IFRS Accounting

Staff paper

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IASB® meeting

Date	**June 2023**
Project	**Equity Method**
Topic	**Towards an Exposure Draft—Contingent consideration on acquisition of an investment in an associate, including subsequent measurement**
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Introduction

1. This paper discusses the application question: *How to, initially and subsequently, recognise and measure contingent consideration on acquisition of an investment in an associate applying IAS 28* Investments in Associates and Joint Ventures*?*

Purpose of this paper

2. The purpose of this paper is to ask the International Accounting Standards Board (IASB) to decide if, and if so how to propose amendments to IAS 28 to recognise and measure contingent consideration on acquisition of an investment in an associate, including the subsequent measurement of that contingent consideration.

Staff recommendation

3. The staff recommend the IASB proposes: An investor:

   (a) on acquisition of an investment in an associate, recognises contingent consideration as part of the cost of the investment and measures that contingent consideration at fair value; and

   (b) after the acquisition date:

      (i) *for contingent consideration classified as equity*—accounts for its subsequent settlement within equity.

      (ii) *for other contingent consideration*—measures it at fair value at each reporting date and recognises changes in fair value in profit or loss.

Structure of this paper

4. The paper is structured as follows:

   (a) understanding of the application question (paragraphs 5–13 of this paper);

   (b) staff analysis (paragraphs 14–23 of this paper):

      (i) does consideration transferred include contingent consideration? (paragraphs 14–18 of this paper); and

      (ii) subsequent measurement of contingent consideration (paragraphs 19–23 of this paper);

   (c) current practice (paragraphs 24–26 of this paper); and

   (d) question for the IASB.

Understanding of the application question

5. Paragraph 32 of IAS 28 requires that an investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the investor's share of the net fair value of the investee's identifiable assets and liabilities is accounted for either as goodwill, or as a gain from a bargain purchase.

6. At its April 2022 meeting, the IASB tentatively decided that an investor would measure the cost of an investment, when an investor obtains significant influence in an associate, at the fair value of the consideration transferred, including the fair value of any previously held interest in the associate.[1]

7. In reaching the tentative decision set out in paragraph 6 of this paper, the IASB considered that measuring the cost of the investment at fair value would be consistent with principle D which measures the associate's identifiable net assets at fair value on obtaining significant influence.[2]

8. Principle D states:

> Fair value at the date that significant influence or joint control is obtained provides the most relevant information and faithful representation of an associate's or joint venture's identifiable net assets.

9. The application question in paragraph 1 of this paper asks how to recognise and measure contingent consideration on acquisition of an investment in an associate, including the subsequent measurement of that contingent consideration.

[1] See paragraphs 9–15 of AP13A: Purchase of an additional interest in an associate while retaining significant influence and AP13A: Purchases of an additional ownership interest in an associate without a change in significant influence.

[2] See June 2021 IASB Meeting; AP13: Identifying the principles in IAS 28.

10. The glossary of the IFRS Accounting Standards has a defined term for the 'contingent consideration', that is extracted from IFRS 3 *Business Combinations*:[3]

> Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

11. For example, an investor acquires a 25% interest in an associate, which results in it having significant influence, for consideration that is payable in two tranches:

    (a) an immediate payment of CU1,000 on acquisition of the investment in the associate (cash consideration); and

    (b) a further payment that would be calculated as 5% of the associate's profits (before interest and tax) in the two years following the acquisition (*contingent consideration*).

12. The staff think that to answer the application question in paragraph 1 of this paper, the IASB should decide:

    (a) if consideration transferred includes contingent consideration, as part of the cost of an investment (see paragraph 6 of this agenda paper); and

    (b) if (a) is yes, how an investor recognises changes in the fair value of contingent consideration, at each reporting date, until it is settled (subsequent measurement of contingent consideration)?

13. It should be noted that this agenda paper is not analysing the classification requirements of the contingent consideration. This is because the staff think that an investor would apply IAS 32 *Financial Instruments: Presentation* in classifying an obligation to pay contingent consideration that meets the definition of a financial instrument.

[3] The glossary is extracted from the IFRS Accounting Standards and also contains extracts from the *Conceptual Framework for Financial Reporting*.

Staff analysis

Does consideration transferred include contingent consideration?

14. The glossary of the IFRS Accounting Standards has no defined term for the 'consideration transferred'. However, in the context of a business combination, guidance exists in IFRS 3, which provides examples of potential forms of consideration transferred.

15. Paragraph 37 of IFRS 3 states that (**emphasis added**):

> …Examples of potential forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, ***contingent consideration***, ordinary or preference equity instruments, options, warrants and member interests of mutual entities.

16. Paragraph 39 of IFRS 3 states that (**emphasis added**):

> The **consideration** the acquirer transfers in exchange for the acquiree **includes** any asset or liability resulting from a **contingent consideration arrangement**…

17. Given the IASB's tentative decision to measure the cost of an investment, when an investor obtains significant influence, at the fair value of the consideration transferred (see paragraph 6 of this paper), the staff think that it is logical to extend that decision such that consideration transferred has the same meaning as set out in IFRS 3. This has the advantage that the IASB is using consistent definitions and, in this instance, is particularly important to investors who are familiar with the recognition and measurement requirements of IFRS 3 related to contingent consideration on the acquisition of a business.

18. Considering paragraphs 5–17 of this paper, the staff think that:

    (a) because the IASB tentatively decided that an investor would measure the cost of an investment of an associate, when it obtains significant influence, at the *fair value of the consideration transferred*, including the fair value of any previously held interest in the associate; and

    (b) if *consideration transferred* has the same meaning as set out in IFRS 3, which includes *contingent consideration*,

    accordingly, an investor, on acquisition of an investment in an associate, recognises *contingent consideration* as part of the cost of the investment and measures that contingent consideration at fair value.

Subsequent measurement of contingent consideration

19. The subsequent measurement of contingent consideration is in:

    (a) paragraph 58 of IFRS 3 which sets out requirements for the subsequent accounting for contingent consideration. The acquirer shall account for changes in the fair value of contingent consideration as follows:

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

        (ii) other contingent consideration shall be measured at fair value at each reporting date and changes in fair value shall be recognised in profit or loss.

    (b) paragraph 4.2.1(e) of IFRS 9 *Financial Instruments* states that contingent consideration in a business combination shall subsequently be measured at fair value with changes recognised in profit or loss.

20. Paragraph 22 of this paper discusses whether the same is true, regarding the subsequent measurement of contingent consideration on an acquisition of a business combination, in a similar way to an acquisition of an investment in an associate.

21. In doing so, the staff have considered the IASB's rationale in developing IFRS 3 to require that:

    (a) contingent consideration classified as equity shall not be remeasured;

    (b) other contingent consideration should be remeasured at fair value at each reporting date after the acquisition date, until settled; and

    (c) subsequent changes in that fair values should not be reflected as adjustments to the consideration transferred in a business combination (usually in goodwill).[4]

22. The following table summarises the rationale noted in paragraph 21 of this paper and whether the staff consider it also applies to the acquisition of an investment in an associate.

[4] See paragraphs BC353–BC360I of the Basis for Conclusions on IFRS 3 *Business Combinations*.

IASB rationale in a business combination	Staff analysis on whether the same applies to an acquisition of an investment in an associate
Paragraph BC353 of the Basis for Conclusions on IFRS 3 explains that: — the IASB concluded that contingent consideration classified as equity should not be remeasured after the acquisition date, for consistency with the accounting for other obligations that require an entity to deliver its equity shares.	The same rationale applies, because it relates to the measurement of contingent consideration that is classified as equity in accordance with IAS 32.[5]
Paragraph BC354 of the Basis for Conclusions on IFRS 3 explains that: — the IASB observed that many obligations for contingent consideration that qualify for classification as liabilities meet the definition of derivative instruments in IFRS 9. — the IASB concluded that all contracts that would otherwise be within the scope of IFRS 9 (if not issued in a business combination) should be subject to IFRS 9 requirements if issued in a business combination. — therefore, such contingent consideration would subsequently be measured at fair value at the end of each reporting period, with changes in fair value recognised in accordance with IFRS 9.	The same rationale applies, because remeasuring contingent consideration that qualify for classification as liabilities at fair value improves transparency in reporting, regardless of whether they were issued for the acquisition of an investment in an associate.
Paragraph BC355 of the Basis for Conclusions on IFRS 3 explains that: — the IASB concluded that, in concept, all liabilities (even if they are not derivatives) for contingent consideration should be accounted for similarly, ie be remeasured at fair value after the acquisition date.	The same rationale applies, because remeasuring contingent consideration that qualify for classification as liabilities at fair value provides a faithful representation of those liabilities, regardless of whether it meets the definition of a derivative.

IASB rationale in a business combination	Staff analysis on whether the same applies to an acquisition of an investment in an associate
Paragraphs BC356–BC357 of the Basis for Conclusions on IFRS 3 explain that: — the subsequent changes in the fair value of liabilities for contingent consideration are generally directly related to post-combination events and changes in circumstances related to the combined entity. — thus, they should not affect the measurement of the consideration transferred or goodwill on the acquisition date. — therefore, the IASB concluded that subsequent changes in the fair value of liabilities for contingent consideration do not affect the acquisition-date fair value of the consideration transferred.	The same rationale applies, as subsequent changes in the value of the contingent consideration are generally directly related to post-acquisition events and changes in circumstances related to the associate, such as: (a) meeting an earnings target; (b) reaching a specified share price; or (c) reaching a milestone on a research and development project.

23. In the staff's view, the analysis in paragraphs 19–22 of this paper demonstrates that the IASB rationale in a business combination, for the subsequent measurement of contingent consideration, also holds to an acquisition of an investment in an associate. The staff, therefore, think that an investor, after the acquisition date:

(a) for contingent consideration classified as equity—accounts for its subsequent settlement within equity.

(b) for other contingent consideration—measures it at fair value at each reporting date and recognises changes in fair value in profit or loss.

[5] See also paragraph 4.63 of the *Conceptual Framework for Financial Reporting.*

Current practice

Entities applying IFRS Accounting Standards

24. Almost all audit practice manuals state that contingent consideration arising from the acquisition of an investment in an equity-accounted investee could be treated in the same way as contingent consideration arising on the acquisition of a subsidiary. Accordingly, they believe that the contingent consideration should be initially recognised at fair value as part of the cost of acquisition (like IFRS 3) and subsequently accounted for as follows:

    (a) contingent consideration classified as equity: An investor should not remeasure it and should account for its settlement in equity.

    (b) contingent consideration classified as an asset or a liability: An investor should remeasure it to fair value at each reporting date until the contingency is settled, with changes in fair value recognised in profit or loss (like IFRS 3).

US GAAP requirements

25. Paragraph 26 of this paper includes extracts from US GAAP guidance regarding contingent consideration on an acquisition of an equity method investee. Although the US GAAP guidance could lead to different accounting outcomes to the staff recommendation set out in paragraph 3 of this paper, the staff recommendation seems compatible and consistent with IFRS current practice set out in paragraph 24 of this paper.

26. ASC 323-10 *Investments—Equity Method and Joint Ventures* states the following:

    (a) Paragraph 323-10-25-2A

        If an equity method investment agreement involves a contingent consideration arrangement in which the fair value of the investor's share of the investee's net assets exceeds the investor's initial cost, a liability shall be recognized.

(b) Paragraph 323-10-30-2A

Contingent consideration shall only be included in the initial measurement of an equity method investment if it is required to be recognized by specific authoritative guidance other than Topic 805 *Business Combinations*.

(c) Paragraph 323-10-30-2B

A liability recognized under paragraph 323-10-25-2A shall be measured initially at an amount equal to the lesser of the following:

(i) The maximum amount of contingent consideration not otherwise recognized.

(ii) The excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized).

(d) 323-10-35-14A

If a contingency is resolved relating to a liability recognized in accordance with the guidance in paragraph 323-10-25-2A and the consideration is issued or becomes issuable, any excess of the fair value of the contingent consideration issued or issuable over the amount that was recognized as a liability shall be recognized as an additional cost of the investment. If the amount initially recognized as a liability exceeds the fair value of the consideration issued or issuable, that excess shall reduce the cost of the investment.

Question for the IASB

Question for the IASB
1. Does the IASB agree with the staff recommendation in paragraph 3 of this paper to propose amendments to IAS 28 to require an investor: (a) on acquisition of an investment in an associate, to recognise contingent consideration as part of the cost of the investment and measure that contingent consideration at fair value; and (b) after the acquisition date: (i) for contingent consideration classified as equity, to account for its subsequent settlement within equity. (ii) for other contingent consideration, to measure it at fair value at each reporting date and recognise changes in fair value in profit or loss?