Project	**IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*—Contingent pricing of property, plant and equipment and intangible assets**
Topic	**Scope and analysis of possible accounting treatments**

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. At its meeting in January 2011 the Interpretations Committee decided to take the issue onto its agenda.

Purpose of the paper

3. The objective of this paper is to:

   (a) provide background information on the issue and on outreach activities performed to date;

   (b) outline the scope of the project and seek consensus from the Interpretations Committee on the proposed scope;

   (c) provide an analysis on possible alternatives to account for contingent prices;

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

(d) ask for directions from the Interpretations Committee on those alternatives;

(e) ask whether the Interpretations Committee agrees with the staff's recommendations; and

(f) propose a timetable for the project (see Appendix D of this paper).

Background information

Directions from the Interpretations Committee meeting in January 2011

4. At its meeting in January 2011, the Interpretations Committee directed the staff to perform work that would provide background information for discussing:

   (a) the scope of the project; and

   (b) alternatives for the accounting for contingent prices for the purchase of a single item of PPE.

5. The staff performed outreach activities and received feedback from interested parties. Feedback received was mainly in the form of practical examples of situations that involved contingent pricing arrangements and their related accounting treatments.

6. In reviewing the examples provided, the staff can confirm that diversity exists in practice in that:

   (a) examples were provided for:

      (i) a broad range of industries such as real estate, extractive industries, the pharmaceutical industry, the telecom industry, airport activities; and

      (ii) situations ranging from the purchase of a single item of PPE or an investment property (under the cost model) to licensing agreements for the right to use intangible assets.

(b) Contingent prices are accounted for differently with respect to initial recognition and subsequent measurement.

7. Appendix A provides background information on the issue, mainly presented at the meeting in January 2011, and reproduced for ease of reference.

8. The issue was presented in January 2011 in Interpretations Committee agenda paper 10[1].

Insight from recent US GAAP attempts to address a closely related issue

9. As part of their research, the staff were made aware that the FASB Emerging Issues Task Force had discussed the issue of how an entity should account for contingent consideration related to an asset acquisition. This issue was discussed in 2009 and referenced as issue No. 09-2.

10. The staff's understanding is that this issue was specifically raised within the context of research and development assets. In addition, the staff acknowledge that, in accordance with Topic 730 *Research and Development* in the *FASB Accounting Standards Codification®,* research and development assets are only recognised if the assets have a future alternative use; otherwise the assets are expensed at the acquisition date.

11. An extract of the minutes from the November 19, 2009 EITF meeting states that:

> 12. […] the Task Force reached a consensus-for-exposure that contingent consideration in an asset acquisition shall be accounted for in accordance with existing U.S. GAAP. For example, if the contingent consideration meets the definition of a derivative, the guidance related to accounting for derivatives and hedging in Topic 815 would require that it be recognized at fair value. The guidance related to accounting for contingencies in Topic 450 may require recognition of the contingent consideration if it is probable that a liability has been incurred and the amount of that liability can be reasonably estimated. In addition, the guidance in Subtopic 323-10 related to equity method investments may require the recognition of contingent consideration if it relates to the acquisition of an investment that is accounted for under the equity method. When contingent

[1] The paper is available on the following link: http://www.ifrs.org/NR/rdonlyres/A3187A86-D4AF-4F25-9FD9-F9DD305E51C2/0/101101obs10IAS16IAS38Contingentprices.pdf.

> consideration relating to the acquisition of the asset is recognized at inception in accordance with existing U.S. GAAP, such amount would be included in the initial measurement of the cost of the acquired assets. If a contingent payment relating to the asset acquisition is subsequently made that is not recognized at the inception of the arrangement, that payment would be capitalized as part of the cost of the asset. However, if the contingent consideration arrangement is a derivative, changes in the fair value of a derivative instrument subsequent to inception would not be recognized as part of the cost of the asset.
>
> 13. Task Force members noted that this decision does not fully align the accounting for research and development assets acquired in asset acquisitions and business combinations. Some Task Force members were supportive of recognizing all contingent consideration at fair value consistent with the accounting in a business combination. Those Task Force members believed that recognition of contingent consideration at fair value resulted in a better reflection of the economics of the transaction and provided more useful information to investors. Other Task Force members were concerned with complexities associated with recognizing contingent consideration in an asset acquisition at fair value.

12. However, the staff understand that no final decision was reached on the issue.

Highlights from background information

13. Outreach activities performed confirmed that the issue is widespread across industries and that situations with common economic features may be accounted for in different ways.

14. The staff believe that there is room, within the confines of current IFRSs, for interpreting to what extent an additional payment conditional upon the realisation of an event after the asset's recognition date is an element of the asset's cost.

15. In addition, because IFRSs are generally silent as to how to account for the debit side of a liability upon initial recognition, the staff is of the opinion that interpretive guidance in the situations that fall under the narrow scope defined below would be welcome.

Purpose of the analysis in this paper

16. The purpose of the following analysis is to:

(a) outline the confines of the scope; and

(b) propose for discussion alternative accounting treatments within those confines.

Definition of the scope of the project

17. The staff note from their review of the practical examples received that contingent prices may arise from the outright purchase of long-term assets or inventory or from licensing agreements. In some cases, the contingent price is variable and based on future sales or future volumes; in other instances, the contingent price is fixed and payable upon the achievement of milestones specified in the purchase agreement. Alternatively it is fixed and payable upon the buyer obtaining an approval from a regulatory body.

18. The staff highlight below the main characteristics of contingent prices as they appear through the practical examples received with a view to helping to outline the scope of the project.

Characteristics of contingent prices

Effect on the cost of the asset purchased

19. The definition of cost in IAS 16 and IAS 38 is reproduced in Appendix B for ease of reference. Further to that definition, those standards describe the elements the cost of the asset purchased in paragraph 16 of IAS 16 and paragraph 27 of IAS 38 (also reproduced in Appendix B). The staff note that when describing the cost model, IFRSs are silent on whether contingent prices should be considered an element of the cost of the asset purchased.

20. From the analysis of the practical examples received, the staff note that contingent prices are interpreted in various ways as to whether they are elements of the cost of the asset purchased. Some believe that the contingent price should be considered an element of the cost of the asset when it can be reliably estimated on

the date of purchase, even if the triggering event occurs after initial recognition. Others believe that the cost definition implies that cost only includes amounts attributed to an asset when it is initially recognised (i.e. excluding amounts contingent on future events).

21. The staff note that the definition of the cost of an asset in paragraph 6 of IAS 16 or paragraph 8 of IAS 38 refers to ‘the time of its acquisition’ or ‘when initially recognised’ (see Appendix B to this paper for ease of reference). The staff also note that the cost of the asset comprises its purchase price plus ‘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’. From this point on in the analysis, the staff uses the ‘date the asset is ready for its intended use’ to refer to subparagraph 16(b) of IAS 16 or subparagraph 27(b) of IAS 38.

22. The staff believe that for the purpose of determining an accounting treatment for contingent prices, the ‘date the asset is ready for its intended use’ is a cut-off date to determine which costs are elements of the cost of the asset purchased.

23. A reason for the cut-off date mentioned above is that it is usually difficult to tie the contingent price to the asset purchased rather than to the activity or business to which the asset belongs to once it is ready for its intended use.

24. In addition, the staff believe that additional payments based on the realisation of events after the date the asset is ready for its intended use are representative of the value of the asset at the date of realisation of the event rather than of its cost ‘at the time of its acquisition’. The staff note that the value of the asset after recognition is not reflected in the cost model in IFRSs.

25. The staff also note that the date the asset is ready for its intended use is also the date of commencement of depreciation as defined in paragraph 55 of IAS 16. To the staff, this emphasises that costs incurred beyond that date are not part of the cost of the initial asset purchased.

Different variables

26. Through their review of examples received, the staff could identify the following features on which contingent pricing is more commonly based:

    (a) performance and usage of the asset;

    (b) performance of the entity;

    (c) of an index; and

    (d) upon obtaining a regulatory approval.

Performance and usage

27. In the staff's opinion, a contingent price based on performance or usage may be difficult to link to the initial cost of the asset purchased. Such a contingent price reflects events in the asset's operating phase and thus the contingent price is indistinguishable from changes in value of the asset after the date that it is ready for intended use. Thus the contingent price cannot be said to be reflective solely of the cost of the initial asset purchased. This is in relation to the analysis in paragraphs 22 to 25 above.

28. The staff believe that a contingent price based on <u>future performance</u> that would be recognisable on the date of purchase would be measured using an estimate of future <u>cash inflows</u>. The staff is of the opinion that such a measurement is more an attribute of fair value measurement throughout the life of the asset than being representative of the cost model upon initial recognition of the asset.

Indices

29. For contingent prices based on indices, the staff note that there may be indices that would be directly linked to the asset (eg an index of the gold price for an item of PPE principally made of gold), while others could be entirely disconnected from the asset purchased. The staff believe that a direct link to the asset indicates that the contingent price has an effect upon the cost of the asset purchased. Otherwise, if it can be demonstrated that the contingent price is a financial instrument held for

trading purposes, it should be accounted for separately in accordance with IAS 39/IFRS 9 and with no impact upon the initial cost of the asset.

30. However, the staff believe that changes in an index after purchase, even if closely related to the asset, reflect changes in environmental factors after the date of purchase. For example, gold and oil prices change daily (even hourly) in response to world events. Thus contingent prices linked to commodity prices such as these reflect events after the date of purchase rather than providing a better assessment of cost at the date of purchase.

Obtaining regulatory approval

31. To illustrate paragraph 26(c) in this paper, in some situations, a contingent price may be fixed in amount, but the additional payment would be triggered by the occurrence of an event specific to the asset at a single point in time. From the examples reviewed, the events can range from the achievement of a predefined milestone in the purchase agreement; to the buyer obtaining an approval from another party. In those cases, the staff assume that the event is linked to the specific asset purchased and that the additional payment does not account for the provision of further goods or services by the seller. The staff is of the opinion that the additional payment is an element of the original cost of the asset to the extent that it is triggered prior to the asset being ready for its intended use.

Proposed indicators to outline the scope of the project

32. The staff believe that whether contingent prices reflect the cost of the asset purchased should be a primary driver for inclusion within the scope of the project. The analysis above provides for indicators that the staff believe help to outline the scope of the project.

Non-representative of compensation for the provision of further goods or services

33. Contingent pricing in an agreement to purchase a single asset should not be representative of further surplus of goods or services by the seller to the buyer.

Outright purchase of an asset rather than purchase of a right to use an asset

34. Because in the purchase of a right to use an asset the seller typically controls the residual underlying asset, the staff believe that this is a different pattern to the case addressed in the submission.

35. Addressing contingent pricing arising from the purchase of a right to use an asset would widen the scope of the project with consequences not fully analysed at this stage of the project.

36. In addition, the staff think that the purchase of a right to use an asset reflects a continuing performance through the life of the agreement from the seller in the form of continued provision of the licensed item.

Cost incurred between the date the asset is recognised and it is ready for its intended use

37. As discussed in paragraphs 19 to 25 above, the staff believe that whether costs are incurred within the period between the date of purchase (ie the date the buyer obtains control of the asset) and the date when the asset is ready for its intended use is the primary factor to consider for the recognition of the contingent price as an element of the cost of the initial asset purchased.

38. In that regard, paragraph 20(a) of IAS 16 states that costs incurred in the period after the asset is ready for its intended use, but before the asset is in use, should not be included in the carrying amount of an item of PPE. The staff believe that in order to remain consistent with the cost of an asset upon initial recognition in current IFRSs, contingent pricing that is to be considered an element of the cost of an asset purchased should follow the same requirements.

39. In addition, the staff believe that contingent price based on events that occur after the asset is ready for its intended use reflects changes in the value of the asset in

operation rather than its cost upon initial recognition. The contingent price is indistinguishable from changes in the value of the asset after the date it is ready for its intended use.

40. The staff think that contingent prices based on future performance or usage are therefore excluded from the cost of an asset purchased.

Contingent pricing specific to the asset

41. The staff believe that a contingent price based on the occurrence of an event disconnected from the asset should not have an effect upon the cost of the asset upon initial recognition. This is because the cost of an asset is made up of costs that are typically 'directly attributable' to the asset.

42. The staff think that events that are disconnected from the asset include, for example, sales or volumes thresholds, beside the fact that these are thresholds that can only be reached after the date when the asset is ready for its intended use. On the contrary, obtaining an approval prior to an asset being ready for use is an event that is directly attributable to that asset.

Cost model versus revaluation model

43. The staff are aware that the measurement of cost upon initial recognition in both the cost and the revaluation models is the same. However, the staff would need to further explore the interaction with subsequent remeasurement in the revaluation model. Difficulties may arise in cases where, for an asset subsequently measured under the revaluation model, the contingent price is recognised as an element of the cost of the asset subsequent to a revaluation. Should the increase/decrease in the asset's carrying amount resulting from the revaluation be retrospectively corrected for the additional portion of cost arising from the payment of the contingent price?

44. For these reasons, the staff believe that assets subsequently measured using the revaluation model should be excluded initially from the scope of the project. This

decision should be reconsidered after conclusions reached on the accounting for contingent prices using the cost model.

Contingent pricing giving rise to a financial instrument

45. At this stage of the project, because most practical examples reported to the staff as part of their outreach activities are contingent prices payable in cash, the staff have focused exclusively on the accounting for such contingent pricing.

Items to be addressed by the project

46. At this stage of the analysis, in terms of assets in existing IFRSs that would be covered by the project, the scope would include:

    (a) all tangible assets under IAS 16 using the cost model;

    (b) intangible assets that are not the purchase of a right to use an asset under IAS 38 and that are accounted for under the cost model; and

    (c) investment properties at cost under IAS 40 *Investment Property*.

47. Several other assets would be excluded:

    (a) PPE and intangible assets that are measured under the revaluation model;

    (b) investment properties at fair value;

    (c) inventories: although the staff can think of no technical arguments at this stage to exclude inventories, the staff have not performed an analysis of the consequences of including items from IAS 2 *Inventories* within the scope. This could be reconsidered as the project progresses;

    (d) assets that would fall under the scope of IFRS 6 *Exploration for and Evaluation of Mineral Resources*: the staff acknowledge that a number of practical examples received were from the extractive and mining industries and are related to assets that fall within the scope of IFRS 6. The staff note that IFRS 6 provides for an entity's choice as to the accounting for costs (either to be expensed or capitalised) based in part

upon the entity's previous GAAP accounting policies. Such costs are incurred before commercialisation is demonstrable. Consequently, the fact patterns are significantly different from the one raised in the submission. The staff therefore believe that it would be best not to address such cases within the scope of this project; and

(e) biological assets, because they are accounted for at fair value.

Question to the Interpretations Committee

48. The staff identified and discussed in paragraphs 32 to 45 above the following common indicators for contingent prices within the scope of the project:

(a) non-representative of compensation for the provision of further goods or services;

(b) for the outright purchase of an asset rather than purchase of a right to use an asset;

(c) incurred between the date the asset is recognised and it is ready for its intended use;

(d) specific to the asset;

(e) arising from agreements to purchase items accounted for in accordance with the cost model ; and

(f) giving rise to a financial instrument.

49. The staff wish to ask for the views of the Interpretations Committee on the proposed scope before going further into the analysis of alternatives for the accounting treatment:

Question 1—scope of the project
(a) Does the Interpretations Committee agree that the proposed indicators in paragraph 48 outline efficiently the scope of the project?
(b) Does the Interpretations Committee agree with the items that fall under the scope of the project as listed in paragraph 46 and with the items that would be excluded as listed in paragraph 47?
(c) Can the Interpretations Committee think of other indicators that would help to outline the scope?
(d) Does the Interpretations Committee see a hierarchy for those indicators or should they all be given the same weight in deciding whether a contingent price falls within the scope of this project?
(e) Does the Interpretations Committee agree to direct the staff to draft a scope based on those indicators?

Analysis of possible accounting treatments

50. Because contingent prices arise from purchase agreements and are usually settled in cash, they are contractual; hence, when they become an obligation (a right), they usually meet the definition of financial instruments as set out in paragraph 11 of IAS 32 *Financial Instruments: Presentation*. Having reviewed the examples received as part of their outreach activities the staff noted that in practice the buyer will deliver cash to settle the contingent price. The staff are aware, though, that in some situations the liability may be subsequently reassessed at a lower amount than the amount that was measured upon initial recognition. Those variations in measurement are more likely to be a reduction in the financial liability than a reduction in a financial asset. Consequently, the staff focus on instances where the contingent price is a financial liability.

51. The staff believe that for contingent prices that fall into the scope outlined above, those contingent prices represent an element of the cost of the initial asset purchased.

52. The staff note that the timing of recognition of the contingent price as an element of the cost of the asset purchased is dependent on the recognition of the related financial liability.

53. To the staff, the narrow scope defined above opens up two situations depending on whether the contingent price is a contractual obligation on the date of purchase or at a later date. These two situations were described in the original submission with reference to whether or not the buyer is able to avoid the payment of the contingent price.

Obligation or not on the date of purchase

No obligation on the date of purchase

54. In accordance with the analysis in paragraphs 40 through to 52 of the agenda paper 10 presented at the Interpretations Committee in January 2011, the staff believe that when the realisation of the event that triggers the additional payment is within the control of the buyer, there is no obligation before the event occurs. Consequently, no liability should be recognised before it becomes an obligation of the buyer. The paragraphs mentioned above are reproduced in Appendix C for ease of reference.

55. In addition, the staff note that paragraph 13 of IAS 32 introduces the 'little, if any discretion to avoid' feature as one characteristic of contractual agreements:

> 13. In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing. [emphasis added].

56. In practice, the staff are of the opinion that a rational economic behaviour is for the buyer to abide by the agreement to make the most of the asset purchased.

However, the staff are also aware that when managing a portfolio of assets purchased but still to be brought to a state where ready for use, an entity may choose to focus its activities on those projects that are more likely to reach the ready-to-use phase and to generate cash inflows. As a result, a rational economic behaviour may be compromised by other parameters and should not be a basis for accounting. In other words, where a buyer can avoid payment for a contingent price because the contingent event is within its control, the staff is of the opinion that no liability should be recognised, even if the buyer is obliged to make "best efforts" in developing the asset, that could lead to the additional payment being triggered.

57. The staff recall from the discussions in January that there was general agreement among the Interpretations Committee members not to recognise a liability on the date of purchase unless there was an obligation to deliver cash to settle the contingent price as at that date, that could not be avoided.

58. The staff note that IAS 32 is silent on the accounting for the corresponding entry (the debit) upon initial recognition of a financial liability. Consequently, the staff believe that it would be useful to provide interpretive guidance that a contingent price in the scope of the project that is an element of the cost of the asset purchased should adjust the cost of the asset by the same amount as the amount recognised as a financial liability at the date when the obligation arises.

59. The obligation arises upon realisation of the contingent event. The staff therefore note that the amount of the liability is certain at that date and the liability will not be subsequently remeasured, other than to reflect the time value of money if the amount is not payable immediately.

60. The staff also note that because the asset is not yet ready for its intended use, depreciation has not begun. The staff believe that where the contingent price increases the cost of the asset, there should be no impact upon profit or loss. However, the staff note that where the contingent price decreases the cost of the asset, this should be considered as an indicator that the asset may be impaired.

Obligation on the date of purchase

61. An obligation relating to a contingent price might arise on the date of purchase, but for which the contingency has not yet occurred. In these circumstances, the contingent price should be recorded as a financial liability from this date in accordance with IAS 32.

62. Where the contingent price falls within the scope of this project and is an element of the cost of the asset, the staff believe that interpretive guidance would be useful to clarify that the cost of the asset purchased includes an amount equal to the amount recognised for the financial liability on the date of purchase.

63. Because the contingent event has not yet occurred (as at the date of purchase), the final amount for the contingent payment is uncertain at the time of initial recognition of the liability. Because the liability should be measured at fair value upon initial recognition, the staff acknowledge that there is a need for estimating the contingent payment at that date.

64. The remaining question is how to account for variations in the remeasurement of the financial liability upon re-estimation at subsequent reporting dates, or on realisation of the contingent event?

65. Because the financial liability is within the scope of IAS 39 / IFRS 9, the staff believe that there is no room to depart from the requirements in those standards. More specifically the effect of revisions of payments should be recognised in profit or loss. Typically, for a financial liability measured at amortised cost, paragraph AG8 of IAS 39 prescribes that:

> AG8. If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in profit or loss.

Partial conclusion

66. The staff are of the opinion that for contingent prices that fall within the scope of the project as outlined in this paper, one possible approach to interpretive guidance could be to require that the cost of the asset purchased should be adjusted upon initial recognition of the financial liability that reflects the obligation to pay the contingent price.

67. Subsequent remeasurement of the financial liability until the triggering event occurs should be accounted for in accordance with IAS 39 / IFRS 9, ie re-estimations of cash flows and accretion of discount, should be recorded in profit or loss.

Possible analogies to existing IFRS literature

68. At the meeting in January 2011, the Interpretations Committee discussed possible analogies to existing IFRS literature. The January 2011 IFRIC Update's section on those discussions is reproduced below for ease of reference:

> (a) an analogy to IFRS 3 *Business Combinations* [which] would require the cost of the asset to include the fair value of the contingent consideration at the date of purchase, with subsequent changes to the contingent consideration being recognised in profit or loss.
>
> (b) an analogy to IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* [which] would require the cost of the asset to include an estimate of the contingent consideration at the date of purchase, with subsequent changes to the liability, to the extent that they do not reflect the passage of time, be adjusted against the cost of the asset.

Analogy to contingent consideration in IFRS 3

69. An analogy with IFRS 3 raises a number of issues because the measurement basis is different from the measurement basis in the cost model. Specifically, differences arise with respect to the accounting for transaction-related costs and to the recognition of deferred tax assets and liabilities upon initial recognition of a single asset purchased.

70. The staff are of the opinion that if an analogy to IFRS 3 were to be retained as the way forward, interpretive guidance would not be the appropriate process to address those issues. Some believe that contingent pricing in general should be the subject of a comprehensive Board project that could consider the other related factors such as transaction-related costs. The staff point out that such a project would probably not be finalised in time to help those entities that are in jurisdictions that are currently transitioning to IFRSs or plan to do so. In addition, in the light of existing diversity, the staff believe there is a need to address the issue now.

71. The staff has also learnt that there are circumstances in which the terms of the contingent price payable for an asset purchased can be the same (or at least very similar) as the terms for contingent consideration when a similar asset is acquired in a business combination. For example, fixed milestone payments will be come payable to the vendor when a specified asset acquired through a business combination receives specified regulatory approvals. It is questionable as to why there should be different accounting for such contingent payments, solely on the basis of whether the asset was acquired in a business combination or separately. This argument could be seen as support for an analogy to IFRS 3 in that similar accounting would enhance consistency across IFRSs.

72. The staff have some sympathy with this view because it focuses on consistency. However, the staff note that acquiring a business is different from purchasing an asset, in that a business includes two essentials elements, which are inputs and processes. This is stated in paragraphs B7 and B8 of the application guidance of IFRS 3. The staff believe that the purchase of a single asset does not include processes. Consequently, the staff are of the opinion that a contingent payment that is an element of the cost of an asset purchased separately can be directly attributable to the asset purchased. In contrast, upon acquisition of a business, it may be more difficult to establish a direct link between the contingent consideration and the new asset that is acquired as a result of the business

combination. The contingent consideration may relate to other aspects of the business acquired.

Analogy to IFRIC 1

73. This interpretation was issued in the context of a lack of guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* with respect to the debit entry when accounting for a non-financial liability, both upon initial recognition and at the end of each reporting period when the liability is reassessed.

74. The staff note that contingent price are financial liabilities and that there is no such lack of guidance in IAS 39 / IFRS 9 with respect to subsequent remeasurement.

Staff's views on possible analogies

75. The staff are aware that analogising to existing IFRS literature would enhance consistency within IFRSs. However, the staff note that the differences in accounting models raise difficulties that interpretive guidance would not be able to solve such as the accounting for transaction-related costs.

Limits with respect to other Board projects currently under discussion

76. The staff are aware of current related discussions in Board projects—namely *Leases* and *Revenue from Contracts with Customers*, and intend to keep a close watch on decisions on those projects. The staff's objective is to analyse the Board's final decisions on the recognition and measurement of liabilities that could affect the proposals in this paper, assuming that the Interpretations Committee follows the staff's recommendation

77. The staff assume that the timing for completion of the projects mentioned above will remain consistent with the timetable for this project (see the proposed timetable in Appendix D of this paper). This is the case because the Board projects are planned to be completed in June 2011. At that time, according to the proposed timetable, the draft interpretation will be in its draft wording phase. Consequently, even if the effective date for these projects might be as far in the

future as 2015, the final decisions reached will be the most recent decisions from the Board.

78. The staff note that, because contingent pricing gives rise to a financial instrument, irrespective of the Board's future final decisions on the projects mentioned above, IAS 39/IFRS 9 will still apply. However, to the extent that the Board's decisions on the projects mentioned above for the recognition of contractual liabilities are not consistent with the Committee's conclusions on this project, the staff will bring an analysis of this to the Committee before any draft interpretation is published.

Key points

79. The staff believe that, as developed in paragraphs 66 and 67 in this paper, for contingent prices that fall within the scope of the project:

    (a) cost of the asset purchased should be adjusted upon initial recognition of the financial liability that reflects the obligation to pay the contingent price; and

    (b) subsequent remeasurement of the financial liability until the triggering event occurs should be accounted for in accordance with IAS 39 / IFRS 9, ie re-estimations of cash flows and accretion of discount should be recorded in profit or loss.

80. The staff note that the proposals in paragraph 79 above are:

    (a) consistent with existing IFRSs, where there is room for interpretation because current IFRS literature is silent; and

    (b) not inconsistent with the tentative decision by the EITF in 2009 discussed in paragraphs 9 to 11 of this paper.

81. In addition, the staff is of the opinion that IFRS 3 and IFRIC 1 should not be analogised to with respect to the accounting for contingent prices.

82. At this stage the staff would like to get the views of the Interpretations Committee on the proposed path forward towards issuing interpretive guidance related to the initial submission received.

Question 2—views of the Interpretations Committee on the analogies to existing IFRSs
Does the Interpretations Committee agree that IFRS 3 and IFRIC 1 should not be analogised to with respect to the accounting for contingent prices?

Question 3—views of the Interpretations Committee on the proposed path forward
(a) Does the Interpretations Committee agree with the proposals to account for contingent prices presented in paragraph 79? (b) Does the Interpretations Committee agree that the proposed path forward is consistent with existing literature and therefore could provide useful interpretive guidance?

Staff's recommendations

83. The staff recommend that the Interpretations Committee should proceed with the scope of the project as outlined in this paper.

84. In addition, the staff recommend that the Interpretations Committee should direct the staff to either:

    (a) proceed with the proposed accounting treatment for contingent prices; or

    (b) explore alternative views discussed during this meeting.

85. The objective is for the staff to present a draft wording of an interpretation at the Interpretations Committee meeting in July 2011.

86. If the Interpretations Committee agrees with the staff's recommendations, the staff will perform further analysis with a view to discussing presentation and

disclosures, effective date and transition requirements at the Interpretations Committee meeting in May 2011.

Questions to the Interpretations Committee

Question 4—staff's recommendation
Does the Interpretations Committee agree with the staff's recommendations?

Appendix A—Background information

A1. This section was presented in paragraphs 5 to 13 of the agenda paper for the Interpretations Committee meeting in January 2011 and is reproduced here for ease of reference.

Context outlined in the submission

A2. 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.

A3. 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.

A4. 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.

A5. 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

A6. 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

A7. The constituent believes that contingent prices should be defined with reference to the definition of contingent consideration in Appendix A of IFRS 3.

A8. The first issue raised by the submission is whether a financial liability should be recognised for the contingent consideration when the asset is first recognised. 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).

A9. The submission then identifies a second issue concerning the measurement of subsequent changes to the financial liability relating to the contingent price:

(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*.

Appendix B—Selection of IFRS literature

B1 Paragraph 6 of IAS 16 and paragraph 8 of IAS 38 define cost as follows:

> ***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*.**

B2 In addition, paragraph 16 of IAS 16 prescribes those costs that are elements of the cost of the initial item of PPE purchased.

> 16. The cost of an item of property, plant and equipment comprises:
>
> (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
>
> (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) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

B3 In the specific case of a separate acquisition, paragraph 27 of IAS 38 16 prescribes those costs that are elements of the cost of the initial intangible asset purchased.

> 27. The cost of a separately acquired intangible asset comprises:
>
> (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and
>
> (b) any directly attributable cost of preparing the asset for its intended use.

Appendix C—Excerpt of agenda paper 10 presented at the Interpretations Committee in January 2011

C1 Below are reproduced for ease of reference paragraphs 40 through to 52 of the agenda paper 10 presented at the Interpretations Committee in January 2011.

What is a 'financial liability'?

C2 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) […]

C3 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) […].

C4 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*.

C5 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.

C6 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 occurrence of a future event (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. […]

C7 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.

C8 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.

C9 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.

C10 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.

C11 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

C12 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.

C13 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.

C14 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.

Appendix D—Proposed project plan

D1 The proposed project plan is as follows:

	Project plan	Proposed timeline
Committee	Outline the scope of the project	March 2011
	Outline the accounting treatment within the confine of the scope	May 2011
	Present draft wording for an interpretation	July 2011
	Approve final wording of draft interpretation	September 2011
	End of comment period	December 2011
	Analysis of comments received and redeliberations	March 2012
	Present final wording	May 2012
Board	Ballot of Interpretation	June 2012

D2 If this work plan is implemented, the staff believe that the effective date for the Interpretation could be January 2013. The staff also note that January 2013 is the effective date for applying IFRS 9.