STAFF PAPER

May 2013

REG IASB 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*, published in 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.

Objective

2. The objectives of this paper are to:
   (a) provide background information on the issue;
   (b) give an overview of the main comments received on this proposed amendment and the IFRS Interpretations Committee's (the Interpretations Committee) recommendations; and
   (c) ask the IASB whether it agrees with the Interpretations Committee's recommendations and whether it approves the revised, proposed amendments to IFRS 3 and consequential amendments to IFRS 9 *Financial Instruments* for inclusion in the final Improvements to IFRSs that is expected to be issued in 2013.

Structure of the paper

3. The structure of the paper is as follows:

   (a) provides background information on the issues and how the IASB proposed to address the issues (paragraph 5);

   (b) provides a summary of the main comments received (paragraphs 6–0)

      (i) issue 1: Classification of contingent consideration (paragraphs 9–17);

      (ii) issue 2: Subsequent measurement (paragraphs 18–38);

      (iii) issue 3: Disclosures (paragraphs 39–44);

      (iv) other issues (paragraphs 45–53); and

      (v) transitional provisions and effective date (paragraphs 54–58).

4. There are also five appendices:

   (a) Our recommended changes are included as appendices:

      (i) **Appendix A** shows the proposed amendment, including the Interpretations Committee's recommendations, highlighting differences from the currently effective Standard; and

      (ii) **Appendix B** shows revisions to the wording in the previously published ED, following the Interpretations Committee's recommendations.

   (b) **Appendix C** reproduces the US GAAP classification and subsequent measurement requirements for contingent consideration in a business combination.

   (c) **Appendix D** contains diagrams showing the proposals for the subsequent measurements requirements for contingent consideration.

   (d) **Appendix E** contains potential consequential amendments identified.

Background

5. The following table provides some background information about this Annual Improvement, including a summary of the original issue, the IASB's proposal to address the issue and how it aimed to address the issue:

Issue	Paragraph	Original concern	IASB ED proposal	How?
1: Classification of contingent consideration	IFRS 3 paragraph 40	This paragraph refers not only to IAS 32 *Financial Instruments: Presentation*, but also to 'other applicable IFRSs' in determining whether contingent consideration is classified as a liability or equity. There is uncertainty as to when 'other applicable IFRSs' would be required to determine this classification.	Clarify that contingent consideration is assessed as either a financial liability or an equity instrument only on the basis of the requirements of IAS 32.	Deleting the reference to "other applicable IFRSs" in paragraph 40 because it is unclear what other Standards are applicable for classifying either as equity or as a liability.
2: Subsequent measurement of contingent consideration	IFRS 3 paragraph 58—non-financial asset and non-financial liability contingent consideration	There is uncertainty over how paragraph 58(b)(ii) of IFRS 3 should be applied. IFRS 3 requires subsequent measurement of contingent consideration at fair value. Paragraph 58(b)(ii) of IFRS 3 requires changes in fair value of the contingent consideration to be measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, but IAS 37 does not prescribe fair value as its measurement basis.	Clarifying that contingent consideration that is not classified as an equity instrument is subsequently measured at fair value through profit or loss, unless the recognition of the resulting gain or loss is required in other comprehensive income in accordance with IFRS 9.	Deleting the reference to "IAS 37 or other IFRSs as appropriate" in paragraph 58(b) because it is unclear why IAS 37 or other Standards would be used for subsequent measurement when they do not require fair value as their subsequent measurement. Also see Appendix D of this paper.
	IFRS 3 paragraph 58—financial instrument contingent	If the contingent consideration is classified as a financial asset or financial liability, there is an inconsistency because: (a) IFRS 3 paragraph 58(b)(i) requires contingent consideration that is a financial		Amending the classification requirements of IFRS 9 to clarify that contingent consideration that is a financial asset or a financial liability can

	consideration	asset or a financial liability to be measured at fair value in accordance with IFRS 9; but (b) IFRS 9 would, in some circumstances, require a financial asset or a financial liability to be subsequently measured at amortised cost (unless it qualifies for the fair value option).		only be measured at fair value, with changes in fair value being presented in either profit or loss or other comprehensive income depending on the requirements of IFRS 9. This is to ensure that an entity applying the contingent consideration requirements of IFRS 3 will apply fair value, ie to ensure that contingent consideration would not be measured at amortised cost. Also see Appendix D of this paper.
Issue 3: Disclosures	IFRS 3 paragraph B64	Because paragraph 58 of IFRS 3 includes references to other Standards, some constituents are unclear over whether those Standards' disclosure requirements apply in addition to the requirements in paragraph B64.	Clarification proposed in the Basis for Conclusions.	Clarifying in the Basis for Conclusions that IFRS 7 *Financial Instruments: Disclosures* disclosures are required for financial instrument contingent consideration that is within the scope of IFRS 7.

Summary of the comments received

6. The comment period for the ED ended on 5 September 2012. The IASB received 84 comment letters of which, for the proposed IFRS 3 amendments:

   (a) 69 commented on Question 1 ('Do you agree with the Board's proposal to amend the IFRS as described in the exposure draft? If not, why and what alternative do you propose'); and

   (b) 62 commented on Question 2 ('Do you agree with the proposed transitional provisions and effective date for the issue as described in the exposure draft? If not, why and what alternative do you propose?').

7. The following numerical analysis was provided in Agenda Paper 10 from the November 2012 Interpretations Committee meeting:

IFRS 3 Accounting for contingent consideration in a business combination – question 1	Number of Respondents
Agreement	41
Conditional Agreement	9
Disagreement	19
No response	15
Total	**84**

IFRS 3 Accounting for contingent consideration in a business combination – question 2	Number of Respondents
Agreement	47
Conditional Agreement	1
Conditional Disagreement	1
Disagreement	13
No response	22
Total	**84**

8. The summary of the main comments received is in the paragraphs that follow. For a detailed description of the comments received and the source of those comments, please refer to Agenda paper 15B, which was presented to the Interpretations Committee in January 2013.[1]

[1] This issue was also discussed at the January and July 2010 Interpretations Committee meetings and at the February and October 2010 and October 2011 IASB meetings.

Issue 1: Classification of contingent consideration

Views received

9. Some respondents to the ED raised concern that the proposed amendments, both for the classification and subsequent measurement of contingent consideration, implied that contingent consideration only takes the form of a financial instrument, ie there is not non-financial asset or non-financial liability contingent consideration.

Staff analysis and Interpretations Committee recommendations

10. We think that the proposed amendments are clear that contingent consideration can be either a financial instrument or a non-financial asset/liability.

11. We think that the proposed wording in paragraph 40 of IFRS 3 (the classification requirements for contingent consideration) imply that contingent consideration can be a non-financial asset/liability:

> 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… [emphasis added]

This paragraph does not limit contingent consideration to only when it meets the definition of a financial instrument.

12. We think that this paragraph 40 is only necessary to identify whether contingent consideration is classified as equity, because equity has a different subsequent measurement requirement to all other contingent consideration, ie it is not remeasured and its subsequent settlement shall be accounted for within equity.

13. The ED proposed that non-financial asset/liability and financial instrument (that is not equity) contingent consideration has the same subsequent measurement requirement, being fair value through profit or loss, with some financial instruments within the scope of IFRS 9 being required to recognise some changes in fair value through other comprehensive income.

14. We also think that the proposed IFRS 3 paragraph 58 clarifies that contingent consideration is not only a financial instrument by referring to 'other contingent

consideration', ie contingent consideration other than equity. This is consistent with the notion that contingent consideration is not just limited to financial instruments.

15. Lastly, paragraph BC5 (from the ED) to these proposed amendments clarifies that the proposed amendments are not eliminating non-financial asset/liability contingent consideration:

> The Board also noted that the subsequent measurement requirements in paragraph 58(b) **for contingent consideration that is not a financial instrument** conflict with the measurement requirements in other applicable IFRSs…. [emphasis added]

This paragraph acknowledges that there could be non-financial asset/liability contingent consideration.

16. However, we noted that the current wording in the proposed paragraph 58(b) (the subsequent measurement paragraph for non-equity contingent consideration) could be read to imply that contingent consideration must be within the scope of IFRS 9, therefore implying that contingent consideration must be a financial instrument.

17. The Interpretations Committee therefore recommended the wording of the requirement on non-equity contingent consideration subsequent measurement 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.

Issue 2: Subsequent measurement

18. This section is structured as follows:

    (a) overall subsequent measurement requirements (paragraphs 19–23);

    (b) liability contingent consideration subsequent measurement (paragraphs 24–33); and

    (c) financial asset contingent consideration subsequent measurement (paragraphs 34–38).

Overall subsequent measurement requirements

Comments received

19. One respondent disagreed with the subsequent measurement approach in the ED, noting that:

    (a) it is not clear what the appropriate measurement basis for non-financial asset/liability contingent consideration should be and how the resulting difference should be accounted for;

    (b) it is not clear as to why the IASB believes that non-financial asset/liability and financial instrument contingent consideration should be accounted for in the same way; and

    (c) the respondent questions whether subsequent measurement at fair value is appropriate for non-financial asset/liability contingent consideration.

    They also noted that they did not find any discussion by the IASB of the above issues in the Basis for Conclusions for the proposed amendments.

Staff analysis

20. We think that paragraph 39 of IFRS 3 is clear that initial measurement is at fair value. We also think that the proposed subsequent measurement requirements are clear in paragraph 58 of IFRS 3. Also, paragraph 58 of IFRS 3 is clear that subsequent measurement of contingent consideration is fair value:

    > …The acquirer shall account for changes in the **fair value** of contingent consideration that are not measurement period adjustments as follows: … [emphasis added]

21. Paragraph BC5 from the Basis for Conclusions to the amendments noted that:

    > … The proposal therefore maintains fair value as the subsequent measurement basis for all contingent consideration to which IFRS 3 applies. The Board thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.

22. Paragraph BC355 of IFRS 3 states:

> …for contingent payments that are liabilities but are not derivatives, the boards concluded that, in concept, all liabilities for contingent payments should be accounted for similarly. Therefore, liabilities for contingent payments that are not derivative instruments should also be remeasured at fair value after the acquisition date. The boards concluded that applying those provisions would faithfully represent the fair value of the liability for the contingent payment of consideration that remains a liability until settled.

23. We also understand from paragraph BC354 of IFRS 3 that the original intention of the IASB was that all contracts that would have otherwise been within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* should be subject to the requirements of IAS 39 if issued in a business combination. When IFRS 9 was issued this was subsequently footnoted to note that some of requirements of IAS 39 were amended by the IASB and relocated to IFRS 9.

Issue 2: Subsequent measurement – contingent consideration liabilities

24. The proposed consequential amendment to IFRS 9 stated that contingent consideration financial liabilities shall be presented in accordance with paragraphs 5.7.7–5.7.8 as if they had been designated at fair value through profit or loss at initial recognition.

25. Paragraph 5.7.7 of IFRS 9 includes the requirement that the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in other comprehensive income, with the remaining amount of change in the fair value being presented in profit or loss. This is required unless doing so creates or enlarges an accounting mismatch in profit or loss.

26. The proposed amendments therefore required fair value changes for all financial liability contingent consideration to be split between profit or loss and other comprehensive income, with changes in own credit risk being recognised in other comprehensive income.

Views received

27. Some respondents thought that it was not appropriate to split out the fair value changes that are attributable to changes in own credit risk and recognise them instead in other comprehensive income. They gave a variety of reasons for this, which were set out in Agenda Paper 15B from the January Interpretations Committee meeting, including:

    (a) the requirement to split the ‘own credit risk’ portion into other comprehensive income is too onerous and unduly complex. It was also noted that contingent consideration contracts often have features such as variable cash flows that may increase the complexity of separating the own credit risk portion;

    (b) it is unclear to them what the benefit of bifurcating changes in the fair value of contingent consideration is;

    (c) IFRS 3 **requires** fair value measurement, so it is inappropriate to account for the contingent consideration as if it had been **designated** at fair value through profit or loss on initial recognition. This is inconsistent with the presentation principle in IFRS 9;

    (d) fair value measurement of contingent consideration is not analogous to the use of the fair value option for financial liabilities; and

    (e) they question the conceptual basis for this requirement, because a liability for contingent consideration is frequently more akin to a free-standing derivative for which all changes in fair value are recognised in profit or loss under IFRS 9 than a debt instrument for which fair value measurement has been elected.

28. Some respondents also suggested solutions, including that contingent consideration should instead be subsequently measured at fair value through profit or loss.

29. Some respondents noted that the proposed amendments contradict the measurement requirements for derivatives in IFRS 9, with some respondents questioning whether this was the IASB’s intention and another respondent noted that they think that the accounting for contingent consideration derivatives should be consistent with the accounting for other derivative financial liabilities.

Staff analysis and Interpretations Committee recommendation

30. In IFRS 9 all held for trading financial liabilities (which includes derivatives) are required to be measured at fair value through profit or loss. However, as noted in paragraphs 24–26, the proposed amendments stated that all financial liability contingent consideration must be accounted for as if the fair value option has been applied, therefore meaning that fair value changes that are attributable to the credit risk of that contingent consideration would be recognised in other comprehensive income.

31. The proposed amendments therefore contradict the held for trading financial liability subsequent measurement requirements in IFRS 9.

32. The Interpretations Committee discussed requiring all liability contingent consideration to be subsequently measured at fair value through profit or loss. It should be noted that the Interpretations Committee was divided over whether to present all fair value changes through profit or loss for liability contingent consideration or to require the fair value option for financial liabilities, but on balance decided to recommend that all contingent consideration liabilities should be subsequently measured at fair value through profit or loss. Its reasons include that this would be a more straight-forward, less complex approach.

33. The Interpretations Committee also considered an alternative approach for the subsequent measurement of liability contingent consideration (see Agenda Paper 9A from the March 2013 Interpretations Committee meeting for further information). This approach would require a broader use of presentation of own credit risk/non-performance risk in other comprehensive income, but it rejected this approach on the grounds that it would significantly extend the use of bifurcation of risk and was unnecessarily complex.

Issue 2: Subsequent measurement – contingent consideration financial assets

Staff analysis and Interpretations Committee recommendation

34. IFRS 9 permits or requires certain financial assets to be measured at amortised cost (if solely principal and interest) or at fair value (for example, the irrevocable election to present fair value changes of an equity investment in other comprehensive income).

We also note that the ED *Classification and Measurement: Limited amendments to IFRS 9* proposed a fair value through other comprehensive income measurement category (for particular financial assets that contain contractual cash flows that are solely payments of principal and interest).

35. However, the *Annual Improvements 2010–2012 Cycle* ED proposed that financial asset contingent consideration should be subsequently measured at fair value with any gain or loss recognised in profit or loss for the period or in other comprehensive income, in accordance with IFRS 9.

36. In redeliberations, the Interpretations Committee concluded that the conditions required by IFRS 9 for amortised cost measurement would not be met by contingent consideration because contingent consideration financial assets do not give rise to contractual cash flows that are solely principal and interest (ie the cash flows are linked to performance or another factor).

37. Consequently, the Interpretations Committee recommends that the amendment can be simplified because it thinks that there is no need to add guidance for a circumstance that will not arise.

38. Therefore, the Interpretations Committee recommends that the amendment proposed in the ED to paragraph 4.1.2 of IFRS 9 should not be made.

Disclosures (Issue 3)

39. The proposed amendments did not amend the disclosure requirements for contingent consideration. However, a clarifying comment was proposed to be added to the Basis for Conclusions to confirm that the IASB thinks that it is appropriate for the disclosure requirements of IFRS 7 to apply to contingent consideration that is a financial instrument within the scope of IFRS 7.

Views received

40. One respondent noted that the proposed amendments make no reference to disclosure requirements, specifically those of IFRS 7. The respondent recommended that an amendment should be made to IFRS 3 or IFRS 7 to specify which disclosures should be made in respect of contingent consideration that meets the definition of a financial instrument.

Staff analysis and Interpretations Committee recommendation

41. We think that it is clear that an entity is required to make the disclosures in IFRS 7 for financial instrument contingent consideration, because the scope of IFRS 7 is for all types of financial instruments, with some exceptions, of which contingent consideration is not one.

42. We also think that the proposed Basis for Conclusions shows that the IASB thought about this and concluded that IFRS 7 disclosures are required, as shown in paragraph BC6.

43. We also noted that it would be outside the scope of this project to specify which particular disclosures in IFRS 7 should be required for financial instrument contingent consideration.

44. The Interpretations Committee proposed that the amendment is finalised as proposed because it thinks that including the proposed explanation in the Basis for Conclusions of IFRS 3 is sufficient to clarify that the disclosures are required and that no amendment is required to IFRS 3 or IFRS 7.

Other points raised by respondents

45. This section is structured as follows:

    (a) IAS 39–consequential amendment (paragraphs 46–48); and

    (b) convergence (paragraphs 49–53).

IAS 39—consequential amendment

46. No consequential amendment was proposed to IAS 39 in the ED. Only a consequential amendment to IFRS 9 was proposed.

Views received

47. Some respondents also wanted a consequential amendment made to IAS 39 and gave a variety of reasons. One respondent also suggested that the improvement should be allowed to be applied earlier together with IAS 39 and not be dependent on applying IFRS 9.

Staff analysis

48. We disagree that a consequential amendment is also required to IAS 39. We note that the effective date of the proposed amendments is for business combinations with an acquisition date on or after 1 January 2015, which is also the effective date of IFRS 9. Consequently, an entity would be required to apply IFRS 9 at the same time as the proposed amendments. It also does not seem appropriate to consequentially amend IAS 39 for a short period of application. The Interpretations Committee agreed and did not recommend making a consequential amendment to IAS 39.

Convergence

Views received

49. Some respondents noted that IFRS 3 was a converged Standard, undertaken jointly with the US Financial Accounting Standards Board (FASB) and noted that the proposals could create divergence with US GAAP and that the amendments should also be incorporated into the FASB Accounting Standards Codification®.

Staff analysis

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

    (a) US GAAP requires all non-equity contingent consideration to be subsequently measured at fair value with changes recognised in earnings unless the contingent consideration is a hedging instrument; whereas

    (b) IFRS requires contingent consideration to be subsequently measured at fair value in accordance with IFRS 9, IAS 37 or other Standards as appropriate, even though these Standards may not or do not require subsequent measurement at fair value through profit or loss – hence the proposed amendments.

51. US GAAP requirements are reproduced in Appendix D.

52. Consequently, under the proposed amendments, convergence with US GAAP will be furthered because it will be clarified that the subsequent measurement of non-equity

contingent consideration is fair value—which is the same that US GAAP requires, unless the contingent consideration is a hedging instrument.

53. The Interpretations Committee's recommendation that liability contingent consideration should be subsequently measured at fair value through profit or loss also furthers convergence because the presentation of those fair value changes will be in profit or loss, as like US GAAP.

Transitional provisions and effective date

54. The majority of the respondents agreed with the proposed transition provisions and effective date.

Wording issue

Views received

55. One respondent noted that, as currently worded, the amendments could be applied without IFRS 9 being applied. They noted that this issue arises from the interaction between the wording of the effective date paragraph and the effective date of IFRS 9:

(a) the amendment shall be applied to **business combinations for which the acquisition date** is on or after 1 January 2015; whereas

(b) IFRS 9 has an effective date of **annual periods beginning** on or after 1 January 2015.

For example, a business combination could occur in February 2015 (therefore not applying the amendment early), but the entity's annual period does not begin until 1 April 2015.

Staff analysis and Interpretations Committee recommendation

56. The Interpretations Committee recommend that 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.

IFRS 1 First-time Adoption of International Financial Reporting Standards

57. We also looked at whether amendments would be required to IFRS 1 for first-time adopters. However we note that:

    (a) there is the IFRS 3 exemption in IFRS 1 (IFRS 1 Appendix C for past business combinations); and

    (b) any outstanding contingent consideration at the date of transition (if on or after 1 January 2014) will be accounted for in accordance with IFRS 9.

58. Therefore, we do not think that specific relief is needed in IFRS 1 for this amendment.

This amendment as an annual improvement

Views received

59. Some respondents thought/questioned that the proposed amendments should not be addressed at this time/go through Annual Improvements. Reasons given include:

    (a) it is an important issue that affects many transactions, not only business combinations, but a wider study of accounting for contingent consideration should be undertaken before making amendments and they are unconvinced that a minor amendment represents the best way forward;

    (b) if the IASB does not remove the link to IFRS 9, it should deliberate and expose for comments those changes as part of its redeliberations on other selected aspects of the classification and measurement model in IFRS 9;

    (c) the 2008 revisions to IFRS 3 were controversial and contingent consideration has been discussed by the IFRIC before without final resolution; and

    (d) the proposed consequential amendments to IFRS 9 in this annual improvement cycle may give rise to unexpected confusion in relation to the limited amendments to IFRS 9, particularly with regard to the proposed effective date.

60. Some respondents had alternative suggestions, including:

(a) these issues/the entire concept of contingent consideration should be addressed in the Post-implementation Review of IFRS 3 or await the results of the Post-implementation Review;

(b) a wider study should be undertaken into contingent consideration;

(c) this amendment should be addressed simultaneously with the ED of the limited amendments to IFRS 9 or in an annual improvement project cycle in the future; and

(d) the IASB should re-examine the whole issue across all Standards dealing with contingent payments (they noted that the Interpretations Committee is currently working on one such issue – in connection with the purchase of tangible assets and is faced with several existing accounting models across the whole of IFRS).

Staff analysis

61. We note that at its March 2013 meeting the Interpretations Committee rejected these arguments and recommended that this amendment should be completed as an Annual Improvement. Principally, the amendments make the measurement requirements for contingent consideration clear by removing the inconsistencies in the current literature, and retaining the principle of fair value for subsequent measurement.

Annual Improvements criteria

62. We have assessed the amendments against the Annual Improvements criteria:

An annual improvement should (6.11, 6.12):	
• Replace unclear wording; • Provide missing guidance; or • Correct minor unintended consequences, oversights or conflict.	**Yes.** The correction retains the current measurement principle in IFRS 3 but removes conflicts with other Standards and makes clearer how the measurement requirements should be applied.
Not change an existing principle or propose a new principle	**Yes.** The amendment retains the current measurement principle in IFRS 3. It also retains the requirement for remeasurements to be presented in profit or loss except for those contingent consideration financial assets that IFRS 9 requires fair value changes to be

	presented in OCI.
Not be so fundamental that the IASB will have to meet several times to conclude (6.14)	**Yes.** The change is limited to contingent consideration that arises from business combinations, and it therefore has a narrow and well-defined purpose.

63. In our opinion, these amendments continue to meet the Annual Improvements criteria.

Consequential amendments

64. During the preparation of this paper, we undertook a search for other consequential amendments required as a result of the proposed amendments to IFRS 3 and IFRS 9.

65. Appendix E shows the paragraphs that we think require an amendment and how we propose those paragraphs be consequentially amended.

Questions for the IASB

66. The Interpretations Committee recommended that the IASB should proceed with this amendment, incorporating its four recommendations:

67. The questions for the IASB are as follows:

Questions for the IASB
1. Does the IASB agree with the following Interpretations Committee recommendations: (a) the wording of the requirement on non-equity contingent consideration subsequent measurement 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) that the amendment proposed in the Exposure Draft to IFRS 9 paragraph 4.1.2 should not be made; (c) all liability contingent consideration should be required to be subsequently measured at fair value through profit or loss; 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. 2. Does the IASB approve the revised, proposed amendments to IFRS 3 and consequential amendments to IFRS 9 for inclusion in the final Improvements to IFRSs?

Appendix A—Changes for finalising the amendment

A1. The proposed amendments are presented below.

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 or in other comprehensive income~~ in accordance with 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.~~ shall be measured at fair value through profit or loss at each reporting date.

Effective date and transition

Effective date

…

64H *Annual Improvements to IFRSs 2010–2012 Cycle* issued in [date] amended paragraphs 40 and 58. An entity shall apply that amendment prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2015. Earlier application is permitted. An entity may apply that amendment earlier providing IFRS 9 *Financial Instruments* (as amended by *Annual Improvements to IFRSs 2010–2012 Cycle)* has also been applied. If an entity applies that amendment earlier it shall disclose that fact.

Proposed consequential amendment to IFRS 9 *Financial Instruments*

4.2 Classification of financial liabilities

4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost using the *effective interest method*, except for:

(a) …

(e) contingent consideration in a business combination (see IFRS 3 *Business Combinations*), which shall be subsequently measured at fair value through profit or loss.

7.1 Effective date

…

7.1.4 *Annual Improvements to IFRSs 2010–2012 Cycle* issued in [date] amended paragraph 4.2.1. An entity shall apply that amendment prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2015. Earlier application is permitted. An entity may apply that amendment earlier providing IFRS 3 *Business Combinations* (as amended by *Annual Improvements to IFRSs 2010–2012 Cycle*) has also been applied. If an entity applies that amendment earlier, it shall disclose that fact.

Basis for Conclusions on the amendment to IFRS 3 *Business Combinations*

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

Accounting for contingent consideration in a business combination

BC360A The IASB proposed to clarify the accounting for contingent consideration arising from business combinations.

Classification of contingent consideration in a business combination

BC360B The IASB noted that the classification requirements in paragraph 40 were unclear as to when, if ever, 'other applicable IFRSs' would need to be used to determine the classification of contingent consideration as a financial liability or as an equity instrument. Consequently, the IASB deleted the reference to 'other applicable IFRSs' in paragraph 40.

Subsequent measurement of contingent consideration in a business combination

BC360C The IASB also noted that the requirements for subsequent measurement in paragraph 58 of IFRS 3 require contingent consideration, other than equity, to be subsequently measured at fair value; however paragraph 58 then refers to IFRS 9, IAS 37 or other IFRSs as appropriate, which may not or do not require subsequent measurement at fair value.

Subsequent measurement of financial instrument contingent consideration

BC360D The IASB noted that the requirements for subsequent measurement in paragraph 58 of IFRS 3 for contingent consideration that is a financial instrument within the scope of IFRS 9 *Financial Instruments* were inconsistent with the accounting requirements of IFRS 9. Because paragraph 58 of IFRS 3 referred to IFRS 9, which allows amortised cost measurement in certain circumstances, contingent consideration that is a financial liability might be classified as at amortised cost. This would conflict with the requirement in paragraph 58 of IFRS 3 that such contingent consideration should be subsequently measured at fair value. Consequently, the IASB amended the classification requirements of IFRS 9 to ensure that the subsequent measurement requirement for financial liability contingent consideration is fair value. The IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.

BC360E In redeliberating the issue, the IASB decided that it would not be possible for a contingent consideration financial asset to meet the requirements in IFRS 9 to be subsequently measured at amortised cost. Consequently, the IASB decided that the Exposure Draft's proposed amendments to IFRS 9 paragraph 4.1.2 were not needed.

Subsequent measurement of non-financial asset and non-financial liability contingent consideration

BC360F The IASB also noted that the subsequent measurement requirements in paragraph 58(b) for contingent consideration that is not a financial instrument conflicted with the measurement requirements in other applicable Standards. The conflict arises because paragraph 58 refers to changes in the fair value of contingent consideration but paragraph 58(b) refers to standards that do not require fair value as a measurement basis, for example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Consequently, the IASB deleted the reference to 'IAS 37 or other IFRSs as appropriate' from paragraph 58(b). This therefore maintains fair value as the subsequent measurement basis for all contingent consideration to which IFRS 3 applies. The IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.

BC360G The IASB also decided that those changes in the fair value of any non-financial asset and non-financial liability contingent consideration should be recognised in profit or loss.

BC360H The IASB considered alternatives for the subsequent measurement requirements for contingent consideration. It considered whether all references to other IFRSs, including the references to IFRS 9 should be removed and instead include all necessary guidance for the subsequent measurement of contingent consideration in IFRS 3, however it decided to retain the link to IFRS 9. This reflects the IASB's original intention, as explained in paragraph BC354, that fair value gains and losses from contingent consideration should be presented in accordance with IAS 39 (now IFRS 9). The IASB also considered whether some liability contingent consideration should be measured at fair value with some fair value changes being presented in other comprehensive income. However, it decided that it was preferable that the guidance was consistent for all liability contingent consideration; consequently it decided that all liability contingent consideration should be subsequently measured at fair value through profit or loss.

Disclosure

BC360I Some stakeholders had questioned whether the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* are intended to apply to contingent consideration because there are disclosure requirements for contingent consideration in IFRS 3. The IASB thinks that it is appropriate for the disclosure requirements of IFRS 7 to apply to contingent consideration that is a financial instrument within the scope of IFRS 7. Consequently, the IASB did not propose any changes to the scope of IFRS 7 to exclude such instruments.

Effective date and transition

BC360J The IASB also considered whether the transitional provisions of paragraph 19 in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* should apply, which require retrospective application. The IASB considered that the amendments required fair value measurement, and that some entities might not have previously applied fair value measurement for the subsequent measurement of contingent consideration. Therefore, retrospective application might require the determination of fair value for contingent consideration which might not have been previously subsequently measured at fair value. Consequently, the IASB decided to require prospective application to avoid the risk of hindsight being applied. In addition, the IASB thinks that the proposed amendments should not be applied before IFRS 9 (2010) because of the proposed consequential amendment to that Standard.

Appendix B—Changes from the Exposure Draft published in May 2012 following the Interpretations Committees recommendations

B1 The proposed amendments to IFRS 3 and IFRS 9 are presented below. Proposed amendments to the proposals in the ED are shown, with new text underlined and deleted text 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*. 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 contingent consideration <u>that:</u>

<u>(i)</u> <u>is within the scope of IFRS 9</u> shall be measured at fair value at each reporting date~~, with any resulting gain or loss recognised in profit or loss~~

~~for the period, unless the recognition of the resulting gain or loss is required in other comprehensive income in accordance with IFRS 9.~~

(ii) is not within the scope of IFRS 9 shall be measured at fair value through profit or loss at each reporting date.

Effective date and transition

Effective date

…

64~~G~~H *Annual Improvements to IFRSs 2010–2012 Cycle* issued in [date] amended paragraphs 40 and 58. An entity shall apply that amendment ~~to those paragraphs~~ prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2015. Earlier application is permitted. An entity may apply that amendment earlier providing IFRS 9 *Financial Instruments* (as amended by *Annual Improvements to IFRSs 2010–2012 Cycle)* has also been applied. If an entity applies that amendment earlier, it shall disclose that fact. ~~and at the same time apply IFRS 9 *Financial Instruments* (as amended by *Annual Improvements to IFRSs 2010–2012 Cycle*).~~

Proposed consequential amendment to IFRS 9 *Financial Instruments*

4.1 Classification of financial assets

…

4.1.2 A financial asset shall be measured at amortised cost if all of the following conditions are met:

(a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

~~**(c) The asset is not a contingent consideration to which IFRS 3 *Business Combinations* applies.**~~

Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions ~~the conditions in (a) and (b)~~.

4.2 Classification of financial liabilities

4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost using the *effective interest method*, except for:

(a) …

(e) contingent consideration in a business combination (see IFRS 3 *Business Combinations*), which shall be subsequently measured at fair value through profit or loss. ~~Such financial liabilities shall be subsequently measured at fair value with changes in the fair value of the financial liabilities being presented in accordance with paragraphs 5.7.7–5.7.8 as if~~

~~**they had been designated at fair value through profit or loss at initial recognition.**~~

7.1 Effective date

…

7.1.4 *Annual Improvements to IFRSs 2010–2012 Cycle* issued in [date] amended paragraph~~s 4.1.2 and~~ 4.2.1. An entity shall apply that amendment prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2015. Earlier application is permitted. An entity may apply that amendment earlier providing IFRS 3 *Business Combinations* (as amended by *Annual Improvements to IFRSs 2010–2012 Cycle*) has also been applied. If an entity applies that amendment earlier, it shall disclose that fact ~~and at the same time apply IFRS 3 *Business Combinations* (as amended by *Annual Improvements to IFRSs 2010–2012 Cycle*)~~.

Basis for Conclusions on the ~~proposed~~ amendment to IFRS 3 *Business Combinations*

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

Accounting for contingent consideration in a business combination

BC~~1~~360A The ~~Board~~ IASB ~~proposes~~ proposed to clarify the accounting for contingent consideration arising from business combinations.

Classification of contingent consideration in a business combination

BC~~2~~360B The ~~Board~~ IASB noted that the classification requirements in paragraph 40 ~~are~~ were unclear as to when, if ever, 'other applicable IFRSs' would need to be used to determine the classification of contingent consideration as a financial liability or as an equity instrument. Consequently, the ~~Board~~ IASB ~~proposes to delete~~ deleted the reference to 'other applicable IFRSs' in paragraph 40.

Subsequent measurement of contingent consideration in a business combination

BC360C The IASB also noted that the requirements for subsequent measurement in paragraph 58 of IFRS 3 require contingent consideration, other than equity, to be subsequently measured at fair value; however paragraph 58 then refers to IFRS 9, IAS 37 or other IFRSs as appropriate, which may not or do not require subsequent measurement at fair value.

Subsequent measurement of financial instrument contingent consideration

BC360D ~~In addition, the Board~~ The IASB noted that the requirements ~~on~~ for subsequent measurement in paragraph 58 of IFRS 3 for contingent consideration that is a financial instrument within the scope of IFRS 9 *Financial Instruments* ~~are~~ were inconsistent with the accounting requirements of IFRS 9. Because paragraph 58 of IFRS 3 ~~refers~~ referred to IFRS 9, which allows amortised cost measurement in certain circumstances, contingent consideration that is a financial liability might be classified as at amortised cost. This would conflict with the requirement in paragraph 58 of IFRS 3 that such contingent consideration should be subsequently measured at fair value. Consequently, the IASB ~~Board proposes to amend~~ amended the classification requirements of IFRS 9 ~~so~~ to ensure that the subsequent measurement requirement for financial liability contingent consideration is fair value ~~requirements of IFRS 9 that do not require the use of fair value do not apply to contingent consideration that arises from a business combination. The Board thinks that this will make clear that subsequent measurement of contingent consideration is required to be at fair value in accordance with paragraph 58~~. The ~~Board~~ IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.

~~BC4 The Board considered removing from IFRS 3 all the references to other IFRSs (which would have included the references to IFRS 9) and instead including in IFRS 3 a requirement to measure all contingent consideration at fair value through profit and loss. However, the Board noted that this would not be a clarification, but would instead be a change to the intended requirements of IFRS 3. As explained in paragraph BC354, the Board's original intention for contingent consideration was that the fair value gains and losses should be presented in accordance with IAS 39 (now IFRS 9). IFRS 9 requires some changes in fair value to be recognised through other comprehensive income (for example changes in an entity's credit risk for certain types of financial liabilities). Consequently, the Board thinks that measuring the changes in fair value in accordance with IFRS 9 by reference to this Standard is the best way of clarifying the original intention of IFRS 3 with respect to contingent consideration.~~

BC360E In redeliberating the issue, the IASB decided that it would not be possible for a contingent consideration financial asset to meet the requirements in IFRS 9 to be subsequently measured at amortised cost. Consequently, the IASB decided that the Exposure Draft's proposed amendments to IFRS 9 paragraph 4.1.2 were not needed.

Subsequent measurement of non-financial asset and non-financial liability contingent consideration

BC~~5~~360F The ~~Board~~ IASB also noted that the subsequent measurement requirements in paragraph 58(b) for contingent consideration that is not a financial instrument conflicted with the measurement requirements in other applicable ~~IFRSs~~ Standards. The conflict arises because paragraph 58 refers to changes in the fair value of contingent consideration but paragraph 58(b) ~~requires contingent consideration to be measured in accordance with~~ refers to standards that do not require fair value as a measurement basis, for example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Consequently, the ~~Board~~ IASB ~~proposes to delete~~ deleted the reference to 'IAS 37 or other IFRSs as appropriate' from paragraph 58(b).~~The proposal~~ This therefore maintains fair value as the subsequent measurement basis for all contingent consideration to which IFRS 3 applies. The ~~Board~~ IASB thinks that this clarifies the original intention for subsequent measurement of contingent consideration as explained in paragraph BC355.

BC360G The IASB also decided that those changes in the fair value of any non-financial asset and non-financial liability contingent consideration should be recognised in profit or loss.

BC360H The IASB considered alternatives for the subsequent measurement requirements for contingent consideration. It considered whether all references to other IFRSs, including the references to IFRS 9 should be removed and instead include all necessary guidance for the subsequent measurement of contingent consideration in IFRS 3, however it decided to retain the link to IFRS 9. This reflects the IASB's original intention, as explained in paragraph BC354, that fair value gains and losses from contingent consideration should be presented in accordance with IAS 39 (now IFRS 9). The IASB also considered whether some liability contingent consideration should be measured at fair value with some fair value changes being presented in other comprehensive income. However, it decided that it was preferable that the guidance was consistent for all liability contingent consideration; consequently it decided that all liability contingent consideration should be subsequently measured at fair value through profit or loss.

Disclosure

BC~~6~~360I Some ~~have~~ stakeholders had questioned whether the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* are intended to apply to contingent consideration because there are disclosure requirements for contingent consideration in IFRS 3. The ~~Board~~ IASB thinks that it is appropriate for the disclosure requirements of IFRS 7 to apply to contingent consideration that is a financial instrument within the scope of IFRS 7. Consequently, the ~~Board is not proposing~~ IASB did not propose any changes to the scope of IFRS 7 to exclude such instruments.

Effective date and transition

BC~~7~~360J The ~~Board~~ IASB also considered whether the transitional provisions of paragraph 19 in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* should apply, which require retrospective application. The IASB considered that the amendments required fair value measurement, and that some entities might not have previously applied fair value measurement for the subsequent measurement of contingent consideration. Therefore, retrospective application might require the determination of fair value for contingent consideration which might not have been previously subsequently measured at fair value. Consequently, the IASB decided to require prospective application to avoid the risk of hindsight being applied. ~~However, given the potential impact of the change, the Board thinks that the proposed amendments to IFRS 3 and IFRS 9 should be applied prospectively.~~ In addition, the ~~Board~~ IASB thinks that the proposed amendments should not be applied before IFRS 9 (2010) because of the proposed consequential amendment to that ~~IFRS~~ Standard.

Appendix C—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.

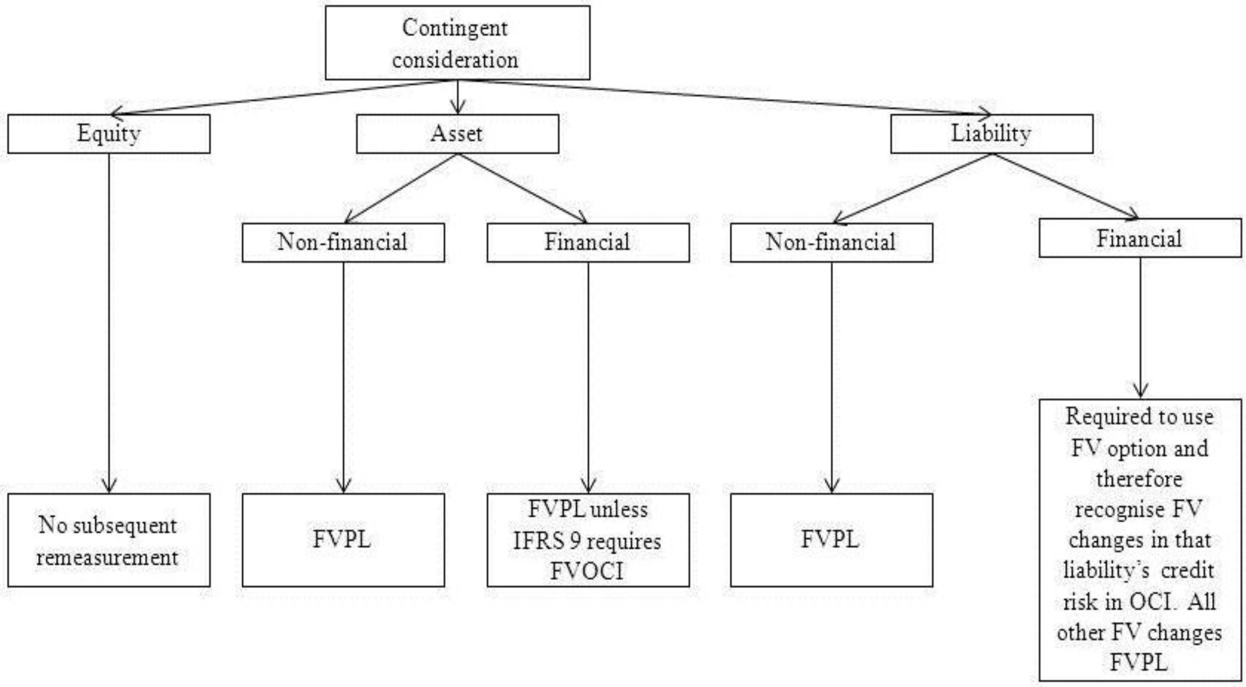
Subsequent measurement in Topic 805-30-35-1

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:

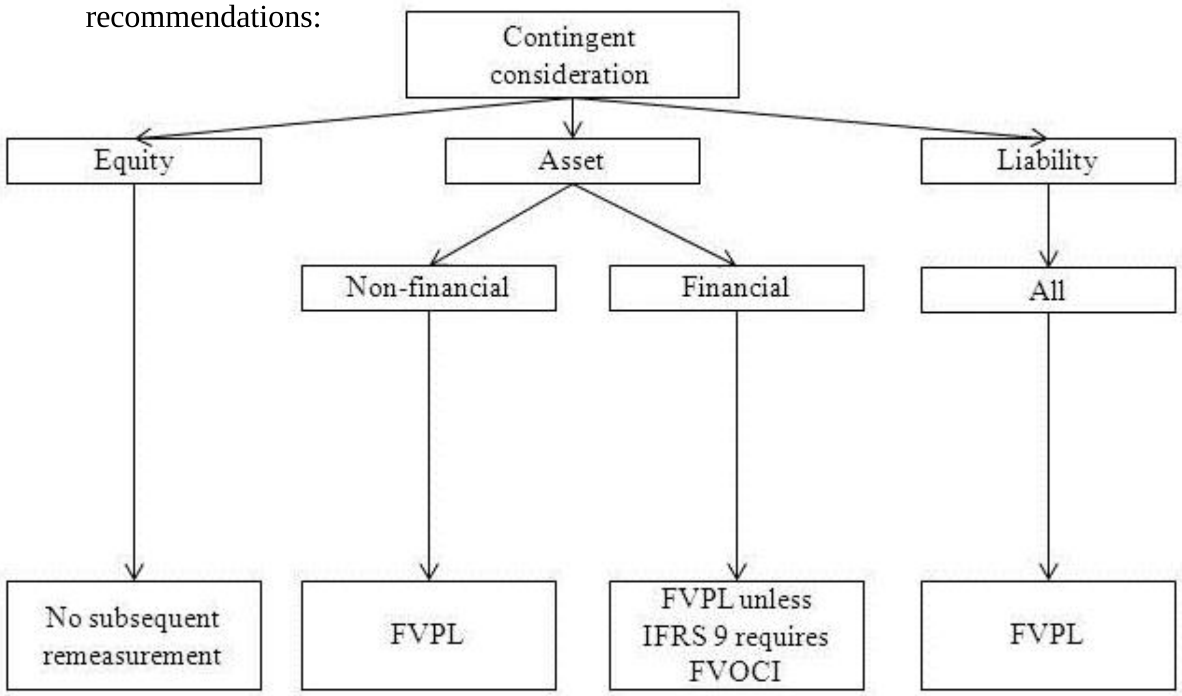
- a. Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.
- b. Contingent consideration classified as an asset or a liability shall be remeasured to fair value at each reporting date until the contingency is resolved. 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.

Appendix D–Subsequent measurement requirements for contingent consideration

D1 The following diagram shows the subsequent measurement requirements for contingent consideration which were proposed in the ED:



D2 The following diagram shows the proposed subsequent measurement requirements for contingent consideration, incorporating the Interpretations Committee's recommendations:



Appendix E–Consequential Amendments

E1 During the preparation of this paper, we undertook work to identify other consequential amendments required as a result of the proposed amendments to IFRS 3 and IFRS 9. The following table shows the paragraphs found we think require amending and how we propose those paragraphs be consequentially amended.

Standard and paragraph	Current text	Proposed amendment
IFRS 3 paragraph BC437(c)	The revised IFRS 3 builds on the core principles established by IFRS 3. However, the IASB sought to improve the understandability, relevance, reliability and comparability of information provided to users of financial statements as follows: (a) … (b) … (c) **Contingent consideration** Paragraph 58 of the revised IFRS 3 requires contingent consideration that is classified as a liability and is within the scope of IAS 39[31] to be remeasured to fair value (or for those within the scope of IAS 37 or another IFRS, to be accounted for in accordance	We propose to footnote this paragraph, '…and that contingent consideration classified as equity is not remeasured' with the following text: *Annual Improvements to IFRSs 2010–2012 Cycle* modified the subsequent measurement requirements for contingent consideration issued in a business combination. This modification makes clear that contingent consideration, other than that classified as equity, shall be subsequently remeasured to fair value.

	with that IFRS) and that contingent consideration classified as equity is not remeasured. The IASB understands that remeasuring the fair value of contingent consideration after the acquisition date results in additional costs to preparers. Preparers will need to measure the fair value of these arrangements or will need to obtain external valuations at the end of each reporting period. However, users have stated that the information they receive under IFRS 3 is too late to be useful. The IASB concluded therefore that the benefits of relevance and representational faithfulness and the increased information that would be provided to users outweigh the costs. [31] In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.	
IFRS 3 IE Table of Concordance	The main revisions made in 2008 were: • … • Consideration transferred by the acquirer, including contingent consideration, must be measured and recognised at fair value at the acquisition date. Subsequent changes in the fair value of contingent consideration classified as liabilities are recognised in accordance with	We propose to amend this paragraph as follows (new text underlined, deleted text struck-through): Consideration transferred by the acquirer, including contingent consideration, must be

	IAS 39, IAS 37 or other IFRSs, as appropriate (rather than by adjusting goodwill). The disclosures required to be made in relation to contingent consideration were enhanced.	measured and recognised at fair value at the acquisition date. Subsequent changes in the fair value of contingent consideration classified as liabilities are recognised in accordance with ~~IAS 39, IAS 37~~ IFRS 9 or ~~other~~ IFRS~~s~~ 3, as appropriate (rather than by adjusting goodwill). The disclosures required to be made in relation to contingent consideration were enhanced.