STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**Annual Improvements to IFRSs 2010–2012 Cycle**
Paper topic	IFRS 3 *Business Combinations*—Accounting for contingent consideration in a business combination

CONTACT(S) Amy Bannister abannister@ifrs.org +44 (0)20 7246 6947

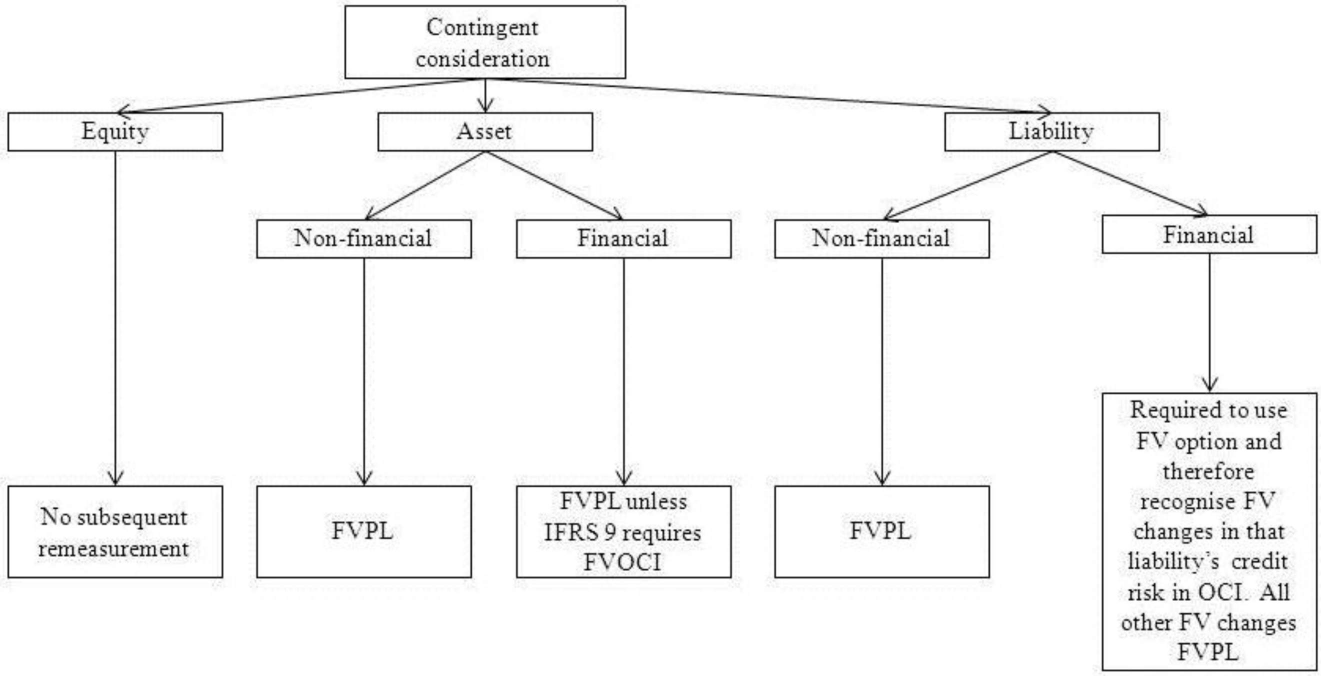
Introduction

1. The Exposure Draft (ED) *Annual Improvements to IFRSs 2010-2012 Cycle* (ED/2012/1) published in May 2012 ('ED (May 2012)') proposed amendments to IFRS 3 *Business Combinations*. The proposed amendments aimed to clarify certain aspects of accounting for contingent consideration in a business combination.

Background

2. In January 2013, we presented Agenda Paper 15B to the Interpretations Committee, which was an analysis of the comment letters received on the proposed IFRS 3 amendments.

3. The ED (May 2012) proposed the following subsequent measurement requirements for contingent consideration:



4. At the January 2013 meeting we recommended that the proposals be confirmed subject to the following staff recommendations:

   (a) the wording in paragraph 58(b) of IFRS 3 should be amended to ensure that it does not imply that contingent consideration can only be a financial instrument;

   (b) held for trading contingent consideration (which includes derivatives) shall be subsequently measured at fair value through profit or loss. An entity should not be required to apply the fair value option for financial liabilities to held for trading contingent consideration;

   (c) that the amendment proposed in the ED to IFRS 9 paragraph 4.1.2 should be deleted; and

   (d) the wording of the transition and effective date paragraph should be amended to ensure that the proposed amendment to IFRS 3 could not be applied without also applying IFRS 9.

5. The Interpretations Committee agreed with the recommendations in paragraph 4(a), 4(c) and 4(d); however they questioned the inconsistency of the subsequent measurement requirements for contingent consideration liabilities. In particular, they questioned the inconsistency of recognising fair value changes relating to changes in

the entity's credit risk in other comprehensive income for some contingent consideration liabilities and not for others.

6. The Interpretations Committee requested that we should look into whether the subsequent measurement requirements for contingent consideration liabilities could be made more consistent.

7. In order to do this, in this paper we consider what the most appropriate subsequent measurement basis is for the three different types of liability contingent consideration: held for trading financial liability, other financial liability and non-financial liability.

Structure of the paper

8. The structure of the paper is as follows:

   (a) Held for trading contingent consideration (paragraphs 9–13)

   (b) Other financial liability contingent consideration (paragraphs 14–21)

   (c) Consistency (paragraph 22)

   (d) Non-financial liability contingent consideration (paragraphs 23–28)

   (e) Overall requirements (paragraph 29)

   (f) Implications (paragraphs 30–39)

   (g) Staff recommendation and questions for the Interpretations Committee (paragraphs 40–43)

Held for trading contingent consideration

9. The ED proposed that all financial liability contingent consideration fair value changes would be required to be recognised in profit or loss or in other comprehensive income in accordance with IFRS 9 *Financial Instruments*. A consequential amendment was proposed to IFRS 9 to require that an entity should present fair value changes of contingent consideration in a business combination in accordance with paragraphs 5.7.7 and 5.7.8 of IFRS 9 (the fair value option). Therefore fair value changes of financial liability contingent consideration attributable

to changes in the credit risk of the entity would be presented in other comprehensive income.

10. However, 'held for trading' financial liabilities are required in IFRS 9 to be measured at fair value through profit or loss. Own credit is not accounted for separately. This reflects the targeted approach to the treatment of own credit that was taken in IFRS 9. Essentially, only the effects of own credit for non-derivatives measured at fair value under the fair value option are subject to the requirements. This resulted from the outreach that the IASB undertook at the time of the amendments where users of financial statements raised concerns about the own credit effect on non-derivatives.

11. Paragraph BC4.52 of IFRS 9 acknowledged that held for trading financial liabilities are required to be measured at fair value through profit or loss when the IASB considered the requirements in IAS 39 for classification and measurement of financial liabilities and their retention in IFRS 9:

> …Liabilities that are held for trading (including all derivative liabilities) would continue to be subsequently measured at fair value through profit or loss, which is **consistent with the widespread views that all fair value changes for those liabilities should affect profit or loss**. [emphasis added]

12. One of our recommendations in the January 2013 paper was that held for trading financial liability contingent consideration should be required to be measured at fair value through profit or loss. This is so its subsequent measurement requirements do not contradict the subsequent measurement requirements for held for trading financial liabilities in IFRS 9. This would mean that all fair value changes on contingent consideration that meets the definition of a derivative would be recognised in profit or loss.

13. We continue to think that contingent consideration held for trading financial liabilities should not contradict the requirements of IFRS 9 because the subsequent measurement requirement of derivatives, ie at fair value through profit or loss, is a basic requirement of IFRS.

Other financial liability contingent consideration

14. We noted in the January 2013 paper that we think it is appropriate for an entity to be required to apply the fair value option to 'other financial liability' contingent consideration such that an entity would be deemed to have applied the option in order to achieve fair value subsequent measurement for those liabilities.

Is presenting the fair value changes that are attributable to changes in credit risk in other comprehensive income appropriate for contingent consideration?

15. We note paragraph BC5.35 of IFRS 9:

> As noted above, if an entity designates a financial liability under the fair value option, IAS 39 required the entire fair value change to be presented in profit or loss. However, many users and others told the Board over a long period of time that changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading.

16. We also note paragraph 5 of Agenda Paper 5A from the September 2010 IASB meeting ('*Fair value option for financial liabilities–Whether the effects of changes in a liability's credit risk should be recognised in profit or loss*'):

> Most respondents agreed with the proposals that the effects of changes in the liabilities' credit risk ought not to affect P&L unless the liability is held for trading. Those respondents said that reporting in P&L the portion of the fair value change attributable to changes in the liability's credit risk is counter-intuitive, confusing and does not result in useful information–unless the issuer has the ability, intention and opportunity to buy back its liabilities at fair value.

17. We think that these arguments also apply to other financial liability contingent consideration. We would expect the same questions about the usefulness of the information provided to arise when the underlying transaction in question is contingent consideration and the liability is not held for trading. As a consequence we think it is appropriate that an entity should be required to present in other

comprehensive income the changes in fair value attributable to the credit risk of that financial liability for contingent consideration that is not held for trading, in the same way as for other 'non-held for trading' financial liabilities in IFRS 9 that use the fair value option.

18. We note paragraph 5.7.9 of IFRS 9:

> Despite the requirements in paragraph 5.7.7 and 5.7.8, an entity shall present in profit or loss all gains and losses on loan commitments and financial guarantee contracts that are designated as at fair value through profit or loss.

19. Paragraph BC5.43 of IFRS 9 explains that this specific exception from the presentation of own credit changes in other comprehensive income for loan commitments and financial guarantee contracts was because these types of financial liabilities either meet the definition of a derivative, or are very similar to a derivative from an economic perspective, and therefore the IASB decided that changes in the fair value of these items should always be presented in profit or loss. We understand that this exception was designed to be narrow and to reflect that the nature of these items was akin to that of a derivative (including that these items typically would require no initial net investment).

20. We note that the consequential amendment to IFRS 9 proposed in the ED did not reference paragraph 5.7.9 of IFRS 9, only paragraphs 5.7.7 and 5.7.8. However, we think that this requirement should also apply, so if financial liability contingent consideration was a loan commitment or financial guarantee contract, all fair value changes would be recognised in profit or loss.

21. We therefore propose that if the Annual Improvement is finalised that a reference to paragraph 5.7.9 is added to ensure that if a loan commitment or a financial guarantee contract was contingent consideration, then it would be accounted for at fair value through profit or loss.

Consistency

22. The conclusion reached in paragraph 17 would therefore lead to an inconsistency in that:

(a) **fair value gains/losses** on a financial liability contingent consideration attributable to credit risk are presented in OCI (unless the liability is held for trading); but

(b) **fair value gains/losses** on a non-financial liability contingent consideration attributable to credit risk are presented in P&L.

Non-financial liability contingent consideration

Fair value

23. The proposals in the ED meant that the subsequent measurement of non-financial liability contingent consideration would be at fair value. Therefore, an entity would have to use the requirements of IFRS 13 *Fair Value Measurement* to calculate that fair value.

24. We note the following requirements from IFRS 13:

> **42 The fair value of a liability reflects the effect of *non-performance risk*. Non-performance risk includes, but may not be limited to, an entity's own credit risk (as defined in IFRS 7 *Financial Instruments: Disclosures*). Non-performance risk is assumed to be the same before and after the transfer of the liability.**
>
> 43 When measuring the fair value of a liability, an entity shall take into account the effect of its credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled …

25. Consequently, when subsequently measuring the fair value of a non-financial liability contingent consideration, an entity would have to reflect non-performance risk, which includes credit risk.

Non-performance risk

26. When the term 'non-performance risk' is used for a financial liability this is essentially the credit risk of that financial liability. However, although credit risk is

still a risk for a non-financial liability, we think there could be other factors/risks that may prevent the acquirer from meeting its contingent consideration obligation.

Should non-performance risk for non-financial liability contingent consideration be presented in profit or loss or in other comprehensive income?

27. We think that the same arguments (see paragraphs 15–16) for why changes in fair value attributable to the credit risk of that financial liability should be presented in other comprehensive income, are relevant for contingent consideration non-financial liabilities measured at fair value. That is:

    (a) the changes in fair value associated with the non-performance risk of a non-financial liability are unlikely to be realised because non-financial liabilities (generally) are not trading liabilities; and

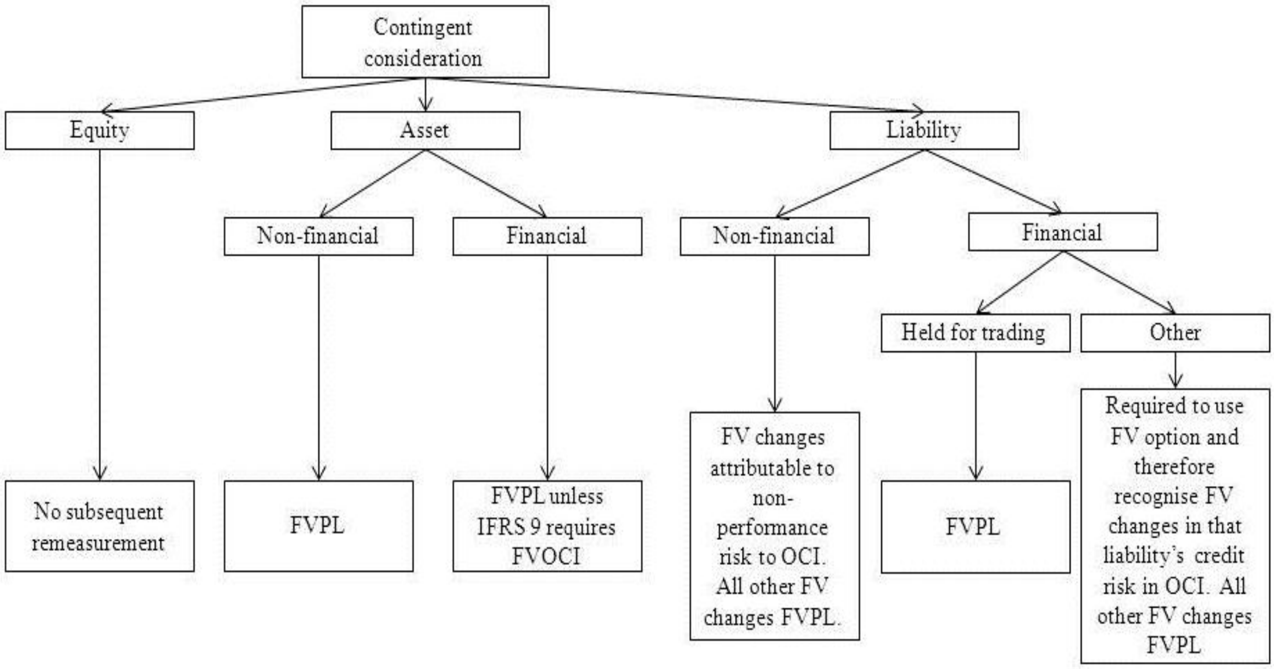
    (b) presenting in profit or loss the change in fair value relating to non-performance risk of a non-financial liability would, we think, give rise to information that may not be useful and may be counter-intuitive as described above for financial liabilities that are not trading financial liabilities.

28. Consequently, we think that it would be consistent for non-financial liability contingent consideration issued in a business combination, that the fair value changes attributable to the non-performance risk of that non-financial liability contingent consideration be required to be presented in other comprehensive income, and the remaining amount of change in the fair value of that non-financial liability contingent consideration should be presented in profit or loss.

Overall requirements

29. This would mean that the subsequent measurement requirements for contingent consideration would be as follows[1]:

[1] We also propose to include a reference to paragraph 5.7.9 of IFRS 9 in the consequential amendment to IFRS 9 to ensure that if a loan commitment or a financial guarantee contract was contingent consideration, then it would be accounted for at fair value through profit or loss.



Implications

Consistent

30. The advantage of this approach is that, within the requirements for contingent consideration liabilities and assets, the approach is consistent with the approach taken in IFRS 9.

Practicability

31. However, we are uncertain about the practicability of this approach.

32. We note that requiring the fair value changes attributable to non-performance risk to be presented in other comprehensive income is not a requirement for any other non-financial liabilities in IFRS. We also note that this approach to present the fair value changes attributable to non-performance risk for a non-financial liability in other comprehensive income was not proposed in the Exposure Draft and we received very little feedback about this particular point.

33. Also, in finalising the treatment of own credit in IFRS 9 the practical implications of requiring separate accounting for the own credit component were a major factor considered by the IASB. The IASB was concerned that separating out this effect

could be burdensome for preparers. In fact, the complexity of separating out the portion of the change in fair value attributable to own credit was one of the reasons why the IASB decided to retain bifurcation for financial liabilities such that the own credit separation would only be required for those who use the fair value option. This means for example, that if an entity issues structured debt they can bifurcate the liability and thus are not required to recognise the effect of own credit in other comprehensive income.

US GAAP

34. We note that IFRS 3 was a joint project between the IASB and the US Financial Accounting Standards Board (FASB).

35. We noted in Agenda Paper 15B from the January Interpretations Committee meeting that convergence would be furthered if the subsequent measurement requirements were fair value because the FASB requirements are that contingent consideration, other than hedging instruments, would be measured at fair value.

36. However, the US GAAP presentation requirements for contingent consideration are that the fair value changes are presented in profit or loss. The above approach would require that in IFRS the non-performance risk element of fair value changes of a liability for contingent consideration (other than for a held for trading financial liability) would be presented in other comprehensive income.

37. Therefore, although convergence with US GAAP would be furthered in terms of the statement of financial position, the presentation of the fair value changes would not be converged. However, we think this would be reflective of differences in our respective guidance on financial instruments and non-financial liabilities rather than due to our respective guidance on business combinations.[2]

38. We also note IFRS 3 paragraph BC354 of IFRS 3 which said that:

> … Accordingly, liabilities for payments of contingent consideration that are subject to the requirements of IAS 39 or SFAS 133 would subsequently be measured at fair value at the end of each reporting period, with changes in fair value

[2] The FASB has proposed separating own credit on financial liabilities in its recent Classification and Measurement ED.

recognised in accordance with which of those standards an entity applies in its financial statements.

39. Consequently we do not think that our proposals detract from the convergence achieved for business combination accounting.

Staff recommendation

40. If the Interpretations Committee think that the fair value changes attributable to the non-performance risk of a non-financial liability contingent consideration issued in a business combination should be required to be presented in other comprehensive income, and the remaining fair value changes should be presented in profit or loss, we recommend that this amendment should not be proposed to the IASB for finalisation at this time.

41. This is primarily because we feel that further information and feedback is required on the practicability and appropriateness of the proposed approach and therefore we need to perform further outreach.

42. We do note that the post-implementation review (PIR) for IFRS 3 is scheduled to begin later this year. We think that the PIR could be an opportunity to obtain more information about this issue. Although we note that the PIR may not be the right forum in which to gather that information. We need more information about an approach that isn't required at present, whereas the PIR will otherwise gather information about what is required at present.

43. We would therefore recommend that the Interpretations Committee recommend to the IASB that they should not proceed with the proposed amendments as an Annual Improvement and that we should undertake further outreach about this issue.

Questions for the Interpretations Committee

(a) Does the Interpretations Committee agree that:

i. Held for trading financial liability contingent consideration issued in a business combination should be subsequently measured at fair value through profit or loss;

ii. Other financial liability contingent consideration issued in a business combination should be required to apply the requirements for liabilities designated as at fair value through profit or loss in IFRS 9 paragraph 5.7.7–5.7.9; and

iii. for non-financial liability contingent consideration issued in a business combination the fair value changes attributable to the non-performance risk of that non-financial liability contingent consideration should be required to be presented in other comprehensive income, and the remaining amount of change in the fair value of that non-financial liability contingent consideration should be presented in profit or loss.

(b) If the Interpretations Committee agrees with question (a)(iii), does the Interpretations Committee agree to recommend to the IASB that they should not proceed with the proposed amendments as an Annual Improvement and that we should undertake further outreach about this issue?