that it makes sense to effectively mandate 5.7.8 rather than 5.7.7.
No example of contingent consideration that would fall under the scope of IAS 37.
No example provided by constituents.
No concern raised with respect to that issue.
No practical example outside the scope of IAS 39 / IFRS 9.
No practical example outside the scope of IAS 39 / IFRS 9.
Constituent believes that the following examples are not within the scope of IAS 39/IFRS 9: 1. Where a vendor gives a warranty or an indemnity for legal disputes, for example if the vendor indemnifies the purchaser for a particular contractual dispute with a customer or say a claim for unfair dismissal by an employee. 2. Where a vendor gives a warranty or an indemnity for tax, ie against tax computations that are not settled with the tax authorities and the tax position is uncertain. These arrangements would obviously need to be outside the scope of any completion accounts.
We do not have additional examples on contingent consideration.
We are not aware of situations where an acquirer has structured the payment of contingent consideration with anything other than cash or shares. We think that would essentially require the contingent consideration to be settled with 'goods or services'. We are not aware of contingent consideration that was based on an 'ongoing lawsuit'.

Appendix B—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. 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 64F 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 that meets the definition of a financial instrument as a financial 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~~. 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 IFRS 9~~ 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, unless the recognition of the resulting gain or loss is required ~~or~~ in other comprehensive income in accordance with the relevant IFRS~~IFRS 9~~.

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

Effective date and transition

Effective date

64F *Improvements to IFRSs* issued in [date] amended paragraphs 40 and 58. An entity shall apply those amendments for annual periods beginning on or after 1 July 2013. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact. Application should be prospective to contingent consideration balances arising from all business combinations from the date the amendments are effective.

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 the classification requirements in paragraph 40 of IFRS 3 are unclear as to when, if ever, 'other applicable IFRSs' would need to be used to determine the classification of contingent consideration. In addition, the Board noted that the 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* is inconsistent when compared with the accounting requirements of IAS 39. Because paragraph 58 of IFRS 3 refers to IAS 39 which allows amortised cost measurement in certain circumstances, 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 a contingent consideration should be subsequently measured at fair value. Consequently, the Board proposes to exclude contingent consideration arising from business combinations from the scope of IAS 39 for the measurement of subsequent changes only when the use of fair value is not required. In addition, the Board proposes to delete the reference to 'other applicable IFRSs' in paragraph 40 of IFRS 3. This will eliminate the confusion as to when, if ever, 'other applicable IFRSs' would apply to contingent consideration in a business combination and it will clarify that subsequent measurement can only be fair value in accordance with paragraph 58 of IFRS 3.

BC2 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 to be measured in accordance with standards that do not require fair value as a measurement basis. Consequently, 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 that this is different from the accounting that would apply if these items were not contingent consideration. However, the Board believes that the proposed amendment will increase consistency with the principle in IFRS 3 for measuring consideration transferred at fair value.

BC3 The Board also noted that IFRS 7 disclosure requirements apply to contingent consideration that meet the definition of a financial instrument.

Appendix to proposed amendments to IFRS 3 Amendments to IAS 39 *Financial Instruments: Recognition and Measurement*

Paragraphs 2A and 108D are added (new text is underlined).

Scope

2A The subsequent measurement provisions of this IFRS that do not require the use of fair value do not apply to contingent consideration to which IFRS 3 *Business Combinations* applies.

Effective date and transition

108D *Improvements to IFRSs* issued in [date] amended paragraph 2. An entity shall apply those amendments for annual periods beginning on or after 1 July 2013. 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 is effective.

Appendix C—Subsequent measurement—overview

We note 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:

<table>
<tr><th>Nature of adjustments</th><th>When do they occur?</th><th>Applicable IFRSs</th><th>Measurement and presentation requirements</th></tr>
<tr><td rowspan="2">Measurement period adjustments[3]</td><td>During the measurement period</td><td>IFRS 3.45-49</td><td>Fair value remeasurement.
Adjustments booked against goodwill.
Restatement of comparative information.</td></tr>
<tr><td>After the measurement period</td><td>IFRS 3.50
IAS 8.41-49</td><td>Accounting for errors.
Fair value remeasurement.
Adjustments booked to profit or loss for the relevant period.
Restatement of comparative information.</td></tr>
<tr><td rowspan="3">Non-measurement-period adjustments</td><td rowspan="3">Any time from the date of acquisition</td><td>Contingent consideration classified as equity
IFRS 3.58(a)</td><td>No remeasurement.
Subsequent settlement accounted for within equity.</td></tr>
<tr><td>Contingent consideration classified as a financial instrument
IFRS 3.58(b)(i)
IAS 39/IFRS 9</td><td>Fair value remeasurement.
Resulting gain or loss in
✓ P&L, or
✓ OCI.
Appropriate disclosures from IFRS 7.</td></tr>
<tr><td>Other contingent consideration
IFRS 3.58(b)(ii)
IAS 37
Other IFRSs</td><td>Measurement:
✓ best estimate, or
✓ in accordance with appropriate IFRSs.
Appropriate disclosures from IAS 37 or other IFRSs.</td></tr>
</table>

[3] 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.

Appendix D-US GAAP requirements for contingent consideration

Initial recognition in Topic 805-30-25-5/6/7

25-5 The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

25-6 The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity in accordance with Subtopics 480-10 and 815-40 or other applicable generally accepted accounting principles (GAAP). For example, Subtopic 480-10 provides guidance on whether to classify as a liability a contingent consideration arrangement that is, in substance, a put option written by the acquirer on the market price of the acquirer's shares issued in the business combination.

25-7 The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

Subsequent measurement in Topic 805-30-35-1

35-1 Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. Such changes are measurement period adjustments in accordance with paragraphs 805-10-25-13 through 25-18 and Section 805-10-30. 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. Contingent consideration classified as an asset or a liability shall be remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value shall be recognized in earnings unless the arrangement is a hedging instrument for which Topic 815 requires the changes to be initially recognized in other comprehensive income.