IFRIC POTENTIAL AGENDA ITEM REQUEST

I. The issue

Contingent Considerations
agreed for separate acquisitions of
property, plant and equipment (IAS 16) or
intangible assets (IAS 38),
outside the scope of IFRS 3

Suppose that an entity separately acquires an

- item of property, plant and equipment, for which IAS 16 *Property, plant and equipment* shall be applicable, or
- an intangible asset, for which IAS 38 *Intangible assets* shall be applicable,

and all or part of the purchase price is agreed in the form of a contingent consideration. The described transaction shall not fall into the scope of IFRS 3 *Business combinations*.

Further, the contingent consideration shall be defined (in analogy to the definition as provided in IFRS 3) as follows:

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

Referring to the measurement at recognition (initial recognition) and the measurement after recognition (subsequent measurement), two main issues or questions have arisen, for which significantly divergent interpretations have been identified.

The **first question** relates to whether the acquirer upon recognition of the asset has to recognise a financial liability as far as it relates to the contingent consideration. In particular, the following two views are held:

- View A: A financial liability has to be recognised irrespective of whether the acquirer may be able to influence whether the future events will occur or the conditions will be met.
- View B: A financial liability has not to be recognised for the contingent consideration in case the acquirer is in a position to influence whether the future events will occur or the conditions will be met.

Assuming a financial liability has been recognised upon recognition of the asset (following view A above), the **second question** relates to the treatment of subsequent changes in measurement of the financial liability relating to the contingent consideration. In particular, the following two views are held:

- View A: Subsequent changes need to be reflected in profit or loss, strictly in line with the requirements of IAS 39.
- View B: Subsequent changes need to be treated as changes of the acquisition costs of the underlying asset due to the historical-cost-method, which is the underlying basis of both, IAS 16 and IAS 38.

Question 1 - View A: For the purchase price obligation, as far as it relates to the contingent consideration, IAS 39 is applicable since it is a 'financial instrument' as defined in IAS 32 and none of the scope exclusions as mentioned in IAS 39.2 applies to this financial instrument.

Proponents of view A emphasise that according to IAS 32.AG8 the 'ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event.'

Therefore, the contingent consideration needs to be qualified as a financial liability, to which the requirements of IAS 39 must be applied. Whether or not the acquirer is in a position to influence the future events as to whether they will occur or the conditions will be met, is irrelevant.

Question 1 - View B: For the contingent portion of the purchase price obligation IAS 39 is not applicable since it is not a 'financial instrument' as defined in IAS 32 in case the acquirer is in a position to influence whether agreed future events will occur or conditions will be met. As an example, this is claimed to be the case when the contingent consideration is based on future sales volumes in relation to the underlying asset.

In such instances no liability is recognised for the contingent consideration upon recognition of the acquired asset.

Proponents of view B give the following reasons:

(1)

Proponents of view B point out that a contingent consideration as described above does not meet the basic requirement for a liability as defined in the framework (para. 60), since the acquiring entity does not have 'a present obligation'. In the instances described there is no obligating event as long as the contingency has not been removed which is considered to be fully controllable by the acquiring entity.

(2)

It is further argued that in such situations only the agreed and fixed minimum payments determine the acquisition costs of the purchased asset. Contingent considerations with the inherent characteristics of being 'controllable' by the acquirer do not form part of the cost of the acquired asset – and are, therefore, not to be considered a financial liability.

(3)

This view is further supported by IAS 32.25, according to which contingent settlement provisions are considered to be financial liabilities only in case the acquirer is required to deliver cash or another financial asset (or otherwise to settle a financial instrument in such a way that it would be a financial liability), in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument. By contrast, in case the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) is within the control of the acquirer (e.g. the amount of the acquirer's future revenues or net income relating to the purchased asset), no financial liability would need to be recognised. In line with the contractual agreement, the acquirer in this situation would have the possibility to avoid delivering cash or another financial asset (or to settle otherwise in such a way that it would be a financial liability). Thus, by deliberately not meeting the contractual requirements to deliver cash etc., it would represent an unconditional right so that no financial liability must be recognised.

Assuming a financial liability has to be recognised for the contingent part of the consideration upon recognition of the asset (following view A above), the **second question** relates to the treatment of subsequent changes in measurement of the financial liability relating to the contingent consideration.

Question 2 - View A: Subsequent changes need to be reflected in profit or loss in line with the requirements of IAS 39. Within this view the possible designation of the financial instrument as a financial asset or financial liability at fair value through profit of loss is not taken into consideration.

(1)

Proponents of view A emphasise that in accordance with IAS 39.14 an entity shall recognise a financial liability in its statement of financial position when the entity becomes part to the contractual provisions of the instrument (that is the case when the requirements of IAS 16.7 or IAS 38.18 are met). The measurement at recognition needs to be in compliance with IAS 39.43 (that includes – following this view – the contingent part of the consideration as agreed with the supplier). The subsequent measurement needs to be made in line with the requirements of IAS 39.47, for which IAS 39.AG8 stipulates that any adjustments are recognised in profit or loss as income or expense. Thus, it will not be possible to adjust the costs capitalized for the asset acquired as determined upon recognition. Namely, there are no comparable provisions as included in IFRS 3 (para. 45 ff.).

However, the total purchase price (i.e. the non-contingent and the contingent portion of it) may be a hybrid (combined) instrument with the non-contingent part of the purchase price representing the non-derivative host-contract and the contingent part of it representing an embedded derivative. In case the embedded derivative would not need to be separated from the host contract, the subsequent measurement would not change as compared to the situation as described above.

If the acquirer would be required to separate the embedded derivative (i.e. the contingent part of the purchase price agreement), the host contract would fall into the scope of IAS 39 triggering the same accounting consequences as described above. The separated derivative also would be subject to the requirements of IAS 39 – specifically following the subsequent measurement rules as lined out in IAS 39.47 (a), there would not be an impact (change) on the purchase price as capitalised for the acquired asset upon recognition. The same would be true in case the contingent consideration of the purchase price agreement would be a freestanding derivative (although this scenario is considered to be rather rare and exceptional in practice).

In this context it should be noted, that the requirements in terms of the definition for an (embedded) derivative in accordance with IAS 39.11 (b) in combination with IAS 39.9 (a) may not be met: this would be the case if the value changes of the derivative are in response to a non-financial variable, that is specific to a party of the contract. In this context the IFRS Interpretations Committee issued an agenda decision in July 2006 as follows:

> 'The IFRIC was … asked to provide guidance on whether a contract that is indexed to an entity's own revenue or own earnings before interest, tax, depreciation and amortisation (EBITDA) meets the definition of a derivative under IAS 39.
> … paragraph 9 of IAS 39 excludes from the definition of a derivative those contracts whose value changes in response to changes in a non-financial variable that is specific to a party to the contract. The IFRIC was, therefore, asked for guidance on whether revenue or EBITDA are financial or non-financial variables.
> The IFRIC accepted that it is unclear from the Standard whether revenue or EBITDA are financial or non-financial variables. However, [the IFRIC decided] not to take this issue on to its agenda as it believed it would be unable to reach a consensus on a timely basis.'

Based on this agenda decision it currently appears to be within the reporting entities' discretion how to treat purchase price agreements subject to revenues or performance-measures (like EBITDA) as derivatives. However, the accounting treatment - either way - would lead to subsequent measurement adjustments to be taken to profit or loss.

(2)

The requirements for contingent considerations as specified in IFRS 3 (2008) are considered to be requirements for business combinations, which in accordance with IAS 8.11 (a) shall be used in making the judgement described in IAS 8.10 in order to develop and apply an accounting policy as described in IAS 8.10 . In this light the requirements for contingent considerations as specified in IFRS 3 (2008) are considered to be similar and related to contingent considerations agreed for separate acquisitions of property, plant and equipment (IAS 16) or intangible assets (IAS 38). Thus, the requirements as specified in IFRS 3 (2008) shall be applied to separate acquisitions of other assets outside the scope of IFRS 3 (2008) in analogy. Accordingly, subsequent measurement changes of purchased assets (in the scope of IAS 16 and IAS 38) referring to contingent considerations would generally need to be reflected in profit or loss in line with the requirements of IAS 39.

This view is further argued with the similarity of the transactions of (a) obtaining control of one or more businesses by an acquirer and (2) the purchase of an asset subject to the scope of IAS 16 or IAS 38 for contingent considerations. Therefore, both types of transactions should be accounted for following similar accounting rules.

Question 2 - View B: Subsequent changes in the measurement of the financial liability (i.e. the contingent consideration) need to be treated as changes of the acquisition costs of the purchased asset due to the historical-cost-method, which is the underlying basis of both, IAS 16 and IAS 38.

Proponents of view B give the following reasons:

(1)

Proponents of view B argue that both standards, IAS 16 and IAS 38, are based on the historical-cost-method (the possibility to apply the revaluation model for property, plant and equipment items as well as for intangible assets is considered to be a separate issue not further considered for the discussion in this document). In line with this historical-cost-method the assets qualifying for recognition shall be measured at their cost, irrespective of the timing for such costs to be finally determined.

This understanding has explicitly been expressed in the IFRIC Interpretation 1 – *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. According to IFRIC 1.5 and in case the cost model is applied to measure an asset subject to the Interpretation, changes in the liability shall be added to the cost of the related asset in the current period. It further appears to be common practice that in accordance with IAS 17 – *Leases* a finance lease accounted for by a lessee will be adjusted by debiting “leased asset” in case the “lease liability” needs to be increased (e.g. due to the lessee opting for a further lease term to continue the lease for which at the inception of the lease it was not reasonably certain the lessee would exercise the option).

Only by understanding contingent considerations as elements of costs for acquisition transactions in the scope of IAS 16 and IAS 38, the purpose of financial statements as laid out in IAS 1.9 will be met.

(2)

This view has developed in the light of the previous rules for business combinations. As laid out in IFRS 3 (2008).BC344, the IASB had carried forward in IFRS 3 (2004) the requirements for contingent considerations from IAS 22 without reconsideration. In accordance with IFRS 3 (2004), an acquirer recognised consideration that is contingent on future events at the acquisition date only if it is probable and can be measured reliably. If the required level of probability or reliability for recognition was reached only after the acquisition date, the additional consideration was treated as an adjustment to the accounting for the business combination and to goodwill at that later date.

That the additional consideration recognised after the acquisition date was treated as adjustment to the accounting for the business combination and to goodwill (instead of being charged to profit and loss), was mirrored to acquisitions of separate acquisitions of property, plant and equipment (IAS 16) or intangible assets (IAS 38), outside the scope of IFRS 3.

The new requirements for contingent considerations as specified in IFRS 3 (2008) are considered to be specific requirements for business combinations, only. In opposition to the argument described further above, they may not be applied to separate acquisitions of other assets outside the scope of IFRS 3 (2008) in analogy. Therefore, the approach as it had established in practice for acquisitions under the regime of IAS 16 and IAS 38 and outside the scope of IFRS 3 – according to the proponents of this view – was not changed when IFRS 3 (2008) became effective.

II. Current practice: diversity in practice

We have inquired the national audit firms (both the Big Four as well as other larger audit firms) about the current practice of their clients and it has been confirmed that there is significantly divergent practice (both, with regard to question 1 and question 2).

We further had inquired the national IFRS offices of the audit firms and also a limited number of preparers about their understanding of how to account for contingent considerations in case of separate acquisitions in the scope of IAS 16 and IAS 38. The different answers which were shared with us also confirmed that there are significantly divergent interpretations and diversity in practice.

III. Reasons for the IFRIC to address the issue:

a) Is the issue widespread and has it practical relevance?

Based on the above mentioned inquiries made into audit firms and additional discussions with prepares, it was confirmed the issues as described in this document are widespread and are of practical relevance. They appear to be more important for some industries (e.g. biotechnology, pharmaceuticals, real estate) than for others though.

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

As outlined above – there are currently the two views A and B for both questions, which lead to fundamentally different treatments.

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

Financial reporting would be improved greatly by clarifying this issue since the accounting for contingent considerations referring to separate acquisitions of property, plant and equipment (IAS 16) or intangible assets (IAS 38), outside the scope of IFRS 3 based on an appropriate interpretation of the IFRS Interpretations Committee would enhance comparability among companies' financial reportings.

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

We are of the opinion that the issue is sufficiently narrow in order to be addressed by an interpretation of the IFRS Interpretations Committee.

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

N.A.

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