Project	**Tentative agenda decision**
Topic	**IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* – Accounting for contingent price for the purchase of single assets**

Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request asking for guidance on how to account for contingent payments agreed for the separate purchases of property, plant and equipment (PPE) or intangible assets.
2. The submission suggests the issue be taken onto the Interpretations Committee's agenda and be dealt with through an interpretation.
3. The submission is reproduced in full in Appendix A.

Objective

4. The objective of this paper is to:
   (a) provide background information and present the issue raised in the submission;
   (b) provide an analysis on the issue;
   (c) ask for directions from the Interpretations Committee on the ways forward for the analysis;
   (d) make a recommendation to the Interpretations Committee to add the issue to its agenda; and
   (e) ask whether the Interpretations Committee agrees with the staff's recommendation.

Issue raised

Background information

5. The request asks for guidance on how to account for contingent prices when an entity purchases a separate asset, whether PPE or intangible asset.

6. In the submission, the constituent refers to the IFRS 3 *Business Combinations* version issued in 2004. The submission claims that a practice on the accounting for contingent prices on the purchase of separate asset has developed by analogy to the guidance in IFRS 3 (2004) for contingent consideration arising in business combinations.

7. In this context, some entities account for contingent prices arising on the purchase of a separate asset in the same way as adjustments to the accounting for business combinations and goodwill under IFRS 3 (2004). Thus adjustments to the price (eg additional price upon realisation of the contingent event) are reflected in the cost of the asset and would not be expensed in the period of realisation of the event that triggered the additional payment.

8. The constituent notes that the revised version of IFRS 3 (2008) sets out requirements for the accounting of contingent consideration arising from business combinations that are different from the previous requirements in IFRS 3 (2004). Specifically, the accounting for subsequent adjustments to contingent consideration has changed from adjusting goodwill to recognising changes in profit or loss. Related paragraphs BC343 to BC360 of the Basis for Conclusions of IFRS 3 are reproduced in Appendix B for ease of reference

9. In addition, the submission refers to the scope exclusion in IFRS 3 (2008), noting that the purchase of a group of assets, which is not a business, is outside the scope of IFRS 3 (2008). The staff note that the 2004 version of IFRS 3 included a similar scope exclusion.

Request

10. The submitter notes that there are significant divergent practices in accounting for contingent prices arising on the purchase of a single asset. An interpretation on this issue would therefore be welcome.

Summary analysis and views presented in the submission

11. The constituent believes that contingent prices should be defined with reference to the definition of contingent consideration in Appendix A of IFRS 3.

12. The first issue raised by the submission is <u>whether a financial liability should be recognised for the contingent consideration when the asset is first recognised</u>. The following views exist:

    (a) View A: A financial liability should be recognised irrespective of whether the acquirer may be able to influence whether the future events will occur or conditions that must be met, for the contingency to occur, or

    (b) View B: A financial liability should not be recognised for the contingent consideration in the case where the acquirer is in a position to influence whether the future events will occur or the conditions will be met (and thus could avoid the additional payment).

13. The submission then identifies a second issue concerning the <u>measurement of subsequent changes to the financial liability relating to the contingent price</u>:

    (a) View 1: Subsequent changes need to be reflected in profit or loss, strictly in line with the requirements of IAS 39/IFRS 9 *Financial Instruments*.

    (b) View 2: Subsequent changes need to be treated as changes of the purchase price of the underlying asset in accordance with the historical-cost-method, which is the underlying measurement basis of IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

14. The staff note that an equivalent question arises if no liability is initially recognised for a contingent price that subsequently becomes payable. The staff

think that diversity in practice can be addressed by answering the following questions:

(a) Question 1: Initial recognition: Should a financial liability be recognised when the entity can control the contingent event that would trigger payment (i.e. the entity can avoid payment)?

(b) Question 2: Subsequent measurement:

(i) If a financial liability is recognised on recognition of the asset, should changes in the financial liability be recognised in profit or loss or as an adjustment to the cost of the asset?

(ii) If a financial liability is not recognised on initial recognition of the asset, it will be recognised at a later date when the contingency occurs. At that date, is the financial liability recognised as an expense to profit or loss or as an adjustment against the asset previously recognised?

Staff analysis

15. The analysis below covers the following topics:

(a) Clarifying assumptions – paragraphs 16 to 32

(b) Presentation of views and analysis of **initial recognition** - paragraphs 33 to 62,

(c) Presentation of views and analysis on **subsequent measurement**- paragraphs 63 to 85, and

(d) Staff summary conclusion on the analysis - paragraphs 86 to 89.

Clarifying assumptions

Identification of situations that may arise in practice

16. The staff envisage below several situations in practice where a purchase agreement for a single asset may contain a contingent price:

    (a) The purchase price is not fixed at the date of purchase and the purchase agreement contains a contingent price feature that changes other than with the passage of time;

    (b) The contingent price covers a future purchase of goods or services; or

    (c) Control over the asset is not entirely transferred to the buyer until the contingency occurs.

17. The submission addresses situation (a). The staff think that the other situations (b) and (c) are distinctly different fact patterns. The paper therefore focuses only on (a).

18. More specifically, the staff believe that executory contracts such as licence agreements are not the subject of the submission. This is because those agreements involve the on-going performance through the life of the agreement in the form of continued provision of the licensed item and the staff are of the opinion that they fall under situation (b). Therefore focus in the following analysis is on agreements for the outright purchase of single assets.

19. The staff also considered contingent consideration that involves the transfer of equity instruments. In those instances the staff are of the opinion that the guidance in IFRS 2 *Share-based Payment* applies. In addition, the submission is focused on the transfer of assets, not the transfer of equity.

Review of existing IFRS guidance

20. The staff analyse, from paragraph 33 onwards, existing principles throughout IFRS literature to account for contingent prices arising from the purchase of single assets.

21. The staff note that IAS 16 and IAS 38 already provide guidance on the purchase of single assets. However, the staff identified a lack of specific guidance in relation to contingent prices. It is only this area that is the subject of the discussion in this paper. Therefore there may be a need to look to other standards for guidance in developing an appropriate accounting treatment for contingent prices.

22. Because the submission suggests a possible analogy to IFRS 3, the staff present, ahead of the analysis of existing principles across IFRSs, a discussion on whether such an analogy can be made.

Analogy to IFRS 3

Scope of IFRS 3 (revised 2008) – specific exclusion for the purchase of a group of assets

23. Paragraph 2(b) of IFRS 3, revised 2008 and now effective, specifically states that the requirements in IFRS 3 do not apply to the purchase of a group of assets. The paragraph is reproduced below for ease of reference:

> 2 This IFRS applies to a transaction or other event that meets the definition of a business combination. This IFRS does not apply to:
>
> (a) […]
>
> (b) the acquisition of an asset or a group of assets that does not constitute a *business*. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, *intangible assets* in IAS 38 *Intangible Assets*) and liabilities assumed. The <u>cost</u> of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative *fair values* at the date of purchase. Such a transaction or event does not give rise to goodwill (emphasis added).
>
> (c) [...].

24. In the following analysis, the staff assume that in the situation described in the submission, the asset or group of assets being purchased doesn’t have the features of a business as defined in Appendix A of IFRS 3.

25. In addition, in the analysis below, the staff refer to the purchase of a single asset rather than to the purchase of a group of assets because they believe this is the specific context of the submission.

Pros and cons for analogising contingent prices to contingent consideration under IFRS 3 (revised 2008)

26. The staff note that paragraph BC20 of IFRS 3 explains that extending the scope of IFRS 3 to all acquisitions of group of assets was considered as part of the phase 2 of the project on *Business Combinations*. The Board decided that it would require further research and deliberation.

27. Though the scope exclusion in IFRS 3 revised in 2008 is clear, some believe that paragraphs 7 to 12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* still provide for a possible analogy. This is because no specific technical reason not to apply the principles in IFRS 3 was provided at the time the 2008 revised version of IFRS 3 was discussed.

28. In that respect, the staff analyse the two different views below:

    (a) View A1 contingent prices for the purchase of separate assets should not be analogised to contingent consideration arising in business combinations;

    (b) View A2: an analogy to IFRS 3 is reasonable and consistent with the guidance in IAS 8.

29. The staff note that in accordance with paragraph 17 of IAS 16 the cost and fair value models upon initial recognition are different in that, at that date, transaction costs are included within the cost-based measure, but excluded in the fair value model in IFRS 3 (see paragraph 53 of IFRS 3).

30. The staff believe that the current different approaches in IFRSs to account for the acquisition of a business and to account for the purchase of a single asset should lead to two different accounting treatments.

31. Proponents of view A2 argue that upon initial recognition of a <u>single asset</u>, cost is initially the same as fair value, as it is measured as the cash price equivalent at the recognition date based on paragraph 23 of IAS 16. Cost is defined consistently in IFRSs in the context of PPE (see paragraph 6 of IAS 16, reproduced below for ease of reference), intangible assets (see paragraph 8 of IAS 38) and investment property (see paragraph 5 of IAS 40):

> *Cost* **is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment*.**

32. The staff propose an analysis of other standards before concluding on the appropriateness of an analogy to IFRS 3 – see paragraphs 33 onwards.

Presentation of views and analysis of <u>initial recognition</u>

33. The staff think that the analysis should be performed from both the asset cost and the liability perspective to determine the accounting. Therefore, the staff proposes the following approach for the analysis:

    (a) discussion of what cost is and whether a contingent price meets the definition of cost for the asset purchased,

    (b) discussion of what a financial liability is and whether a liability should be recorded in all cases to account for the contingent price,

    (c) difficulties under current literature in reconciling recognition of cost and liability upon initial recognition of the asset purchased, and

    (d) discussion of proposed literature in Board projects under consideration.

What is ‘cost’?

Existing literature

34. IAS 16, IAS 38 and IAS 40 *Investment Property* (cost model) require that an asset purchased be measured at cost, with measurement after recognition at cost less any accumulated depreciation and any accumulated impairment losses. Additions to the asset cost are accounted for as elements of the cost of the asset if they meet the initial recognition criteria.

35. The definition of cost is reproduced in paragraph 31 of this paper. In addition, paragraph 16 of IAS 16 provides guidance as to what comprises the cost of an item of PPE:

> 16. The cost of an item of property, plant and equipment comprises
>
> (a) […]
>
> (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
>
> (c) […]

36. The staff is of the opinion that a payment contingent to a future event, when no further good or service is to be provided and control of the asset purchased has been transferred, is an element of the cost of the asset purchased. This is because both the fixed element of the price agreed on the date of purchase and the agreement to pay the contingent element of the price are necessary for the buyer to take control of the asset purchased on the date of purchase.

Views from current Board projects under consideration

37. The staff note that considering that a contingent price is an element of the cost of an asset is consistent with recent decisions by the Board in the *Revenue Recognition* project.

38. In paragraph 36 of the *Revenue from Contracts with Customers* exposure draft, requirements for determining the transaction price clearly include variable

consideration. Further, this paragraph contains guidance that the entity should estimate the transaction price at each reporting period. For obvious economic reasons the staff is of the opinion that the purchase price of the asset for the buyer on the date of purchase should be the same as the transaction price for the seller.

Staff's view

39. Therefore, the staff are of the opinion that a contingent price should be considered a part of the fair value of the consideration given to purchase the asset. The buyer estimates the contingent price upon initial recognition if the amount for this additional price is reliably determinable.

What is a 'financial liability'?

40. Paragraph 11 of IAS 32 *Financial Instruments: Presentation* provides a definition of a financial liability:

> 11. A financial liability is any liability that is:
>
> (a) a contractual obligation :
>
> (i) to deliver cash or another financial asset to another entity; or
>
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
>
> (b) […]

41. For ease of reference the definition of a liability as set out in paragraph 49 of the *Conceptual Framework* is reproduced below:

> 49 The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:
>
> (a) […].
>
> (b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
>
> (c) […].

42. The staff note that a contingent price is a future payment, whose amount is conditional, that arises from a contractual agreement. Therefore, if a liability is recognised for a contingent price, it ought to be a financial liability as opposed to a non-financial liability under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

43. The staff is of the opinion that the guidance is clear that a contingent price meets the definition of a financial liability when the occurrence of the future event is outside the control of the buyer.

44. In those instances where the occurrence of the future event is within the control of the buyer, some believe that a present obligation exists and a liability should be recognised. They rely on paragraph AG8 of IAS 32 that states that satisfying a contractual obligation may be contingent on the occurrence of a future event:

> 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 <u>occurrence of a future event</u> (emphasis added). […]. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. […]

45. Some read paragraph AG8 as permitting recognition of a contractual obligation contingent on the occurrence of a future event that is within the control of the buyer.

46. The staff note that in that case, the buyer would have the ability to avoid payment and the staff is of the opinion that this is contrary to the existence of a present obligation.

47. The staff also note that paragraph 25 of IAS 32 states that contingent settlement provisions are considered to be financial liabilities only in cases where the acquirer is required to deliver cash in the event of the occurrence or non-occurrence of uncertain future events that are beyond the control of both the issuer and the holder of the instrument.

48. In addition, the staff note that an obligation that characterises a liability is defined in paragraph 60 of the *Conceptual Framework* (paragraph 4.15 of *The Conceptual*

Framework for Financial Reporting 2010) as ‘a duty or responsibility to act or perform in a certain way’. The staff believe that when the occurrence of the future event is within the control of the buyer, the corresponding obligation is not a duty or responsibility of the buyer to act or perform in a certain way. Therefore it is not a present obligation that characterises a liability.

49. Therefore the staff believe that under current IFRS literature a financial liability should be recognised to account for a contingent price only to the extent that the occurrence of the future event is outside the control of the buyer.

Difficulties under current literature arising from the recognition of cost and liabilities as discussed in paragraphs 33 through to 49

50. In cases when the occurrence of the event that triggers the payment of the contingent price is outside the control of the buyer, a financial liability should be recognised and the contingent price should be considered an element of the cost of the asset upon initial recognition. At that date, the buyer should estimate the cost of the contingent price and should record a financial liability for the same amount.

51. The staff note that a difficulty arises in situations when the buyer can avoid payment of the contingent price, eg when the contingent price is based on performance exclusively within the control of the buyer.

52. As outlined in paragraph 39 of this paper, even if the occurrence of the event that triggers the payment of the contingent price is within the control of the buyer the contingent price is an element of the cost of the asset. However, as expressed in paragraph 49 of this paper, the staff is of the opinion that in that case no liability should be recorded under current IFRS literature.

Analysis of proposed literature – Exposure draft on **Leases**

53. The staff note that different views are currently being considered as to the measurement upon initial recognition of liabilities. For example, in the *Leases* project, paragraph 12 of the exposure draft on *Leases* requires:

> **12 At the date of inception of the lease, a lessee shall measure:**
>
> **(a) the liability to make lease payments at the <u>present value of the lease payments</u> (see paragraphs 13–15), discounted using the *lessee's incremental borrowing rate* or, if it can be readily determined, *the rate the lessor charges the lessee* (see paragraph B11).** [emphasis added]
>
> **(b) the right-of-use asset <u>at the amount of the liability</u> to make lease payments, plus any *initial direct costs* incurred by the lessee (see paragraphs B14 and B15).** [emphasis added]

54. Paragraph 14 of the exposure draft explains 'present value of the lease payments':

> 14 A lessee shall determine the <u>present value of lease payments</u> payable during the lease term determined in accordance with paragraph 13 <u>on the basis of expected outcome</u>, determined using all relevant information. The expected outcome is the present value of the <u>probability-weighted average of the cash flows for a reasonable number of outcomes</u> (see paragraph B21). [emphasis added]

55. The staff note that a measurement of the contingent price based on the expected outcome would take into account the fact that the buyer can avoid payment as one possible outcome. Under this approach, the staff think that a financial liability would be recognised for the contingent price irrespective of whether the event that triggers the payment is within or outside the control of the buyer.

Possible consequences of the proposals in the project **Leases**

56. Given the directions in the *Leases* project as set out in paragraphs 53 to 55 of this paper, and given the difficulties identified raised by current IFRS literature as set out in paragraphs 50 to 52, the staff believe a path forward could be the recognition of the element of cost and the liability for the same amount measured upon initial recognition based on the probability-weighted average of the cash flows for a reasonable number of outcomes.

Analogy to IFRS 3

57. Because the fair value and cost models are different, the staff believe that applying the hierarchy in IAS 8 should not lead to analogising the accounting treatment for contingent prices for the purchase of single assets to the accounting treatment for contingent consideration arising in business combinations.

Staff conclusion on initial recognition

58. The staff view on initial recognition is that current guidance allows the contingent price to be considered an element of the cost of the asset purchased, but that in some circumstances, the contingent price does not meet the definition of a liability.

59. The staff note that:

    (a) IAS 32/IAS 39/IFRS 9 applies to the liability;

    (b) current literature (IAS 32/IAS 39/IFRS 9) prevents recognition of a liability when payment can be avoided; and

    (c) the leases proposals, if finalised as set out in the ED, will not change the accounting under IAS 32/IAS 39/IFRS 9 that will still apply.

60. As outlined in the analysis above, the staff believe current IFRS literature lacks clear guidance that leads to diversity in practice as set out in the submission. Therefore there is a need to reduce diversity in the initial accounting of contingent prices in purchase agreements of single assets.

61. In addition, the staff note that when a contingent price is a financial liability, it falls under the scope of IAS 39/IFRS 9 and should follow the classification requirements for financial liabilities, ie liabilities should be classified as at amortised cost or as at fair value through profit or loss.

Question 1 – Cost of the asset purchased
Does the Interpretations Committee agree that the contingent price in a purchase agreement is an element of the cost of the asset purchased?

Question 2 – Limit to the recognition of a financial liability
Does the Interpretations Committee agree with the analysis that, under current IFRS literature, the contingent price should be recognised as a financial liability only to the extent that the buyer does not have control over the realisation of the event that triggers the contingent price?

62. The staff acknowledge that the above analysis does not consider measurement upon initial recognition. If the Interpretations Committee decides to take the issue onto its agenda, then the staff will come back at a later meeting with further analysis on measurement upon initial recognition.

Presentation of views and analysis on <u>subsequent measurement</u>

63. Given the divergence of views that are highlighted in the submission with respect to the accounting for subsequent changes in the financial liability, the staff acknowledge that two views arise:

(a) View B1: the subsequent changes in the financial liability are the remeasurement of a financial liability and are independent of the asset. Accordingly, the remeasurement should not be adjusted against the carrying amount;

(b) View B2: the subsequent changes to the amount payable represent changes to the cost of the asset. Therefore adjustments should be reflected as increases or decreases to the carrying amount of that asset under the cost model.

Analysis of view B1 – IAS 39/IFRS 9 requirements

Consistency with IAS 39/IFRS 9 requirements

64. Proponents of view B1 advocate that there should be no departure from the accounting for financial liabilities from initial recognition through to settlement. They think that contingent prices that are financial liabilities should follow all of

IAS 39/IFRS 9 requirements upon initial recognition, for subsequent measurement and upon settlement.

65. The staff note that depending on the classification of the liability upon initial recognition as at amortised cost or as at fair value through profit or loss, subsequent changes have different measurement bases.

Analogy to IFRS 3 (revised 2008)

66. View B1 is consistent with the accounting for contingent consideration arising in business combinations. Paragraph 58 of IFRS 3 states that subsequent measurement of contingent consideration that is a financial liability affects profit or loss. This view brings in the issue of the analogy to the accounting treatment of contingent consideration in IFRS 3, discussed in paragraphs 23 to 32 of this paper.

67. In addition, the staff note that paragraph BC357 of the Basis for Conclusions to IFRS 3 explains that: ‘subsequent changes in value for post-combination events and circumstances should not affect the measurement of the consideration transferred or goodwill on the acquisition date’.

68. The staff has some sympathy for this view as it would provide for one accounting principle for contingent payments irrespective of whether such contingent payment is to purchase a business or a single asset.

Interaction with the cost of the asset purchased

69. The staff note that taking the view that subsequent changes in contingent prices are not an element of the cost of the asset purchased - which means that such changes should be expensed when they occur - is consistent with view B1 that subsequent changes to the financial liability to account for contingent prices be recognised in profit or loss.

Analysis of existing literature on contingent rents in IAS 17 Leases

70. The staff believe that to complete the analysis it is useful to consider the current requirements for contingent rents as defined in paragraph 4 of IAS 17 reproduced below for ease of reference:

> **4 […]**
>
> ***Contingent rent* is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (eg percentage of future sales, amount of future use, future price indices, future market rates of interest).**
>
> **[…]**

71. The staff note that the definition of contingent rent is close to what the staff believe a contingent price arising in the purchase of a single asset is. In that sense, the staff believe there are some merits in analogising the accounting for contingent prices and the accounting for contingent rents.

72. Paragraph 25 of IAS 17 states that contingent rents for financial leases should be expensed in the periods in which they are incurred. The staff note that this requirement is contrary to the analysis of the contingent price being an element of the cost of the asset purchased.

73. In addition, the staff note that the Interpretations Committee published an agenda decision in July 2006 that recommended that the Board amend IAS 17 to clarify the accounting for contingent rentals.

Proposed literature – Exposure draft on Leases

74. The staff note that a project is currently proposing a change to the accounting for contingent rentals. For ease of reference, the proposed definition for contingent rentals is reproduced below:

contingent rentals	**Lease payments** that arise under the contractual terms of a **lease** because of changes in facts or circumstances occurring after the **date of inception** of the lease, other than the passage of time.

75. The exposure draft *Leases* proposes that contingent rentals be included within the present value of lease payments (liability for the lessee) as stated in paragraph 14(a) of the ED. The proposals for the accounting for subsequent changes are set out in paragraph 18 of the ED. Subsequent changes in contingent rentals should be recognised:

 (a) in profit or loss to the extent that those changes relate to current or prior periods.

 (b) as an adjustment to the right-of-use asset to the extent that those changes relate to future periods.

76. The staff note that considering that a contingent price arising in the purchase of single assets is an element of the cost of the asset is consistent with the project *Leases*.

77. With respect to the measurement of subsequent changes to the contingent price, the staff note that view B2 discussed above is consistent with the proposed requirements in paragraph 18(b) of the exposure draft *Leases*.

Staff's views

78. The staff note that there is support in current literature for accounting for subsequent changes arising from the remeasurement of the financial liability in profit or loss. This support can be found in:

 (a) IAS 32/IAS 39/IFRS 9;

 (b) An analogy to contingent consideration in IFRS 3; and

 (c) An analogy to contingent rents in IAS 17.

Analysis of view B2 – remeasurement of the financial liability entails adjustments to the cost of the asset

79. Under view B2, the primary driver of the recognition of the liability is the view that the contingent price is an element of the cost. This is consistent with the

historical cost concept that suggests that the cost of the asset is what was paid for it [refer to arguments set out in initial measurement section].

80. The staff note that IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* contains accounting requirements for a component of cost that arises from a liability that falls under the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In accordance with IFRIC 1, subsequent changes to the liability should be recognised as an adjustment to the related component of cost for the asset purchased; the periodic unwinding of the discount shall be recognised in profit or loss as a finance cost as it occurs.

81. As discussed in paragraphs 73 and 74 of this paper, the exposure draft *Leases* proposes that contingent rentals be included within the present value of lease payments. The ED also provides for subsequent changes in contingent rentals to be recognised:

    (a) in profit or loss to the extent that those changes relate to current or prior periods.

    (b) as an adjustment to the right-of-use asset to the extent that those changes relate to future periods.

82. The staff note that considering that a contingent price arising in the purchase of single assets is an element of the cost of the asset is consistent with the project *Leases*.

83. The staff is concerned that allowing subsequent changes to the contingent price to be adjusted to the cost of the asset could create a departure from current requirements in IAS 39/IFRS 9.

84. However, the staff favour view B2 as being the view that better reflects the price to pay to obtain control of the asset from the date of purchase.

85. At this stage of the analysis, the staff seek directions from the Interpretations Committee.

Question 3 – Accounting for subsequent changes
Does the Interpretations Committee agree with the staff's view that the subsequent changes to the amount payable represent changes to the cost of the asset - and therefore adjustments should be reflected as increases or decreases to the carrying amount of that asset under the cost model?

Staff's overall conclusion

86. The staff note that conflicting views currently exist on the accounting for contingent prices upon initial recognition and subsequent measurement. Applying current IFRS literature may lead to different accounting treatments for similar agreements.

87. More specifically, the staff believe that applying current literature might lead to account for a contingent price as an element of cost of the asset purchased on initial recognition with subsequent changes recognised in profit or loss, hence having no impact on the cost of the asset after initial recognition. The staff think this would inappropriately lead to a cost based on an estimate that is not to be corrected for future events.

88. Therefore the staff favour an accounting treatment that would recognise the full cost once the contingencies realise as this adequately reflects the price of the asset purchased. The staff believe that this view enhances comparability between entities.

89. Therefore the staff recommends that guidance be developed specifically.

Question 4 – Need for guidance on the accounting for the initial recognition and subsequent measurement of liabilities arising in the purchase of single assets
Does the Interpretations Committee agree that further guidance should be provided within IFRSs to reduce divergence in practices to account for the initial recognition of financial liabilities that are contingent prices? If so, does the Interpretations Committee agree that directions in current projects, eg *Leases*, could provide a sound background to further analysis? Does the Interpretations Committee agree that an accounting model similar to the accounting model in IFRIC 1 is an appropriate path forward? If not, what path forward would the Interpretations Committee recommend that the staff explore?

Agenda criteria assessment

90. The staff's assessment of the Interpretations Committee's agenda criteria is as follows:

(a) *The issue is widespread and has practical relevance.*

The issues described in this document are widespread and are of practical relevance.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

There are currently differing views as to how to account for contingent prices upon initial recognition and for subsequent changes, which lead to different treatments.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Financial reporting would be improved by clarifying this issue. The accounting for contingent price arising from the purchase of separate items of property, plant and equipment (IAS 16) or intangible assets (IAS 38) is outside the scope of IFRS 3. An appropriate interpretation from the IFRS Interpretations Committee would enhance comparability among companies' financial reporting.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

The issue is sufficiently narrow in order to be addressed by an interpretation of the IFRS Interpretations Committee.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Although there is a lack of guidance, the staff believe the solution proposed is consistent with current IFRS literature. Therefore, at this stage of the analysis the staff does not foresee any major reason why the Interpretations Committee should not reach a consensus on a timely basis.

(f) *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).*

The issue does not relate to a current Board project.

Staff's recommendation

91. Given the agenda criteria assessment above and because there is a current lack of specific guidance in IFRSs with respect to the accounting for contingent prices arising in the purchase of single assets, the staff recommend that the Interpretations Committee take the issue to its agenda.

92. In addition, the staff note that to the best of their knowledge, US GAAP does not provide for guidance on the accounting for contingent prices arising from the purchase of single assets.

93. If the Interpretations Committee agrees to take the issue forward, the staff will provide further analysis of practical examples.

Question to the Interpretations Committee

Question 5 – Limit to an analogy to IFRS 3
Does the Interpretations Committee agree that the accounting for contingent prices should not be analogised to the accounting for contingent consideration arising in business combinations?

Question 6 – Staff's recommendation
Does the Interpretations Committee agree with the staff's recommendation to take the issue to its agenda?

Appendix A – Interpretations Committee potential agenda item request

I. The issue

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.

IASB Staff paper
Appendix A

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.

<u>Question 2 - View B:</u>

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.

Appendix B – IFRS 3 *Business Combinations* paragraphs BC343 to BC360

Contingent consideration, including subsequent measurement

BC343 In accordance with the guidance in SFAS 141, which was carried forward from APB Opinion 16 without reconsideration, an acquirer's obligations to make payments conditional on the outcome of future events (often called *contingent consideration*) were not usually recognised at the acquisition date. Rather, acquirers usually recognised those obligations when the contingency was resolved and consideration was issued or became issuable. In general, issuing additional securities or distributing additional cash or other assets upon resolving contingencies on the basis of reaching particular earnings levels resulted in delayed recognition of an additional element of cost of an acquiree. In contrast, issuing additional securities or distributing additional assets upon resolving contingencies on the basis of security prices did not change the recognised cost of an acquiree.

BC344 The IASB carried forward in IFRS 3 the requirements for contingent consideration from IAS 22 without reconsideration. In accordance with IFRS 3, 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.

BC345 Therefore, in accordance with both SFAS 141 and IFRS 3, unlike other forms of consideration, an obligation for contingent consideration was not always measured at its acquisition-date fair value and its remeasurement either sometimes (SFAS 141) or always (IFRS 3) resulted in an adjustment to the business combination accounting.

BC346 In developing the 2005 Exposure Draft, both boards concluded that the delayed recognition of contingent consideration in their previous standards on business combinations was unacceptable because it ignored that the acquirer's agreement to make contingent payments is the obligating event in a business combination transaction. Although the amount of the future payments the acquirer will make is conditional on future events, the obligation to make them if the specified future events occur is unconditional. The same is true for a right to the return of previously transferred consideration if specified conditions are met. Failure to recognise that obligation or right at the acquisition date would not faithfully represent the economic consideration exchanged at that date. Thus, both boards concluded that obligations and rights associated with contingent consideration arrangements should be measured and recognised at their acquisition-date fair values.

BC347 The boards considered arguments that it might be difficult to measure the fair value of contingent consideration at the acquisition date. The boards acknowledged that measuring the fair value of some contingent payments may be difficult, but they concluded that to delay recognition of, or otherwise ignore, assets or liabilities that are difficult to measure would cause financial reporting to be incomplete and thus diminish its usefulness in making economic decisions.

BC348 Moreover, a contingent consideration arrangement is inherently part of the economic considerations in the negotiations between the buyer and seller. Such arrangements are commonly used by buyers and sellers to reach an agreement by sharing particular specified economic risks related to uncertainties about future outcomes. Differences in the views of the buyer and seller about those uncertainties are often reconciled by their agreeing to share the risks in such ways that favourable future outcomes generally result in additional payments to the seller and unfavourable outcomes result in no or lower payments. The boards observed that information used in those negotiations will often be helpful in estimating the fair value of the contingent obligation assumed by the acquirer.

BC349 The boards noted that most contingent consideration obligations are financial instruments, and many are derivative instruments. Reporting entities that use such instruments extensively, auditors and valuation professionals are familiar with the use of valuation techniques for estimating the fair values of financial instruments. The boards concluded that acquirers should be able to use valuation techniques to develop estimates of the fair values of contingent consideration obligations that are sufficiently reliable for recognition. The boards also observed that an effective estimate of zero for the acquisition-date fair value of contingent consideration, which was often the result under IFRS 3 and SFAS 141, was unreliable.

BC350 Some respondents to the 2005 Exposure Draft were especially concerned about the reliability with which the fair value of performance-based contingent consideration can be measured. The IASB and the FASB considered those concerns in the context of related requirements in their standards on share-based payments (IFRS 2 and SFAS 123(R), respectively), neither of which requires performance conditions that are not market conditions to be included in the market-based measure of an award of share-based payment at the grant date. For example, remuneration cost is recognised for a share option with vesting requirements that depend on achievement of an earnings target based on the number of equity instruments expected to vest and any such cost recognized during the vesting period is reversed if the target is not achieved. Both IFRS 2 and SFAS 123(R) cite constituents' concerns about the measurability at the grant date of the expected outcomes associated with performance conditions as part of the reason for that treatment.

BC351 The boards concluded that the requirements for awards of share-based payment subject to performance conditions should not determine the requirements for contingent (or conditional) consideration in a business combination. In addition, the boards concluded that the negotiations between buyer and seller inherent in a contingent consideration arrangement in a business combination provide better evidence of its fair value than is likely to be available for most share-based payment arrangements with performance conditions.

BC352 The boards also noted that some contingent consideration arrangements oblige the acquirer to deliver its equity securities if specified future events occur. The boards concluded that the classification of such instruments as either equity or a liability should be based on existing IFRSs or US GAAP, as indicated in paragraph 40 of the revised IFRS 3.

Subsequent measurement of contingent consideration

BC353 For reasons similar to those discussed in the context of contingent liabilities (paragraphs BC232 and BC243), the boards concluded that the revised standards must address subsequent accounting for contingent consideration. For consistency with the accounting for other obligations that require an entity to deliver its equity shares, the boards concluded that obligations for contingent payments that are classified as equity should not be remeasured after the acquisition date.

BC354 The boards observed that many obligations for contingent consideration that qualify for classification as liabilities meet the definition of derivative instruments in IAS 39 or SFAS 133. To improve transparency in reporting particular instruments, the boards concluded that all contracts that would otherwise be within the scope of those standards (if not issued in a business combination) should be subject to their requirements if issued in a business combination. Therefore, the boards decided to eliminate their respective provisions (paragraph 2(f) of IAS 39 and paragraph 11(c) of SFAS 133) that excluded contingent consideration in a business combination from the scope of those standards. Accordingly, liabilities for payments of contingent consideration that are subject to the requirements of IAS 39 or SFAS 133 would subsequently be measured at fair value at the end of each reporting period, with changes in fair value recognised in accordance with whichever of those standards an entity applies in its financial statements.

BC355 In considering the subsequent accounting 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.

BC356 The boards also considered whether subsequent changes in the fair values of liabilities for contingent consideration should be reflected as adjustments to the consideration transferred in the business combination (usually in goodwill). Some respondents to the 2005 Exposure Draft favoured that alternative because they thought that changes in the fair value of contingent consideration effectively resolve differing views of the acquirer and the former owners of the acquiree about the acquisition-date fair value of the acquiree. The boards acknowledged that a conclusive determination at the acquisition date of the fair value of a liability for contingent consideration might not be practicable in the limited circumstances in which particular information is not available at that date. As discussed in more detail in paragraphs BC390–BC400, the boards decided that the revised standards should provide for provisional measurement of the fair value of assets acquired or liabilities assumed or incurred, including liabilities for contingent payments, in those circumstances.

BC357 Except for adjustments during the measurement period to provisional estimates of fair values at the acquisition date, the boards concluded that subsequent changes in the fair value of a liability for contingent consideration do not affect the acquisition-date fair value of the consideration transferred. Rather, those subsequent changes in value are generally directly related to post-combination events and changes in circumstances related to the combined entity. Thus, subsequent changes in value for post-combination events and circumstances should not affect the measurement of the consideration transferred or goodwill on the acquisition date. (The boards acknowledge that some changes in fair value might result from events and circumstances related in part to a pre-combination period. But that part of the change is usually indistinguishable from the part related to the post-combination period and the boards concluded that the benefits in those limited circumstances that might result from making such fine distinctions would not justify the costs that such a requirement would impose.)

BC358 The boards also considered arguments that the results of the requirements of the revised standards for recognition of changes in the fair value of contingent consideration after the acquisition date are counter-intuitive because they will result in:

(a) recognising gains if the specified milestone or event requiring the contingent payment is not met. For example, the acquirer would recognise a gain on the reversal of the liability if an earnings target in an earn-out arrangement is not achieved.

(b) recognising losses if the combined entity is successful and the amount paid exceeds the estimated fair value of the liability at the acquisition date.

BC359 The boards accept the consequence that recognising the fair value of a liability for payment of contingent consideration is likely to result subsequently in a gain if smaller or no payments are required or result in a loss if greater payments are required. That is a consequence of entering into contingent consideration arrangements related to future changes in the value of a specified asset or liability or earnings of the acquiree after the acquisition date. For example, if a contingent consideration arrangement relates to the level of future earnings of the combined entity, higher earnings in the specified periods may be partially offset by increases in the liability to make contingent payments based on earnings because the acquirer has agreed to share those increases with former owners of the acquiree.

BC360 The boards also observed that liabilities for contingent payments may be related to contingencies surrounding an outcome for a particular asset or another liability. In those cases, the effect on income of the period of a change in the fair value of the liability for the contingent payment may be offset by a change in the value of the asset or other liability. For example, after an acquisition the combined entity might reach a favourable settlement of pending litigation of the acquiree for which it had a contingent consideration arrangement. If the combined entity is thus required to make a contingent payment to the seller of the acquiree that exceeds the initially estimated fair value of the liability for contingent consideration, the effect of the increase in that liability may be offset in part by the reduction in the liability to the litigation claimant. Similarly, if the acquirer is not required to make a contingent payment to the seller because an acquired research and development project failed to result in a viable product, the gain from the elimination of the liability may be offset, in whole or in part, by an impairment charge to the asset acquired.