Staff paper

Agenda reference: 2

IFRS® Interpretations Committee meeting

Date	**September 2023**
Project	**Payments Contingent on Continued Employment during Handover Periods (IFRS 3)**
Topic	**Initial consideration**
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Purpose of the paper

1. The IFRS Interpretations Committee (Committee) received a submission about how an entity accounts for payments to the sellers of an acquired business when those payments are contingent on the sellers' continued employment during a post-acquisition handover period.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add a standard-setting project to the work plan.

Structure of this paper

3. This paper includes the following:

   (a) background information;

   (b) summary of outreach;

(c) staff analysis; and

(d) staff recommendation.

4. There are three appendices to the paper:

(a) Appendix A—proposed wording of the tentative agenda decision;

(b) Appendix B—submission; and

(c) Appendix C—January 2013 Agenda Decision.

Background information

5. The submitter describes a fact pattern in which an entity acquires a business and, as part of the acquisition agreement, requires the sellers to continue as employees of the entity. The sellers' continued employment aims to ensure the appropriate transfer of knowledge from the sellers to the new management team, including the relationships with key customers, vendors and employees (handover of the business). The sellers' duties are limited to the handover of the business and therefore exclude the development of new businesses.

6. The sellers are compensated for their services at a level comparable to other management executives. The entity also agrees to make additional payments to the sellers that are contingent upon:

(a) the acquired business achieving a specified level of earnings before interest, taxes, depreciation, and amortisation (EBITDA); and

(b) the continued employment of the sellers during a limited period to complete the handover of the business (the handover period).

7. The continued employment condition in paragraph 6(b) includes 'good leaver' and 'bad leaver' provisions. The submitter describes those provisions as follows:

(a) the sellers leave as 'good leavers' and are entitled to receive the additional payments if employment terminates due to specified circumstances—such as death or disability—or with the entity's agreement.

(b) the sellers leave as 'bad leavers' and forfeit the additional payments if employment terminates in any other circumstance.

8. The submitter notes that the January 2013 agenda decision *Contingent payments to shareholders and continuing employment* (reproduced in Appendix C to this paper) addresses arrangements in which contingent payments are automatically forfeited if employment terminates. That agenda decision explains the Committee's conclusion that, applying paragraph B55(a) of IFRS 3 *Business Combinations,* those arrangements are compensation for post-combination services rather than additional consideration for an acquisition, unless the service condition is not substantive.[1]

9. Nonetheless, the submitter asks whether, in the fact pattern described in the submission:

(a) the entity may, based on its analysis of the 'substance' of the transaction, split the accounting for the additional payments between:

(i) remuneration for post-combination services; and

(ii) additional consideration for the business combination.

(b) the entity considers payments under the good and bad leaver provisions to be *automatically forfeited* if the sellers' employment terminates.

10. Appendix B to this paper reproduces the submission, which provides additional details about the fact pattern and the views identified by the submitter.

[1] Paragraph B55(a) of IFRS 3 states that '…A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services…'.

Outreach

Information request

11. We sent information requests to members of the International Forum of Accounting Standard Setters, securities regulators and large accounting firms. The submission was also made available on our website.

12. The request asked those participating to provide information about:

(a) whether fact patterns such as the one described in the submission are common;

(b) if such fact patterns are common:

(i) whether payments contingent on continued employment are generally material for entities; and

(ii) in which jurisdictions and industries fact patterns are common.

(c) how entities account for these payments—in particular, whether entities apply the accounting described in the January 2013 Agenda Decision (that is, whether entities recognise these payments as remuneration for post-combination services).

13. We received 19 responses—seven from large accounting firms, ten from national standard-setters, one from a securities regulator and one from an organisation representing a group of securities regulators. The views received represent informal opinions and do not reflect the official views of those respondents or their organisations.

Findings from the Outreach

Are fact patterns common and material?

14. Most respondents say that fact patterns such as the one described in the submission are common across many jurisdictions. A few respondents report mixed views or say such fact patterns are not common in some jurisdictions.

15. Most respondents say that payments contingent on continued employment are generally material or can be material for affected entities. A few respondents report mixed views about whether those payments are generally material.

16. Most respondents say that fact patterns such as the one described in the submission are common across many industries. Some respondents say fact patterns are particularly common in industries that require expert technical knowledge or that are heavily reliant on customer relationships or human capital. While respondents mention various industries, most say such fact patterns are common in the technology sector. Some respondents also say that such fact patterns are most common for entities acquiring start-up businesses or smaller or medium-sized entities whose owners also manage the business.

17. A few respondents say they have observed variations of the fact pattern described in the submission. For example, fact patterns in which payments contingent on continued service are embedded in put and call options over non-controlling interests or where payments are only partially forfeited if employment terminates.

How do entities account for payments contingent on continued employment?

18. All respondents say that entities apply, or generally apply, the accounting described in the January 2013 Agenda Decision—that is, entities recognise these payments as remuneration for post-combination services. Many respondents also say there is no diversity in how entities account for such payments in their jurisdiction. A few respondents say that regulators and auditors enforce the accounting treatment

described in the January 2013 Agenda Decision and refer to guidance published by accounting firms prescribing such treatment. However, one respondent also reports the view of one practitioner in the respondent's jurisdiction that says that an entity applies judgement and that those payments could potentially be viewed as consideration for the business.

19. Some respondents say some stakeholders disagree with the accounting outcome of applying the January 2013 Agenda Decision in some situations. In their view, such an accounting outcome does not always reflect the economic substance of the arrangement and could even result in an entity recognising a gain from a bargain purchase.[2] However, one respondent says the accounting outcome is appropriate because the payments are remuneration for the services received rather than compensation for assets acquired in the business combination—for example, the respondent says that, if knowledge is based on a few people and not on the workforce, such knowledge is lost if the selling shareholders leave the business.

20. A few respondents also say that:

    (a) some entities try to avoid recognising these payments as remuneration for post-combination services, but are unable to do so;

    (b) entities try to structure acquisitions differently from the fact pattern described in the submission to achieve different accounting outcomes; and

    (c) management sometimes overlook the accounting for such arrangements, resulting in subsequent restatements for the correction of prior period errors.

21. Finally, a few respondents say the Committee has already addressed the accounting for payments contingent on continued employment and express concerns about reopening this matter.

[2] See paragraphs 34–36 of IFRS 3.

Staff analysis

Should the Committee add a standard-setting project to the work plan?

Is the matter widespread and expected to have a material effect?

22. Paragraph 5.16 of the *Due Process Handbook* sets out the criteria the Committee considers when determining whether to add a standard-setting project to the work plan. One criterion, included in sub-paragraph 5.16(a), is that 'the matter has widespread effect and has, or is expected to have, a material effect on those affected'.

23. The results from the outreach do not indicate significant diversity in how entities account for payments contingent on continued employment in fact patterns such as the one described in the submission—entities account for the payments as remuneration for post-combination services as described in the January 2013 Agenda Decision. These results are also consistent with the submitter's statement that 'current practice is led by the authority of the … January 2013 agenda decision.'

24. Therefore, we have not obtained evidence that the matter satisfies the criterion in the paragraph 5.16(a) of the *Due Process Handbook.* Accordingly, we recommend that the Committee not add a standard-setting project to the work plan but instead publish a tentative agenda decision explaining its reasons for not adding a standard-setting project.

25. Our recommendation is:

    (a) consistent with the Committee's approach on other matters in which the fact pattern described in the submission could be common but for which the Committee has obtained little, if any, evidence of diversity in accounting. The most recent example of such a matter is the one addressed in the tentative agenda decision *Merger between a Parent and Its Subsidiary in Separate Financial Statements* (IAS 27 *Separate Financial Statements*).

(b) based on the evidence we obtained from our information request. Should there be additional evidence which could lead to a different conclusion on whether the matter is widespread, stakeholders will have the opportunity to share this with the Committee by providing feedback to the tentative agenda decision.

Previous discussions of the matter

26. The January 2013 Agenda Decision states:

> …The [Committee] also noted that IFRS 3 is part of the joint effort by the IASB and the US-based Financial Accounting Standards Board (FASB) to promote the convergence of accounting standards. The [Committee] was advised that the Post-implementation Review of FASB Statement No. 141R *Business Combinations* is in progress, and that the opportunity to co-ordinate any work on this issue with the FASB would arise after the conclusion of the Post-implementation Review of FASB Statement No. 141R. Consequently, the Interpretations Committee decided not to add this issue to its agenda at this time and to revisit this issue after completion of the Post-implementation Review of FASB Statement No. 141R.

27. After the publication of the January 2013 Agenda Decision, the IASB considered stakeholders' requests to revisit the requirement in paragraph B55(a) of IFRS 3 as part of the post-implementation review of IFRS 3. The feedback statement for the post-implementation review, published in June 2015, includes the following summary of messages received and the IASB's response:

> **Message received**—Many participants asked the IASB to revisit the guidance in paragraph B55(a) of IFRS 3 for contingent payments to selling shareholders in circumstances in which those selling shareholders become, or continue as, employees. They note that the paragraph appears to mandate that an arrangement

in which contingent payments are forfeited if employment terminates is treated as post-acquisition remuneration. In their view, this should not be an individually conclusive rule, but should instead be one of the indicators that should be considered in assessing whether such contingent consideration should be treated as part of the consideration transferred in the acquisition or as a post-acquisition expense.

Our response—We assessed this issue as being of low significance. We think that in most cases these payments are post-acquisition expenses. However, depending on the feedback received from the 2015 Agenda Consultation, we could start working on this issue; for example, by investigating in which circumstances these payments should be considered as consideration transferred in the acquisition.

28. The IASB has not identified this matter as a high priority in its 2015 Agenda Consultation or the recently completed Third Agenda Consultation. In our view, neither the information included in the submission nor that obtained in our information request includes information that the IASB has not already considered.

Staff recommendation

29. Based on our assessment of the work plan criteria in paragraph 5.16 of the *Due Process Handbook* (discussed in paragraphs 22–25 of this paper), we recommend that the Committee does not add a standard-setting project to the work plan. Instead, we recommend publishing a tentative agenda decision that explains the reasons the Committee decided not to add a standard-setting project.

30. Appendix A to this paper sets out the proposed wording of the tentative agenda decision.

Questions for the Committee

1. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan?
2. Does the Committee have any comments on the wording of the tentative agenda decision suggested in Appendix A to this paper?

Appendix A—proposed wording of the tentative agenda decision

Payments Contingent on Continued Employment during Handover Periods (IFRS 3 *Business Combinations*)

The Committee received a request about how an entity accounts for payments to the sellers of a business it acquired when those payments are contingent on the sellers' continued employment during a post-acquisition handover period.

Fact pattern

In the fact pattern described in the request:

(a) an entity acquires a business and, as part of the acquisition agreement, requires the sellers to continue as employees of the entity. The sellers' continued employment aims to ensure the appropriate transfer of knowledge from the sellers to the new management team (handover of the business).

(b) the sellers are compensated for their services at a level comparable to other management executives. The entity also agrees to make additional payments to the sellers that are contingent upon both the performance of the acquired business and the continued employment of the sellers during a limited period to complete the handover of the business.

(c) the sellers are entitled to receive the additional payments if employment terminates due to specified circumstances—such as death or disability—or with the entity's agreement. The additional payments are forfeited if employment terminates in any other circumstance.

Findings

Evidence gathered by the Committee [to date] does not indicate significant diversity in the accounting for payments that are contingent upon continued employment in fact patterns such as those described in the request. In these fact patterns, entities apply the accounting described in the agenda decision *Contingent payments to shareholders and continuing employment* (published in January 2013) and account for the payments as compensation for post-combination services rather than additional consideration for the acquisition, unless the service condition is not substantive.

Conclusion

Based on its findings, the Committee concluded that the matter described in the request does not have widespread effect. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—submission

B1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of the request.

…

I am writing to you to address a remaining harmful difficulty for those affected, to implement properly the provisions of IFRS 3.B.55.a about contingent payments, since the 2013 agenda decision made by the Interpretations Committee.

You will find here-after the issue and the rationale followed we would be grateful the IFRS Interpretations Committee to address.

1 The matter

1.1 The fact pattern

The Company ("Co") carries out every year several business combinations by taking over small and medium entities in its areas of business that become 100% subsidiaries. These entities are privately-owned by their founders and managers at the time of their acquisition by Co.

When acquiring a business, the main concern of Co's management is to achieve the appropriate transfer of knowledge to the new management team, especially the relationships with key-customers, vendors and employees, and then, the current stream of revenue and profitability of the acquirees.

For this purpose, Co requires in the share purchase agreement ("SPA") the sellers-managers to hand over the business to the new managers appointed by Co. The related duty of the sellers is limited to staying during a limited period of time ("the hand-over period"), often on a part-time basis, to manage this transfer of knowledge and relationships.

The SPA and labour or service contract signed together between Co and the sellers-managers provide for the following terms and provisions:

- The sellers-managers are compensated at a level that is comparable to other top management executives for their services during the hand-over period;
- Their duty is limited to providing hand-over services, excluding for instance business development;
- The earnout payment is contingent to reaching a specific level of normative EBITDA (that is actual EBITDA at the time of acquisition) and to the continued employment of the sellers-managers during the whole hand-over period (on a "good/bad leaver" basis)

Currently, the earnout payments made by Co are qualified as a post-acquisition compensation and are expensed in the consolidated income statement of the Group, on the basis of the current interpretation of IFRS3.B55.a by the IFRS IC[3]. In this context, Co has faced harmful effects where it cannot implement a condition of presence to achieve safely its hand-over process.

1.2 Business cases

To illustrate the pattern, we provide here-below two recent business cases encountered by Co.

Business case #1 (figures in thousand CU)

Purchase price: 17.000

- Fixed price: 14.000
- Earnout: 3.000

Annual compensation: 150 (on a full time basis)
Trigger of the earnout: 50% of the normative EBITDA
Hand-over period: 9 months
Earnout represents 121% of the FY22's EBITDA

Business case #2 (figures in thousand CU)

Purchase price: 22.000

- Fixed price: 19.000
- Earnout: 3.000

Annual compensation: 88 (corresponding to a quarter-time basis)
Trigger of the earnout: 100% of the normative EBITDA
Hand-over period: 2 years
Earnout represents 75% of the FY22's EBITDA

[3] IFRIC *Update*, January 2013, Agenda Decision, 'IFRS 3 *Business Combinations—Continuing employment*'

1.3 Questions proposed for the Interpretation Committee's consideration

1. **Does the January 2013 agenda decision[4] allows for an "in-substance" analysis of the contingent payment as it has been suggested by some respondents to the IFRS3 PIR in 2015?[5]**
   An analysis of the substance of the transaction leads to split the accounting of the contingent payment between its "service" component if any, and its "additional consideration for the business combination" component.

   Split accounting is of widespread use in IFRS to reflect the substance of transactions. For example, to account for hybrid contracts (IAS32 and IFRS 9) or for service contracts that contain a lease (IFRS 16).

   The "service component" would be measured at its fair value, on the basis of IFRS 13 rules and guidance. Markets rates may be obtained by reference to the compensation granted to comparable key-managers.

   The "additional consideration for the business combination" component will be equal to the remaining portion of the payment, after deducting the amount of the service component.

2. **Should a good and bad leaver provision be regarded as an "automatic forfeiture"?**
   According to the IFRS IC Agenda Decision[6], *"payments to an employee that are forfeited upon termination of employment are remuneration for post-combination services"*.

   In the SPAs signed by Co, the condition of presence associated with the earnout payment is based on a "good and bad leaver" provision.

   Bad leaving / good leaving provisions are designed to manage the early leaving of the manager-seller. It is not intended to compensate a service but rather to secure the hand-over process.

   The bad leaving of the sellers (before the end of the hand-over period) triggers the forfeiture of the earnout payment by Co (the acquirer). The good leaving (before the of the hand-over period) permits the sellers to earn the contingent payment. The good leaving is subject to either the observance of specific conditions (death, disability), or the agreement of Co.

   Thus, a bad leaver that "slams the door" will harm the hand-over and consequently the business, leading to trigger a kind of penalty or indemnification (that is the forfeiture of the payment). Good leaving will trigger the payment of the contingent consideration.

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[4] *"the Interpretations Committee observed that an arrangement in which contingent payments are automatically forfeited if employment terminates would lead to a conclusion that the arrangement is compensation for post-combination services rather than additional consideration for an acquisition, **unless the service condition is not substantive**"* [emphasis added].

[5] For instance Comment letter issued by the French standard setter ("Autorité des Normes Comptables") to the IASB, in June 2014 , p.17 (Question 9).

[6] IFRIC *Update*, January 2013, Agenda Decision, 'IFRS 3 Business Combinations—Continuing employment'

At the end of the day, there is not an automatic forfeiture, as in the case of a good leaving, the payment is due.

2 Current practice

[A brief description of current or emerging accounting practices, outlining the alternatives, and referring to the applicable requirements in IFRS Accounting Standards.]

Current practice is led by the authority of the IFRIC's January 2013 agenda decision. The earnout payments contingent to the continued employment of the sellers are systematically accounted for as an expense, regardless of the substance of the transaction.

3 Reasons for the Interpretations Committee to address the matter

3.1 Does the matter have widespread effect and does it, or is it expected to, have a material effect on those affected?

Yes, many Issuers and Preparers are facing difficulties, including in Europe, to get alternative solutions to the condition of presence in order to secure their hand-over process.

The accounting of those contingent payments as an expense has a material effect on the financial statements. For instance, this expense currently counts for 11% of Co's consolidated operating income, whereas the contribution of the related acquired entities to this consolidated operating income is of 32%.

This issue has been raised by many respondents, including several European standards setters (such as United-Kingdom and France among others), to the Agenda Consultation about the IFRS 3 post-implementation review. Following the IFRS3 PIR, the IASB's staff agreed to further investigate this issue: *"However, depending on the feedback received from the 2015 Agenda Consultation, we could start working on this issue; for example, by investigating in which circumstances these payments should be considered as consideration transferred in the acquisition."*[7]. But considering this topic as of "low priority", the staff did not add it to the IASB Work Plan 2017-2021.

3.2 Is it necessary to add or change requirements in IFRS Accounting Standards to improve financial reporting—that is, do the principles and requirements in the Accounting Standards not provide an adequate basis for an entity to determine the required accounting?

As described above, we believe that the "conclusive language" in paragraph IFRS3.B55.a could be shifted to a more conditional wording so that it remains as an indicator. Additional guidance from

[7] Report and Feedback Statement on the Post-implementation review of IFRS 3, p.26 (June 2015)

IFRS IC to provide for an “in-substance” analysis of the payments contingent to the continued employment of the seller would be a valuable input.

3.3 Can the matter be resolved efficiently within the confines of the existing Accounting Standards and the Conceptual Framework for Financial Reporting?

Yes, even if the IFRS IC may have to consider a narrow-scope amendment of IFRS3.B55.a.

3.4 Is the matter sufficiently narrow in scope that the IASB or the Interpretations Committee can address it in an efficient manner, but not so narrow that it is not cost-effective for the IASB or the Interpretations Committee and stakeholders to undertake the due process required to change an Accounting Standard?

The current accounting treatment of contingent payments linked to a condition of presence has material adverse effects on the financial statements, regardless the substance of the transaction.

We believe a narrow-scope amendment targeting IFRS3.B55.a would be an efficient manner to solve this issue, unless the IFRS IC assesses an Agenda Decision based on the substance of the transaction would be a sufficient way to do it.

Appendix C—January 2013 Agenda Decision

C1. We have reproduced below the January 2013 Agenda Decision:

Contingent payments to shareholders and continuing employment

The Interpretations Committee received a request for guidance on the accounting in accordance with IFRS 3 *Business Combinations* for contingent payments to selling shareholders in circumstances in which those selling shareholders become, or continue as, employees. The submitter asked the Interpretations Committee to clarify whether paragraph B55(a) of IFRS 3 is conclusive in determining that payments to an employee that are forfeited upon termination of employment are remuneration for post-combination services and not part of the consideration for an acquisition. The question arose because the submitter asserted that paragraph B55 introduces subparagraphs (a)–(h) as indicators, but paragraph B55(a) uses conclusive language stating that the arrangement described is remuneration for post-combination services.

The Interpretations Committee observed that an arrangement in which contingent payments are automatically forfeited if employment terminates would lead to a conclusion that the arrangement is compensation for post combination services rather than additional consideration for an acquisition, unless the service condition is not substantive. The Interpretations Committee reached this conclusion on the basis of the conclusive language used in paragraph B55(a) of IFRS 3. The Interpretations Committee also noted that IFRS 3 is part of the joint effort by the IASB and the US-based Financial Accounting Standards Board (FASB) to promote the convergence of accounting standards. The Interpretations Committee was advised that the Post-implementation Review of FASB Statement No. 141R *Business Combinations* is in progress, and that the opportunity to co-ordinate any work on this issue with the FASB would arise after the conclusion of the Post-implementation Review of FASB Statement No. 141R. Consequently, the Interpretations Committee decided not to add this issue to its agenda at this time and to revisit this issue after completion of the Post-implementation Review of FASB Statement No. 141R.