

# IFRS news

## Giving with one hand; taking away with the other – related-party disclosures

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**Eli Seller reminds management that, for the first time in the 2011 annual financial statements, it will have to disclose sensitive arrangements between the entity and key management personnel.**

IAS 24, ‘Related party disclosures’, was amended in November 2009 to remove the requirement for government-related entities to disclose all transactions with the government and to clarify the definition of a related party. Attention was focused on those two amendments, which reduced the disclosure requirements for many, particularly state-owned enterprises. But a few other amendments and clarifications crept in, including a requirement to disclose commitments with related parties. This extends to commitments between the entity and members of key management. ‘Commitments’ means transactions that have not yet occurred but are either contractual promises or constructive obligations. This amendment may well expand related-party disclosures for others.

What types of arrangement might now need to be disclosed? Arrangements

between an entity and a related party to purchase an asset from the entity would need to be disclosed, even if the purchase has not yet occurred. Commitments by an entity to members of key management, such as a commitment to provide a loan, would also need to be disclosed. Such commitments were often not disclosed in the past, as they were not seen as ‘transactions’ because there was no accounting impact until the event occurred.

The explicit reference to commitments has been added to the standard to avoid any doubt. Reporting entities might therefore find themselves disclosing commitments for the first time in their 2011 annual financial statements. Management should be aware of this change to ensure they capture and disclose the necessary information. These may be sensitive in nature – such as and rights to buy assets from the entity.

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## IASB told: ‘We need a period of calm’

The IASB is expected to discuss a development plan for its ‘agenda consultation’ this month, after requesting its staff in January to conduct further research into feedback received in the comment letters. It has requested clarification of some of these issues and has suggested further ways to assess the project’s priorities. The summary feedback was also discussed at the IFRS Advisory Council last month.

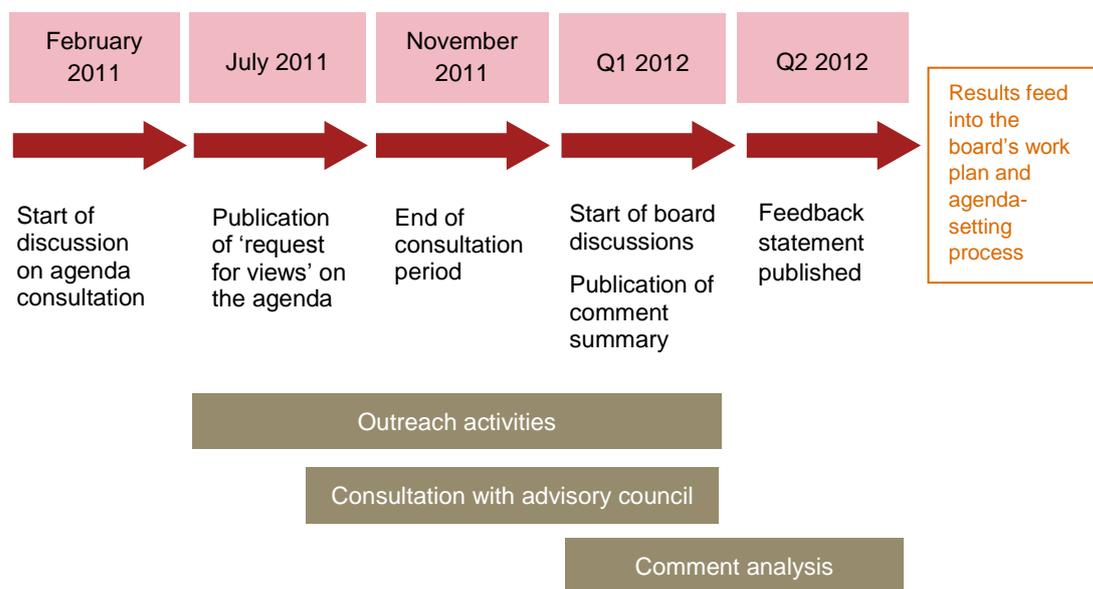
The IASB’s request last year for input on the strategic direction and the overall balance of its work plan elicited 245 comment letters. The aim of the ‘agenda consultation’ is to receive feedback on the Board’s possible agenda items. In particular, the IASB wanted stakeholders’ views on how it should balance new financial reporting guidance with maintaining existing IFRSs and – considering time and resource constraints

– what areas of financial reporting should be given priority for improvement.

The key messages from commentators were:

- Complete the revenue, financial instruments, leases projects as a priority;
- We need a ‘period of calm’;
- Emphasis should shift from development of standards to maintenance;
- The future agenda should be less ambitious;
- Board should use wider range of resources – including national standard setters; and
- A conceptual framework is needed, including a disclosure framework.

The board’s timetable for next steps is as follows:



## Viewpoint: IFRS governance



**PwC's global chief accountant, John Hitchins, gives a personal view of the IFRS Foundation and Monitoring Board's recent review of the Foundation's governance. You can find this and John's other views in his IFRS blog at [www.pwc.blogs.com/ifrs](http://www.pwc.blogs.com/ifrs)**

The IFRS Foundation has finally released its strategy review alongside the Monitoring Board's review of the Foundation's governance. It seems the delay was due to the Monitoring Board's difficulties arriving at a consensus. The reports do not propose any radical change to IFRS governance. The current three-tier structure (the IASB being responsible for the technical quality of the standards, and the two oversight bodies ensuring independent standard setting and accountability) will continue. I think that's sensible – it seems to be working. Some of the detail, though, points to changes of emphasis.

Both reviews have involved extensive consultation, and it is clear that commentators have been listened to carefully. The process should allay the concerns of those who have been critical of IASB governance in the past – or those whose concern is about the transparency of the governance rather than a disagreement with the technical content of the standards. This may help resolve one of the barriers to IFRS adoption cited in the US roundtables on adoption.

The review by the IFRS Foundation Trustees is similar to the October draft. I was glad to see the commitment to do more to promote consistency of IFRS interpretation across borders was widely supported; this might be the biggest challenge for the IFRS community as it expands. The enhanced role of the Due Process Oversight Committee is also important for building confidence in the standard-setting process among the sceptics.

The Monitoring Board on the other hand has made a number of changes, backing off from what could have been seen as a dramatic extension of its role. Proposals that the Monitoring Board should be able to put topics directly onto the IASB agenda and

should take a much greater role in appointing IASB members have been dropped. There are caveats though: if the Monitoring Board suggests an urgent topic that the IASB rejects, the IASB will have to give the reason why. Similarly, the Monitoring Board will be closely involved in the appointment process for a new Chair.

Membership of the Monitoring Board looks like the area that probably had the most intense discussion. It will be expanded to include some emerging markets representatives, and two of the seats will be rotating – this in itself is uncontroversial. Membership will be restricted to capital markets authorities rather than expanded to include prudential and other regulators – a pragmatic decision, as it would be difficult to know where to stop. More significantly, members in future will have to come from countries where IFRS is required for domestic use. One can see the tensions here, and the elephant in the room is of course the US position – can one conclude that allowing use by foreign companies filing with the SEC amounts to 'domestic' use? On this, no doubt, there will be more!

Finally, the most disappointing part of the reviews is the lack of a concrete proposal on the future funding of the IASB. Both boards agree there should be a transparent system whereby the jurisdictions using IFRS commit funds. The Monitoring Board says the Trustees are primarily responsible; the Trustees comment that they do not have the authority to mandate financing. At the same time, the Trustees have indicated an aspiration to have a significantly expanded budget. This is perhaps the biggest collective challenge for the two oversight bodies to resolve.

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## IFRS quiz: contingent consideration



How much do you know about the art and science of contingent arrangements? Test yourself against PwC's business combination specialist, David Bohl, with this IFRS quiz about the common pitfalls in accounting for business combinations with contingent consideration. These questions are designed to push you, so hold on to your seat. The recently released '[Practical guide to IFRS – The art and science of contingent consideration in a business combination](#)' will be useful background reading if you want to improve your score.

*Q1: How is contingent consideration accounted for in a business combination under IFRS 3?*

- (a) Contingent consideration is classified as an asset, liability or equity and is measured at fair value on the acquisition date.
- (b) Contingent consideration is recorded at the mid-point in the range of estimated outcomes on the acquisition date.
- (c) Contingent consideration is not recorded at the acquisition date unless it is probable it will be paid.
- (d) Contingent consideration is classified a liability and is measured at fair value on the acquisition date.

*Q2: Entity A acquires Entity B in a business combination by issuing 1 million of Entity A's shares to Entity B's shareholders. Entity A also agrees to issue 100,000 shares to the former shareholders of Entity B if Entity B's revenues (as a wholly owned subsidiary of Entity A) equal or exceed C200m during the one-year period following the acquisition. How should the arrangement to issue 100,000 shares be classified at the acquisition date?*

- (a) As equity.
- (b) As a liability.
- (c) As an asset.
- (d) The arrangement is not recorded until it is probable the revenue target will be met.

*Q3: A contingent consideration is payable in the form of the buyer's shares if a revenue target is achieved after the acquisition date. Which of the following*

*scenarios will result in equity classification?*

- (a) The number of shares is set to a value of C10m and is payable only if revenue is >C200m.
- (b) 1 million shares will be transferred if revenue is >C100m in year 1 following the acquisition, and 2 million shares will be transferred if revenue is >C150 million in year 2 following the acquisition date.
- (c) 100,000 shares will be issued for each C1 million revenue >C200m in the year following the acquisition.
- (d) The number of shares is fixed at 1 million if revenue is >C200m and the seller has the option to require settlement in cash.

*Q4: Entity A acquires Entity B in a business combination by issuing 1 million of Entity A's shares to Entity B's shareholders. Entity A also agrees to issue 100,000 shares to the former shareholders of Entity B if Entity B's revenues (as a wholly owned subsidiary of Entity A) equal or exceed C200m during the one-year period after the acquisition. Entity B shareholders become employees of Entity A after the acquisition and they would forfeit the contingent shares if they ceased employment with Entity A. How should the arrangement to issue 100,000 shares be recorded at the acquisition date?*

- (a) The arrangement is recorded at fair value in equity on the acquisition date.
- (b) The arrangement is not recorded until it is probable the revenue target will be met.

- (c) The arrangement is allocated between contingent consideration recorded at fair value at the acquisition date and post-acquisition remuneration.
- (d) The arrangement is not part of the consideration for the business acquired.

*Q5: How should a buyer account for consideration placed in an escrow account of the seller with a condition to release the funds to the seller upon the acquired company reaching a future revenue target?*

- (a) The carrying value of the funds in the escrow should be included in the consideration paid.
- (b) The fair value of the right to the return of escrow funds should be recorded as a financial asset. Any difference between the fair value of the financial asset and the carrying value is part of consideration.
- (c) The full amount of the funds in the escrow should be included in the consideration paid and treated as a contingent asset that is only recognised when it is virtually certain.
- (d) The escrow funds are not included in the consideration paid unless the payment happens within the 12 month window from the acquisition date.

*Q6: Entity A, a listed entity, acquires Entity B for C100m cash and a contingent payment of 100,000 Entity A shares if the acquired business achieves C500m revenue in the year after the acquisition. Entity A pays dividends annually. Which is the most appropriate fair value method formula for the contingent payment?*

- (a) Listed share price of Entity A x 100,000 shares.
- (b) Listed share price of Entity A x 100,000 shares X probability of revenue >C500m.
- (c) [ Listed share price of Entity A x 100,000 shares x probability of revenue >C500m ] – fair value of dividend paid in the year.
- (d) [ Listed share price of Entity A x 100,000 shares ] – fair value of dividend paid in the year

*Q7: Entity A acquires Entity B in a business combination by paying C200m cash to Entity B's shareholders. Entity A also agrees to put C2m cash in the former shareholders of Entity B's escrow to be released to Entity B former shareholders if general warranties and representations contained in the purchase agreement are satisfied. How should the C2m cash in escrow arrangement be recorded at the acquisition date?*

- (a) The escrow cash should be recorded at fair value as contingent consideration.
- (b) The escrow cash should be recorded at fair value as consideration paid for the acquired business.
- (c) The escrow cash should be reclassified from cash to restricted cash.
- (d) The arrangement is not part of the consideration for the business acquired.

*Q8: Entity B sells 60% of a whole owned subsidiary for C100m cash and a contingent payment of C25m if the acquired business achieves C500m revenue in the year after the acquisition. How should Entity B account for the contingent proceeds at the sale date?*

- (a) Do not include the contingent proceeds in the gain/loss on the sale because the proceeds are not virtually certain to be received.
- (b) Record the entire C25m contingent proceeds in the gain/loss on sale if the revenue target is probable.
- (c) Record the estimated fair value of the contingent proceeds as a financial asset in the gain/loss on the sale.
- (d) There is no sale to record because the significant risks and rewards have been retained by Entity B.

*Q9: Entity A acquires Entity B from C100m cash and a contingent cash payment 1 year after the acquisition if the acquired business achieves C500m revenue in the year following the acquisition. The buyer believes the single seller shareholder, who is also the CFO of Entity B, would be valuable to help Entity A integrate systems with Entity B. It therefore offers the CFO an above-market salary at Entity A. The*

*contingent payment does not depend on the CFO continuing employment. An independent valuation of Entity B provides a range of C105-110m. How should the contingent payment be recorded under IFRS 3?*

- (a) As a liability at fair value for contingent consideration.
- (b) As post-combination-period remuneration for employee services.
- (c) Allocate the arrangement into consideration paid to acquire the business and as remuneration expense in the post-combination period.
- (d) As equity at fair value for contingent consideration.

*Q10: Entity A acquires Entity B for C100m cash and a contingent payment if the acquired business achieves C500m revenue in the year following the acquisition. The sellers believe the VP of Entity B operations is integral to meeting the revenue target; they therefore make a separate agreement*

*to split the contingent payment with the VP if the VP continues as an employee with Entity A. None of the sellers is an employee. How should the total contingent payment be recorded under IFRS 3?*

- (a) As consideration paid to acquire Entity B.
- (b) As remuneration expense in the post-combination period.
- (c) Refer to PwC's practical guide on contingent consideration and consult with the firm's Global Accounting Consulting Services.
- (d) As remuneration expense in the post-combination period if the buyers are aware of the separate agreement; otherwise, record as consideration paid to acquire the business.

Click here to see the '[Practical guide – contingent consideration](#)' or visit [pwc.com/ifrs](http://pwc.com/ifrs)

## Answers

**Question 1: A** – Contingent consideration is classified and recognised at fair value at the acquisitions date under IFRS 3.39-40.

**Question 2: A** – The arrangement is classified as equity under IAS 32.16 because the contingent consideration arrangement will result in the issuance of a fixed number of Entity A's equity shares if the target is met.

**Question 3: B** – This arrangement includes two performance targets, each with its own potential share award. This arrangement may still be classified as equity if it is deemed to be a series of separate contracts for each performance target within that overall contract rather than one overall contract. The year-one and year-two performance targets are independent and relate to different risk exposures under IAS 39.AG29 in this example. Each performance target is therefore viewed as a separate contract that would individually result in the issuance of a fixed number of shares. Each individual contract within the contingent consideration arrangement is therefore classified as equity under IAS 32.16 in

this example, as there is no contractual obligation to deliver a variable number of shares.

**Question 4: D** – Contingent payments that are forfeited if employment ceases are accounted for as remuneration under IFRS 3.B55. This type of arrangement results in an expense during the period over which the services are delivered. The arrangement is therefore not part of the consideration for the business acquired.

**Question 5: B** – The escrow arrangement is contingent consideration receivable and meets the definition of a financial asset because it is a contractual right to receive cash. Future changes in the fair value of the contingent consideration based on expectations of meeting the target are recognised in the income statement.

**Question 6: C** – The fair value of the contingent consideration may be based on the acquisition-date share price of the buyer's shares when the arrangement involves future delivery of a fixed number of shares; the

arrangement is therefore classified as equity. The valuation should incorporate the probability of achieving the performance target. The fair value of the acquisition date share price should be adjusted for any expected dividend cash flow the seller will not receive that is priced into in the acquisition-date share price.

**Question 7: B** –The general warranties and representations are verifying conditions that existed at the acquisition date. The escrow payment is included in the upfront acquisition consideration because it is expected that the general warranties and representations will be satisfied, at which point the escrow funds would be released to the former Entity B shareholders.

**Question 8: C** – A contract that provides the seller with a right to receive cash when a contingency is resolved meets the definition of a financial asset in IAS 32.11. The financial asset should be recognised at fair value in determining the gain or loss on the sale of the subsidiary.

**Question 9: A** –IFRS 3.B55 provides indicators to assess whether an arrangement for

contingent payments to employees or selling shareholders are contingent consideration or separate transactions. Here, the selling shareholder will receive an above-the-market salary, and the upfront payment is above the high end of the independent valuation ranges. These factors indicate the arrangement is part of the consideration for the business acquired. The contingent consideration is classified as a liability because it will be paid in cash.

**Question 10: C** –The answer is not clear under IFRS 3. We have developed some additional guidance in the ‘[Practical guide for contingent consideration](#)’ (see section 3). This type of arrangement is complex and we recommend you consult with PwC’s Global Accounting Consulting Services.

*We have more guidance on these issues. In addition to the practical guide, another good place to look is our [topic summary](#) on business combinations. Click [this link](#) or visit or visit [pwc.com/ifrs](#), ‘Additional IFRS resources’.*

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