IFRS news

Emerging issues and practical guidance*

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IFRS 3R and IAS 27R – questions and answers

The revised standards on business combinations and consolidation (IFRS 3 (revised) and IAS 27 (revised)) significantly change the accounting for business combinations and transactions with non-controlling interests. These changes will create challenges and may change how management negotiates and structures transactions. This supplement is the first in a series of questions and answers on the revised standards.

This instalment looks at changes in the recognition and measurement of assets and liabilities and in the measurement of consideration, thereby affecting goodwill. Further instalments will consider presentation in the income and cash flow statements and other topics related to transactions with non-controlling interests. A complete discussion of the revised standards is available in PricewaterhouseCoopers' *Global Guide to Accounting for Business Combinations and Noncontrolling Interests* and *IFRS Manual of Accounting*.

Assets and liabilities

The revised standards have resulted in a few changes to the recognition and measurement of assets and liabilities in the acquisition balance sheet. The existing requirement to recognise all of the identifiable assets and liabilities of the acquiree is retained, with most assets and liabilities recognised at fair value. Some areas to watch out for relate to restructuring costs and modifications to acquiree pension plans, indemnification assets and non-compete agreements.

Restructuring costs and modifications to acquiree pension plans

Many business combinations are promptly followed by major restructurings of the acquired business and by changes in the acquiree's share-based payment and employee benefit plans. Specific guidance is included in the revised standards that address changes in share-based payment plans of the acquired business, including changes introduced by the acquisition agreement. An acquirer that is obliged to replace an acquiree's share-based compensation awards includes all or a portion of the market-based measure of replacement awards in the measurement of consideration. The acquirer is 'obliged' if the employees have the ability to enforce replacement of the awards. This could occur, for example, if the terms of the acquisition agreement require replacement or if the plan itself has a pre-existing change of control clause requiring replacement.

By analogy to the share-based payment guidance in IFRS 3 (revised), questions arise as to whether an acquirer can 'obligate' itself to modify the acquiree's pension plans or to implement a restructuring plan and therefore include the related obligations as part of

acquisition accounting. The following questions and answers address these situations.

1. **Can liabilities for modifications to defined benefit pension plans be included as part of the purchase consideration of a business combination if the modifications are written into the acquisition agreement and appear to be an obligation of the acquirer?**

   The modification of pension plans written into acquisition agreements are generally treated separately from a business combination. IFRS 3 (revised) paragraphs 51-52 require separate accounting for transactions that are not part of a business combination, even if entered into simultaneously. Paragraph 52 specifies that a transaction that primarily benefits the acquirer is likely to be a separate transaction. It also indicates that a transaction that remunerates employees of the acquiree for future services is a separate transaction. An acquirer generally initiates a modification of a pension plan for its own benefit. The modification will also typically relate to future services of the employees and should therefore be recorded as adjustments to future compensation expense. Paragraph B50 provides further interpretive guidance of factors to consider when evaluating what is part of a business combination.

   Treating a pension modification separately from a business combination is in fact theoretically consistent with the underlying approach taken in IFRS 3 (revised) with replacement share-based compensation awards. To the extent replacement awards are vested, the corresponding portion of the fair value of the awards is included in consideration. It receives this treatment because it relates to employees acting in their capacity as shareholders. The portion of the fair value of the replacement awards for the unvested element, however, represents future compensation expense, as it relates to future service of the employees. Similarly, a modified pension plan relates to future service of employees.

2. **Can restructuring costs be included as purchase consideration of a business combination if the restructuring activities are written into the acquisition agreement and appear to be an obligation of the acquirer?**

   IFRS 3 (revised) paragraph 11 specifically refers to the treatment of restructuring costs and assumes that all restructuring costs would be a post-acquisition cost. These costs arise as a result of management's intention rather than obligation. Including a plan for restructuring in the acquisition agreement does not create a liability of the acquiree at the acquisition date.

   A restructuring provision can only be recorded as a liability of the acquired business when it is a liability of the acquiree at the acquisition date. This would only arise if the planned restructuring met the conditions as a constructive obligation of the acquiree in accordance with IAS 37 prior to the business combination and was not done for the benefit of the acquirer. If done for the benefit of the acquirer, management accounts for the restructuring as a separate transaction.

Indemnification assets

The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability (the indemnified item). The acquirer, in accordance with IFRS 3 (revised) paragraph 27, recognises an indemnification asset at the same time that it recognises the indemnified item measured on the same basis as the indemnified item.

The following questions and answers address the application of indemnification accounting under the revised standards.

1. **Can indemnification asset accounting be applied to general representations and warranties?**

   Indemnification asset accounting only applies to indemnification arrangements when the outcome of a contingency or uncertainty relates to a specific asset or liability. The guidance should typically not be applied to general representations and warranties.

2. **Does indemnification asset accounting follow the IFRS 3 (revised) guidance when the indemnified item has not been recognised at the acquisition date or during the measurement period?**

   The indemnification may relate to an acquired asset or assumed liability, or one that is not recognised on the acquisition date. For example, an indemnification may relate to a contingent liability that is not recognised at the acquisition date because its fair value is not reliably measurable at that date. In those circumstances, the indemnification asset is also not recognised at the acquisition date. Rather the indemnification asset is recognised at the same time as the indemnified item and measured on the same basis, subject to collectibility and any contractual limitations on the indemnified amount. This applies whenever the indemnified item is recognised regardless of whether it is at the acquisition date or during or after the measurement period.

3. **Does an indemnification arrangement need to be specified in the acquisition agreement to achieve indemnification accounting?**

   Indemnification accounting can still apply even if the indemnification arrangement is the subject of a separate agreement. Indemnification accounting applies as long as the arrangement is entered into on the acquisition date, is an agreement reached between the acquirer and seller, and relates to a specific contingency or uncertainty as part of a business combination.

Non-compete agreements

A non-compete agreement generally prohibits former owners or key employees from competing with the business. An agreement usually covers a set period of time that typically commences after a change in control or the termination of employment. Non-compete agreements are most common in service businesses where relationships with key customers are crucial, such as investment management. The following questions and answers address the accounting for non-compete agreements entered into at the time of a business combination.

1. Is a non-compete agreement treated as part of a business combination or as a separate transaction?

Non-compete agreements established at the time of a business combination are generally accounted for as separate transactions if they are entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer [IFRS 3R.52]. A non-compete agreement negotiated as part of a business combination will typically be initiated by the acquirer to protect the interests of the acquirer and the combined entity. A non-compete agreement may have been part of an employment contract or shareholder agreement that was in place before the business combination. In those circumstances, the non-compete agreement would represent an intangible asset of the acquired business.

2. What is the accounting for a non-compete agreement that is treated separately?

Non-compete agreements often meet the criteria for separate recognition as an intangible asset under IAS 38 by satisfying the contractual or other legal-right criterion for an asset acquisition. See question 3 below for the accounting in those instances. The combined entity should, however, consider whether any payments made as a result of the non-compete are in fact compensation for future services to be accounted for in accordance with IAS 19. A 'non-compete' that results in a payment made after some period of employment with the acquired business will usually have an element of compensation.

3. What is the subsequent accounting of a non-compete agreement that is recognised as an intangible asset?

A non-compete agreement will normally have a finite life, requiring amortisation of the asset. The amortisation period should reflect the periods over which the benefits from the non-compete agreement are derived. Determining the period is a matter of judgement in which all terms of the agreement, including restrictions on enforceability of the agreement, should be considered. Amortisation will typically be recognised on a straight-line basis.

Measurement of consideration and goodwill

The revised standards introduced changes to the measurement of consideration transferred. Goodwill continues to be a residual, although with the changes to consideration transferred, there is likely to be a different residual amount under the revised standards. One of the most significant differences may arise from the treatment of contingent consideration under the revised standards. There have also been clarifications from the Board that will impact the amount of consideration transferred and goodwill.

Contingent consideration – classification

Contingent consideration is recognised and measured at fair value as of the acquisition date regardless of whether it is probable that the contingent consideration will be paid. The contingent consideration is included in consideration transferred and therefore impacts the amount of goodwill at the acquisition date. The accounting subsequent to the acquisition date, however, depends on the classification of contingent consideration as either an asset/liability or an equity instrument. The accounting subsequent to the acquisition date will not impact goodwill. Previously, contingent consideration was only recognised if probable, and any changes in contingent consideration after the acquisition date were recorded as adjustments to goodwill.

Liability-classified contingent consideration under the revised standards is re-measured to fair value through the income statement each reporting date. Contingent consideration classified as equity is not re-measured in subsequent periods. One of the challenges of the revised standards is determining whether share-settled contingent consideration arrangements are classified as a liability or equity. The following questions and answers address this challenge.

1. When is share-settled contingent consideration classified as a liability?

Liability classification is required when a variable number of shares are to be issued [IAS 32.11]. The following features typically identify an arrangement as having a variable number of shares and thus classified as a liability.

- Fixed value to be paid (number of shares to be issued adjusted to pay a specific amount).
- Multiple performance targets.
- Cumulative performance targets.

Two examples of liability classified arrangements are given below.

Example 1
If a performance target of C100 of net income is achieved in year 1, 100 additional shares will be issued; otherwise a pro

rata number of shares will be issued down to a minimum performance target of C75 of net income.

Analysis
A variable number of shares will be issued depending on which of the multiple performance targets (range between C75 and C100) are met; it is therefore classified as a liability.

Example 2
If the share price of the combined entity of C50 is achieved, additional shares to the value of C100 will be issued.

Analysis
A variable number of shares will be issued to the value of C100; it is therefore classified as a liability.

2. When is share-settled contingent consideration classified as equity?

Equity-classified contingent consideration occurs when a fixed number of shares is to be issued [IAS 32.16]. The following features typically identify an arrangement as having equity classification.

- Explicit terms indicating a fixed number of shares will be issued.
- Either all or none of the shares will be issued – the arrangement does not provide for a variable number of shares to be issued.
- A single performance target is used to determine if shares will be issued.

Two examples of equity-classified arrangements are given below.

Example 1
If performance target of C100 of net income is achieved in year 1, 100 additional shares will be issued; otherwise, no additional shares will be issued.

Analysis
A fixed number of shares (100) will be issued if a single performance target is achieved. Failure to meet the performance target results in no shares being issued; it is therefore classified as equity.

Example 2
If the target market price per share of C100 is achieved by the end of year 1, 100 additional shares will be issued; otherwise, no additional shares will be issued.

Analysis
A fixed number of shares (100) will be issued if a single performance target is achieved. Failure to meet the performance target results in no shares being issued; it is therefore classified as equity. The use of a market performance target (share price) does not prevent equity classification provided the features needed for equity classification are present.

3. Can arrangements with multiple performance targets be classified as equity?

Equity classification may be possible with multiple performance targets, but it depends on a careful analysis of the features of the arrangements. Arrangements that contain multiple performance targets can be equity-classified if each performance target is separate and independent from the other performance targets and the performance targets are not cumulative. Performance targets that are separate and independent must have independent risks from all other targets (that is, year 1 risks need to be separate and independent from year 2 risks). These types of arrangement will individually result in the delivery of a fixed number of shares for each target; as a result, each would be classified as equity.

The following is an example of a multiple performance target arrangement that qualifies as equity because each year's performance target and related risk is considered separate and non-cumulative.

Equity classified

- If a performance target of C100 of net income in year 1 is achieved, 100 additional shares will be issued; otherwise, no additional shares will be issued; and
- If a performance target of C150 of net income in year 2 is achieved (regardless of whether year 1 target is achieved), 120 additional shares will be issued; otherwise, no additional shares will be issued.

By contrast, the following is an example of a multiple performance target arrangement that is classified as a liability. The targets are in effect cumulative and the underlying risk related to achieving the year 2 target is dependent on the year 1 risk. This differs from the equity-classified example wherein year 1 and year 2 were, in effect, two separate and independent arrangements.

Liability classified

- If in year 1 a performance target of C100 of net income is achieved, 80 additional shares will be issued; otherwise, no additional shares will be issued; and
- Additionally, if in year 2 a performance target of C180 of cumulative net income since acquisition date is achieved, 100 additional shares will be issued; otherwise, no additional shares will be issued.

4. Does the length of the performance target period impact classification?

Contingent consideration arrangements typically contain annual performance targets. However, longer or shorter periods may be used and, if defined appropriately, may be classified as equity provided each period and target is independent from the others. Judgement is needed, however, to ascertain whether the use of shorter periods in substance results in a variable number of shares to be issued and thus is a liability arrangement.

Contingent consideration – earlier transactions

All contingent consideration arrangements were outside the scope of IAS 39 under the previous version of IFRS 3. The scope exemption has been removed as part of the consequential amendments relating to the revised standards. It was not clear how contingent consideration arrangements arising from transactions originally accounted for under the previous version of IFRS 3 should be treated once the scope exemption in IAS 39 was removed.

The transition provisions of IFRS 3 (revised) were explicit that it is applied prospectively to new transactions, with the exception of one area of deferred tax accounting. However, there were no explicit transition provisions for the change to IAS 39.

1. **How has the Board clarified the treatment of pre-adoption contingent consideration arrangements?**

   The Board tentatively decided, in May 2009, to clarify that the financial instruments standards (IFRS 7, IAS 32 and IAS 39) do not apply to pre-adoption contingent consideration arrangements. Therefore, contingent consideration arrangements from business combinations that were completed prior to the revised standard taking effect continue to be treated in accordance with the standard in effect at the time of the business combination.

2. **When will this clarification take effect?**

   The clarification is expected to be part of the annual improvements exposed in 2009 for publication in 2010. Improvements are usually mandatory for the following year but often can be early adopted. However, the tentative Board decision represents a clarification and supports our previously held view on this question.

Existing contingent consideration arrangements of an acquiree

IFRS does not have specific guidance on the accounting for contingent consideration arrangements of the acquired business. The Board, at its June 2009 meeting, tentatively concluded that such arrangements would not constitute contingent consideration under IFRS 3 (revised) because the consideration does not arise from the current transaction between the acquirer and the former owners of the acquiree. Rather, contingent consideration arrangements of the acquiree would be liabilities (or in some instances, an asset) of the acquired business. These arrangements would almost always be established by contract and fall within the scope of IAS 39 and be recognised at fair value on the acquisition date. The subsequent accounting would be driven by the classification of the asset or liability under IAS 39.

Contracts between an acquirer and a vendor in a business combination

The 2009 annual improvements project narrowed the existing scope exemptions in IAS 39 that relate to contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date. The Board has amended IAS 39 to clarify that only forward contracts between an acquirer and selling shareholder to buy or sell an acquiree that result in a business combination at a future date qualify for a scope exemption. This will bring more contracts into the scope of IAS 39. The following question and answer addresses some of the practical implications of this clarification.

1. **What types of contract are now likely to be within the scope of IAS 39 as a result of the clarification and therefore subject to fair value accounting?**

   Options, warrants and convertible instruments that could give control of an entity to one party are now likely to be within the scope of IAS 39. Puts and calls with matched terms are frequently observed in business combinations and have the same economic consequences as a forward contract. However, an option contract allows one party to control the occurrence or non-occurrence of the future business combination depending on whether the option is exercised. Therefore, the business combination is not firmly committed and so will not meet the ‘that result in a business combination at a future date’ criteria.

Summary

The mandatory adoption date of the revised standards is quickly approaching (that is, for annual periods starting on or after 1 July 2009). Recognising that the new guidance will change the way companies account for business combinations, the above questions and answers address some of the new challenges. Stay tuned for part two of this series that focuses on financial statement presentation.