

## STAFF PAPER

IFRS Interpretations Committee  
Meeting

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**Project IFRS 3 *Business Combinations*—Continuing employment**CONTACT(S) Leonardo Piombino [lpiombino@ifrs.org](mailto:lpiombino@ifrs.org) +44 (0)20 7246 0571

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. 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. Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*. The approval of a final Interpretation by the Board is reported in *IASB Update*.

**Introduction**

1. In January 2012, the IFRS Interpretations Committee (the Committee) received a request for guidance on the accounting under IFRS 3 *Business Combinations* for contingent payments to selling shareholders in circumstances where those selling shareholders become employees. The submitter asked the Committee to clarify whether paragraph B55(a) of IFRS 3 is conclusive in determining that an arrangement in which payments to an employee that are forfeited upon termination of employment is remuneration for post-combination services and not part of the consideration for an acquisition.
2. We performed outreach with national standard-setters on this topic in order to find out whether the issue raised by the submitter is widespread and whether significant diversity in practice exists. The results of this outreach are included as part of the staff's analysis of this issue (refer to paragraphs 29-36).
3. The submission is reproduced in full in Appendix B to this paper.
4. We received from a constituent a comment letter on this issue. It is reproduced in full in Appendix D to this paper.

## Objective

5. The objective of this paper is to:
  - (a) provide background information on the issue raised in the submission;
  - (b) provide an analysis of the issue, including a summary of the outreach responses received from national standard-setters;
  - (c) present an assessment of the issue against the Committee's agenda criteria and the annual improvements criteria; and
  - (d) make a recommendation that the Board should amend IFRS 3 through Annual Improvements.

## Background information

6. To be included in the accounting for business combinations, the identifiable assets acquired and liabilities assumed must be part of the business combination transaction rather than the result of separate transactions (IFRS 3.12).
7. In accordance with paragraph 51 of IFRS 3, the acquirer shall:
  - (a) identify any amounts that are not part of the business combination;
  - (b) recognise, by applying the acquisition method, only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree; and
  - (c) account for in accordance with the relevant IFRSs the transactions that are not part of the business combination (ie separate transactions).
8. Paragraph 52 of IFRS 3 includes the principle for determining whether a transaction is part of the business combination or is a separate transaction and gives three examples of separate transactions. The principle is that: a transaction entered into by or on behalf of the acquirer, or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. One of the three examples of separate transactions provided by

IFRS 3.52 is a transaction that remunerates employees or former owners of the acquiree for future services (IFRS 3.52 (b)).

9. Paragraphs B54 and B55 of IFRS 3 provide application guidance for determining whether arrangements for contingent payments to employees or selling shareholders are part of the business combination or are separate transactions.

These paragraphs state that [emphasis added]:

B54 Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

B55 If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following **indicators**:

- (a) *Continuing employment*—The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement or some other document. **A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services.** Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.
- (b) ...

## Staff analysis

### *Description of the issue*

10. The submitter asks whether paragraph B55(a) of IFRS 3 is conclusive in determining that an arrangement in which payments to an employee that are forfeited upon termination of employment is remuneration for post-combination services and not part of the business combination transaction.
11. The submitter notes that:

- (a) paragraph B55 of IFRS 3 introduces the subparagraphs (a) to (h) as indicators. It states that: “*If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:..*”;
  - (b) some believe that the wording used in the introduction of paragraph B55 suggests that none of the subparagraphs that follow is, on its own, conclusive, because they are indicators;
  - (c) unlike subparagraphs (b) to (h)<sup>1</sup>, which use inconclusive language (such as ‘may indicate’, ‘may be an indicator’, ‘may suggest’ and ‘might suggest’), subparagraph (a) uses conclusive language; it states that [emphasis added]: “*...A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services...*”.
12. In other words, the issue is whether that provision of paragraph B55(a) of IFRS 3 (ie a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services) *is, on its own, conclusive* that these payments are remuneration for post-combination services (ie they are not part of the business combination) or, like subparagraphs (b) to (h), *is not necessarily conclusive*.
13. We will analyse these views in the following paragraphs.

**View 1—Paragraph B55(a) is, on its own, conclusive**

14. Proponents of this view think that the interpretation of paragraph B55(a) is very straightforward. A contingent consideration arrangement in which the payments are automatically forfeited if the employment terminates is not part of the business combination. These payments are post-combination expenses, even if all the other indicators included in paragraphs B55 (b) to (h) suggest that the payments should be considered to be part of the business combination.

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<sup>1</sup> For ease of reference paragraph B55 of IFRS 3 is reproduced in full in Appendix C of this paper.

15. They believe that: although paragraph B55(a) is included within a list of indicators that the acquirer should consider in determining whether the arrangement is part of the business combination or not, its wording is clear and rules out an alternative interpretation, because the paragraph uses a conclusive word ‘is’.
16. In their view paragraph B55(a) is still an indicator, but an individually conclusive one (ie if the acquirer meets this indicator, the arrangement is not part of the business combination).

**View 2—Paragraph B55(a) is not necessarily conclusive**

17. Proponents of View 2 think that paragraph B55(a) is a strong indicator that the arrangement is not part of the business combination, but it is not necessarily conclusive. The acquirer, as required by the introduction of paragraph B55, should consider all the indicators included in paragraphs B55(a) to (h) in order to determine whether the arrangement is part of the business combination or is a separate transaction.
18. They think that paragraph B55(a) is not conclusive, because it is included in the list of indicators provided by paragraph B55. If paragraph B55(a) were intended to be conclusive, then it would be separated from the other indicators.
19. They believe that judgement is required to determine whether arrangements for contingent payments to employees or selling shareholders are part of the business combination or are separate transactions; and they note that this conclusive wording only appears in paragraph B55(a). This fact might suggest that the use of the word ‘is’ is an anomaly.

**Paragraph B55(a) history**

20. In the following paragraphs we retrace the development of paragraph B55(a) of IFRS 3 in order to understand the boards’ intention.
21. In 1995 the Emerging Issues Task Force (EITF) issued EITF Issue No. 95-8 *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*. That guidance stated that [emphasis added]: “...A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates **is a strong**

*indicator that the arrangement is compensation for postcombination services...*”.

[Issue 95-8 has been nullified by FAS 141R]

22. The exposure draft *Amendments to IFRS 3 Business Combinations* published by the Board in June 2005 stated that [emphasis added]: “...*If future payments are automatically forfeited if employment ends, the arrangement **may be** compensation for post-combination services that will benefit the combined entity and should be accounted for separately from the business combination...*”.
23. In July 2006 the boards discussed this issue. In the staff paper (IASB AP 2A, FASB Memorandum 21) we read that [emphasis added]: “***The staff notes that it was not their intention to modify the application of the guidance in Issue 95-8, but only to incorporate the existing guidance into the business combinations standard. As a result, unless Board members object, the staff plans to state in the application guidance of the final standard that vesting requirements are a **strong indicator** that arrangements are compensation for post-combination services.***”
24. The boards decided to revise the guidance proposed in the exposure draft to make the principles clearer. The July 2006 IASB *Update* states that: “...*The Board reaffirmed that the principles for identifying separate transactions in a business combination should be based on determining whether a transaction was arranged by or on behalf of the acquirer or initiated primarily for the economic benefit of the acquirer or combined entity. The staff will revise the guidance proposed in the Exposure Draft to make the principles clearer.*”
25. ASC 80510-55-25 (originally FAS 141R.A87) contains the same language as paragraph B55(a) of IFRS 3.

**Staff analysis and view**

26. We think that the wording used in paragraph B55(a) is, on its own, conclusive. However, in our view, the paragraph should be amended because it is not consistent with the inconclusive language used:
  - (a) in the principle stated in paragraph 52 of IFRS 3 [emphasis added]: “*A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily*

*for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction... ”;*

- (b) in paragraph BC120 of IFRS 3 [emphasis added]: “*The boards also concluded that **the focus of the principle should be on identifying whether a business combination includes separate transactions that should be accounted for separately in accordance with their economic substance** rather than solely on assessing whether a transaction is part of the exchange for the acquiree... ”;*
- (c) in its application guidance stated in paragraph B54 of IFRS 3 [emphasis added]: “*Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions **depends on the nature of the arrangements**. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement and when the parties entered into the arrangement **may be helpful** in assessing the nature of the arrangement.” and*
- (d) in paragraph B55(d) [emphasis added]: “*Incremental payments to employees—If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact **may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is remuneration**.”. We also think that the current wording of paragraph B55(a) is not consistent with this paragraph because according with View 1 the *entire amount* of the contingent payments *is* remuneration (if the entire amount of the contingent payments are forfeited upon termination of employment), while according to paragraph B55(d) the *incremental amount* of the contingent payments *may be* remuneration and the remaining amount may be part of the consideration for the business combination. In other words, the only way to reconcile these two paragraphs is to consider paragraph B55(a) as an indicator.*

27. In addition, retracing the development of paragraph B55(a), we have not found a decision of the boards to modify the language of paragraph B55(a) (ie the decision to use the word ‘is’ instead of ‘strong indicator’).
28. Consequently, we think that the boards did not intend to use conclusive language in paragraph B55(a) and we recommend that the Committee should propose an amendment to paragraph B55(a) of IFRS 3 in order to clarify that a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is a strong indicator that the arrangement is remuneration for post-combination services.

### **Outreach request to national standard-setters**

29. We asked a group of standard-setters in different countries to provide us with feedback on whether the issue raised in the submission:
  - (a) is widespread and has practical relevance; and
  - (b) indicates that there are significant divergent interpretations (either emerging or existing in practice).
30. In our request we included the information that we have reproduced in Appendix B of this paper. We asked the national standard-setters the following two questions:
  - (a) *In your jurisdiction, how common is this type of arrangement in business combinations? If it occurs, could you provide us with information that the Committee could use to assess how widespread the issue is?*
  - (b) *In your view, is there diversity in practice in determining whether the payments are part of the consideration for a business combination or are remuneration for post-combination services? Please describe the predominant approach that you observe in your jurisdiction.*
31. We received sixteen responses from the following jurisdictions: Europe (6), America (4), Asia (3) Oceania (2) and Africa (1). Nine respondents considered



the issue to be prevalent and six of them noted divergent interpretations in practice.

***Is the transaction prevalent?***

32. Nine national standard-setters considered the issue to be prevalent in practice. One respondent noted that there are many situations in which entities acquire a business from its employee/shareholders (eg software companies, consultancy firms, training firms, etc.). In these ‘people-businesses’ it is very important to retain key employees for a long enough time to ensure that the business does not collapse upon their departure. Consequently, it is very common to have these types of arrangements.
33. Five national standard-setters did not consider the issue to be widespread in their jurisdiction. Two respondents were unable to determine how common the issue is.

***Feedback received on the existence of diversity in practice***

34. Six respondents reported differing views in practice on the classification of payments for contingent consideration. These respondents mentioned that in their jurisdiction there are different interpretations of whether payments to an employee that are forfeited upon termination are part of the consideration for a business combination or are remuneration for post-combination services. They noted that View 1 is the predominant approach but that there is no consensus on this. Consequently, clarification of paragraph B55 seems to be necessary.
35. Seven respondents have not observed diversity in practice. If paragraph B55(a) applies (ie payments are forfeited upon termination), the payment is considered to be remuneration for post-combination services. One of them noted that paragraph B55(a) sometimes causes problems in practice when the acquirer demands that a very large proportion of the consideration in business combination is made contingent upon the continued services of the employee/shareholder. For example, the employee/seller may agree that CU<sup>2</sup>20m out of the total sales price of CU 50m is made contingent on two years of further services. It is very clear in

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<sup>2</sup> In this paper, monetary amounts are denominated in “currency units (CU)”.

most of these types of case that the employee/seller's services are not worth CU10m/year, but that is exactly the accounting that paragraph B55(a) requires.

36. One respondent noted that the predominant approach applied in practice is to read paragraph B55(a) as conclusive as many consider that paragraph (a) is difficult to argue against. However, he noted that some think there may be circumstances in which it is possible to argue against paragraph B55(a) and that entities should contemplate the facts and circumstances for each case, particularly where the period is very short it may be argued that it is clear the payment is not remuneration. That is, such arrangements may not always be associated with employment related services.

### **Agenda criteria assessment**

37. The staff's preliminary assessment of the agenda criteria is as follows:

- (a) *The issue is widespread and has practical relevance.*

Yes. On the basis of our outreach, we understand that the issue is widespread.

- (b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

Yes. On the basis of our outreach we understand that the predominant interpretation is that paragraph B55(a) is conclusive (ie View 1); however, diversity in practice exists in the interpretation of that paragraph.

The submitter notes that three of the four largest audit firms support View 1, but one of them supports View 2 (see Appendix B). In addition, we understand that another international audit firm supports View 2.

- (c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Yes, because different views exist in practice. According to View 1 the payments are recognised in profit or loss, while according to View 2 the

payments can be recognised as assets in the statement of financial position in accordance with the acquisition method. In addition, proponents of View 2 think that View 1 does not reflect the substance of the transaction and that it can result in misleading consequences in financial statements (eg negative goodwill, remuneration above market salary, see Appendix D for further details).

- (d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

Yes. We think that the issue could be resolved efficiently within the confines of IFRS 3.

- (e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Yes, the Committee could be able to reach a consensus on the issue on a timely basis.

- (f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

There is no current IASB project on IFRS 3.

### **Assessment against the annual improvements criteria**

38. The staff's preliminary assessment of the issue against the annual improvements criteria is as follows:

*In planning whether an issue should be addressed by amending IFRSs within the annual improvements project, the IASB assesses the issue against the following criteria. All criteria (a)–(d) must be met to qualify for inclusion in annual improvements.*

- (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.*

We think that paragraph B55(a) of IFRS 3 should be amended in order to resolve the inconsistency between the conclusive wording used in this paragraph and the inconclusive wording used in paragraphs 52 and B54 of IFRS 3. In addition, on the basis of our outreach, we think that diversity in practice exists in the interpretation of that paragraph.

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

Yes, the issue is narrow in scope.

(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.*

Yes, we think that the Board could be able to reach a conclusion on the issue 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 IASB project on IFRS 3.

### **Staff recommendation**

39. On the basis of our technical analysis (see paragraphs 10 to 28) and of our assessment of the annual improvements criteria, we recommend that the Committee should propose an amendment to paragraph B55(a) of IFRS 3 in order to clarify that a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is a strong indicator that the arrangement is remuneration for post-combination services.
40. Our recommended amendment is included in Appendix A of this paper.

#### **Questions for the Committee**

1. Does the Committee agree that the conclusive wording in paragraph B55(a) of IFRS 3 is not consistent with paragraphs 52, B54 and B55(d) of IFRS 3?
  
2. Does the Committee agree with the staff's recommendation that the Committee should propose an amendment to paragraph B55(a) of IFRS 3 in order to clarify that a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is a strong indicator that the arrangement is remuneration for post-combination services?
  
3. Does the Committee have any comments on the proposed amendment to paragraph B55 of IFRS 3 in Appendix A?

## Appendix A—Draft wording of the proposed amendment, showing differences from the currently effective standard

A1 The proposed amendment to IFRS 3 is presented below.

### Proposed amendments to IFRS 3 *Business Combinations*

Paragraph B55 is amended as follows: (new text is underlined)

- B55 If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:
- (a) *Continuing employment*—The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is a strong indicator that the arrangement is remuneration for post-combination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.
  - (b) ...

### Basis for Conclusions on proposed amendments to IFRS 3 *Business Combinations*

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

#### Part of the business combination

- BC1 The Board was asked to clarify whether paragraph B55(a) of IFRS 3 is conclusive, on its own, in determining that an arrangement in which payments to an employee that are forfeited upon termination is remuneration for post-combination services and not part of the consideration for an acquisition.
- BC2 The Board noted that a transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than

primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The Board also agreed that a contingent consideration arrangement in which the payments forfeited upon termination of employment may not always be remuneration for post-combination services. Consequently the Board proposes to amend the paragraph in order to clarify that a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is a strong indicator that the arrangement is remuneration for post-combination services.

## Appendix B—Request

B1 The staff received the following request. All information has been copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

### SUBMISSION

#### **Interpretations Committee potential agenda item request**

This letter describes an issue that we believe should be added to the Interpretations Committee’s agenda. We have included a summary of the issue, the possible views and an assessment of the issue against the Interpretations Committee’s agenda criteria.

#### **The issue**

***Is IFRS 3.B55(a) conclusive in determining that an arrangement in which payments to an employee that are forfeited upon termination is remuneration for post-combination services and not part of the consideration for an acquisition?***

B55 introduces (a) to (h) with the following words: “*If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators.*”

This wording might be read by some to suggest that no item in the list that follows is necessarily conclusive. However, B55(a) states, “... *A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services*” (emphasis added). Unlike B55(b)-(h), which use inconclusive language such as ‘indicate’, ‘suggest’, ‘might’ and ‘may’, B55(a) uses the conclusive language, ‘is’. The issue is whether that provision of B55(a) is, on its own, conclusive that a payment that it describes is remuneration for post-combination services or, like B55(b)-(h), is not necessarily conclusive.

There are two possible views to consider.

#### ***View 1: B55(a) is conclusive***

From a plain reading of B55(a) it is hard to see it as anything other than conclusive. While it is included in a list of indicators, the words used express a conclusive principle: if this indicator is met, then the payment ‘is’ a post-acquisition expense. It is still an indicator, but an individually conclusive one.



In addition, this view is consistent with IFRIC’s approach to a question it discussed in July 2009 related to the meaning of significant and prolonged in IAS 39:

“Paragraph 67 of IAS 39 requires an entity to recognise an impairment loss on available-for-sale equity instruments if there is objective evidence of impairment. Paragraph 61 of IAS 39 states: ‘A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.’ [emphasis added] Consequently, the IFRIC concluded that when such a decline exists, recognition of an impairment loss is required.”

***View 2: B55(a) is not conclusive***

B55(a) gives a strong direction that payments contingent on post-acquisition employee service should be treated separately from acquisition consideration. However, the introduction to B55 describes (a)-(h) as indicators, thereby making clear that this is one of a number of indicators and, accordingly, is not, on its own, conclusive.

Had the IASB wished to make B55(a) conclusive, then it could have separated this paragraph and then followed it with a set of indicators to be applied if B55(a) was not met. The fact that the words are included in a list of indicators implies that it is intended to be given a similar prominence to the other indicators and applied together with them. On the other hand, if the IASB had wanted it not to be determinative, then the IASB could have written it differently, using ‘may indicate’ or perhaps ‘a strong presumption’ instead of ‘is’.

Furthermore, B55(a) is the only place in the standard that this conclusive statement appears. If it were intended to be determinative, then it could be referred to elsewhere; the fact that it isn’t might suggest that the use of the word ‘is’ is an anomaly.

**Current practice**

Current practice under IFRS is mixed (see, for example, the four largest networks’ guidance in the Appendix). This difference in views implies diversity in practice that is significant if the amounts involved are material: are the amounts in question part of the consideration for the business combination (thus becoming goodwill in the statement of financial position) or compensation expense?

IFRS 3 was one of the convergence projects undertaken jointly with the US Financial Accounting Standards Board and ASC 80510-55-25 (originally FAS 141R.A87) contains the same language. It is our understanding that under US GAAP View 1 is applied consistently. We understand that the FASB staff was consulted on this question in the early days of applying FAS 141R and that the FASB staff was in agreement with View 1.

**Reasons for the IFRIC to address the issue**

*(a) Is the issue widespread and practical?*

This is a commonly encountered type of arrangement in business combinations and thus is widespread. It is also practical as the question asked is neither obscure nor conceptually

difficult and addressing the existing divergence in practice should result in an improvement to comparability.

*(b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*

As indicated above, there is diversity in practice. This is significant because although the question is narrow, the related effect is significant because it affects whether the amount in question becomes part of goodwill in the business combination or is recognised in profit or loss.

*(c) Would financial reporting be improved through elimination of the diversity?*

Elimination of the diversity in practice would improve financial reporting for business combinations. There is a significant difference between the results from recording these amounts as part of goodwill or as an expense which harms comparability with no related benefit.

*(d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*

Yes, the scope is appropriately narrow for the Interpretations Committee to consider and resolve in a timely manner for the benefits clear guidance would provide. It is also practical as it is an interpretation of one section of IFRS 3 without ramifications on other areas of literature and discrete with an affirmative or negative answer (rather than a range of possible outcomes).

*(e) If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The Interpretations Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Interpretations Committee would require to complete its due process.)*

The issue does not relate to a current IASB project. It could be considered under the post-implementation review of IFRS 3, scheduled to begin at some point in 2012, with as yet no forecast of the implementation date of any eventual resulting changes. However, we believe that the matter could be addressed, and needs to be addressed, sooner.

## Appendix 1

Diversity evidenced by the published guidance of the four largest networks:

*Deloitte iGAAP 2011 A guide to IFRS reporting (page 2503-2504)*

“IFRS 3(2008):B55(a) establishes a rebuttable presumption that a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services. However, the final determination as to whether arrangements for contingent payments to employees are contingent consideration in the business combination or are separate transactions requires a full assessment of the facts and careful judgement.”

*EY International GAAP 2011 Volume 1 (page 567)*

“Although the guidance says that the acquirer should consider the above factors [*the factors in IFRS 3.B55*] in determining whether the arrangement is part of the business combination or not, in the first bullet point dealing with ‘continuing employment’ it is categorically stated that ‘a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services.’ However, apart from that, no other single indicator is likely to be enough to be conclusive on the accounting treatment. Therefore, judgement will be required in making this assessment.”

*KPMG Insights into IFRS 8th edition 2011/2012 (page 177, paragraph 2.6.400.50)*

“An arrangement under which contingent payments automatically are forfeited if employment terminates is compensation for post-combination services. Although this requirement is included within a group of indicators to assist in identifying amounts that are part of consideration transferred, the language in the standard is plain and rules out an alternative interpretation. Therefore, this is the case even if an evaluation of some, or even all, of the other indicators suggests that the payments otherwise would be considered to be additional consideration transferred in exchange for the acquiree; and even if the relevant employee is entitled to remuneration at rates comparable with those earned by people in similar roles.”

*PwC Manual of accounting IFRS 2011 (page 25111, paragraph 25.291)*

“*All of the above indicators [the indicators in IFRS 3.B55]* should be considered when analysing payments to employees or selling shareholders. However, if the contingent payments are automatically forfeited if employment terminates, the standard requires that the payment is treated as remuneration for post-combination services.”

## Appendix C— Paragraph B55 of IFRS 3

- B55 If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:
- (a) *Continuing employment*—The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.
  - (b) *Duration of continuing employment*—If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, remuneration.
  - (c) *Level of remuneration*—Situations in which employee remuneration other than the contingent payments is at a reasonable level in comparison with that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than remuneration.
  - (d) *Incremental payments to employees*—If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is remuneration.
  - (e) *Number of shares owned*—The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide remuneration for post-combination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The pre-acquisition ownership interests held by parties related to selling

shareholders who continue as key employees, such as family members, should also be considered.

- (f) *Linkage to the valuation*—If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide remuneration.
  
- (g) *Formula for determining consideration*—The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to remunerate employees for services rendered.
  
- (h) *Other agreements and issues*—The terms of other arrangements with selling shareholders (such as agreements not to compete, executory contracts, consulting contracts and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognise separately in its post-combination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.