**Foreword**

Merger and acquisition strategies may be driven by the desire to enhance market position, expand into new markets, reduce costs and gain talented management or a workforce.

These strategic drivers may lead to purchase agreement terms that are more complex than a cash payment of asking price on the acquisition date. Buyers and sellers may want to tailor payment terms to align the value of what is paid with the strategic business purpose of the transaction. Buyers may not want to pay the entire price upfront if there are significant uncertainties associated with the acquired business or the value of the acquired business is dependent on key management personnel. Upfront payment of cash may transfer too much risk to the buyer or, if adjusted downward for risk, force the seller to seek better terms elsewhere.

For example, an energy company might not want to pay the full asking price for a development-stage oil and gas property because of uncertainty around the actual reserve amounts and future energy prices. A pharmaceutical company may prefer to pay the sellers of a biotech company for compounds after the compounds have passed the development phase and once the final drugs have reached sales milestones.

Contingent consideration can be a useful way of sharing risks between the buyer and seller and of aligning the expectations of both parties. A suitable contingent consideration arrangement can allow the buyer to promise more consideration if the business proves to be more valuable. However, management should be careful when agreeing to contingent arrangements, as there can be unexpected cash flow and/or accounting consequences. A company that does not anticipate the accounting consequences when negotiating a contingent term may feel the financial reporting effects for years to come.

**Introduction**

What is contingent consideration? It is the obligation of the buyer to transfer additional assets or equity interests to the seller of the business (usually cash or shares) if future events occur or conditions are met. Contingent consideration can also take the form of a right of the buyer to the return of previously transferred assets or equity interests from the sellers of the acquired business. Contingent consideration that is paid to sellers that remain employed and linked to future services is generally considered remuneration and is expensed as incurred. Management should evaluate any payments made or shares transferred to the sellers of the acquired business.

Contingent consideration is classified as a liability or equity and is measured at fair value on the acquisition date. Contingent consideration that is classified as a liability is remeasured to fair value at each reporting date, with changes included in the income statement in the post-combination period. Contingent consideration that is classified as equity is not remeasured in the post-combination period.

The most desirable accounting outcome for the buyer is a contingent arrangement that is fully recognised at the acquisition date and classified as equity. This results in the least post-acquisition income statement volatility. Buyers are keen to reach this outcome, but there are numerous hurdles to overcome to get there.
Assessing the appropriate contingent arrangement requires the buyer to look at a series of complex questions such as classification, linkage to future service and estimated fair value measurements. The remeasurement requirements have brought sharper focus to these arrangements, and buyers are interested in the accounting consequences of ‘traditional’ transaction structures. Many of the questions arise in the following areas:

- Arrangements settled in a variable number of shares;
- Fair value measurement;
- What is consideration versus remuneration?;
- Escrow arrangements;
- Options to acquire additional interests upon contingent events;
- Royalty arrangements; and
- Accounting from the seller’s perspective.

This guide looks at some of the practical questions on how to apply the contingent consideration principles in IFRS 3, ‘Business combinations’. The examples illustrate the challenges and reflect the complexity that can arise. Management should consider the full text of the standards, consult with their accounting advisors and auditors, and apply professional judgement to their specific accounting question. Consultation with valuation experts is highly recommended to help navigate complex valuation issues arising in many of the examples in this guide.

The guide does not cover contingent consideration outside business combinations, such as upon the acquisition of an asset. IFRS does not provide much guidance, and experts should be consulted in such situations. The IFRS Interpretations Committee has an ongoing project in this area as at the date of this publication.

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**Excerpts from IFRS 3 – contingent consideration**

IFRS 3.39: The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

IFRS 3.40: The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity on the basis of the definitions of an equity instrument and a financial liability in paragraph 11 of IAS 32 Financial Instruments: Presentation, or other applicable IFRSs. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

IFRS 3.58: Some changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with paragraphs 45–49. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

(a) Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.

(b) Contingent consideration classified as an asset or a liability that:

(i) is a financial instrument and is within the scope of IAS 39 shall be measured at fair value, with any resulting gain or loss recognised either in profit and loss or in other comprehensive income in accordance with that IFRS.

(ii) is not within the scope of IAS 39 shall be accounted for in accordance with IAS 37 or other IFRSs as appropriate.
**Practical questions and examples**

1. **Initial classification**

   How should the initial classification be determined when the contingent consideration is based on the buyer’s shares?

   Classification is one of the most important issues in accounting for contingent consideration. The initial classification may significantly impact post-acquisition profit or loss. Fair value changes from period to period of liability-classified arrangements will introduce an element of post-acquisition income statement volatility.

   The liability-classified arrangement is recorded at fair value at initial recognition; measurement is updated at each reporting date, with changes recognised in the income statement each reporting period until the arrangement is settled or derecognised.

   Remeasurement can effectively offset the underlying business performance effect on the income statement; if the acquired business performs well, the amount due to the sellers increases, and the increase is an expense in current-period income statement.

   Equity-classified arrangements are not remeasured, even if the fair value of the arrangement on the settlement date is different. Equity classification is achieved if the arrangement ‘will or may be settled in the issuer’s own equity instrument and it is a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments’ [IAS 32.16].

   In simple terms, this is a fixed number of shares for achieving a specific outcome.

   Arrangements settled in a variable number of the buyer’s shares are likely to be classified as liabilities.

   An arrangement could involve a number of performance targets, each with its own potential share award. This arrangement may still be classified as equity but only if the arrangement is deemed to be a series of separate contracts for each performance target within that overall contract rather than one overall contract.

   To be assessed as separate contracts, the performance targets must be readily separable and independent of each other and must relate to different risk exposures [IAS39.AG29]. Management should determine whether the arrangement is separable without regard to how the legal agreements document the arrangement (that is, separate legal agreements entered into at the same time as the acquisition would not necessarily be accounted for as separate contracts). If separable, the contracts for each performance target may individually result in the delivery of a fixed number of shares and, as a result, be classified as equity (if all other applicable criteria have been met). Otherwise, the arrangement must be viewed as one contract that results in the delivery of a variable number of shares because the number of shares that will be delivered depends on which performance target is met.

   Management needs to exercise judgement to determine whether the unit of account should be the overall contract or separate contracts within the overall arrangement.
**Classification framework**

The following flowchart illustrates the framework to determine the initial classification of contingent arrangements in the buyer’s accounts.

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**Example 1.1 – initial classification of arrangement settled in a fixed number of shares with a single measurement period**

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 €200m during the one-year period following the acquisition.

**Question:** How should the arrangement to issue 100,000 shares be classified?

**Simplifying assumption(s):** Assume the arrangement is not linked to providing services.

**Solution:**

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.

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1. Judgment is required to determine whether the unit of account should be the overall contract or separate contracts within the overall arrangement. Refer to example 1.3 and 1.4.
**Example 1.2 – initial classification of arrangement settled in variable shares with a single measurement period**

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 B’s revenues (as a wholly owned subsidiary of Entity A) equal or exceed €200m during the one-year period following the acquisition. If Entity B’s revenues exceed €200m, Entity A will issue an additional 1,000 shares for each €2m increase in revenues in excess of €200m, not to exceed 100,000 additional shares (that is, 200,000 total shares for revenues of €400m or more).

How should the arrangement to issue additional shares be classified?

**Simplifying assumption(s):** Assume the arrangement is not linked to providing services.

**Solution**

Management assesses the contingent consideration arrangement to determine whether each of the performance targets represents a separate contract. The contingent consideration arrangement may be one contractual arrangement under IAS 39.AG29 because the number of Entity A’s shares that could be issued under the arrangement is variable and relates to the same risk exposure (that is, the number of shares to be delivered will vary depending on revenue in the one-year period following the acquisition). The arrangement is classified as a liability in accordance with IAS 32.11 in these circumstances, as it will result in a variable number of shares being issued.

**Example 1.3 – initial classification of arrangement settled in a variable number of shares with multiple contracts**

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 B’s revenues (as a wholly-owned subsidiary of Entity A) equal or exceed €200m during the one-year period following the acquisition. Entity A agrees to issue an additional 50,000 shares to the former shareholders of Entity B if B’s revenues (as a wholly-owned subsidiary of Entity A) equal or exceed €300m during the second one-year period following the acquisition. Each contingent promise is independent — that is, outcomes could be zero (target not met), 50,000 (year 2 target only met), 100,000 (year 1 only target met) or 150,000 additional shares issued (year 1 and year 2 target met).

How should the arrangement to issue additional shares be classified?

**Simplifying assumption(s):** Assume the arrangement is not linked to providing services.

**Solution**

The contingent consideration arrangement is assessed to determine whether each of the performance targets represents a separate contract. The year-one and year-two arrangements are independent and relate to different risk exposures under IAS 39.AG29 in this circumstance. Each performance target is therefore viewed as a separate contract that would individually result in the issuance of a fixed number of Entity A’s equity shares. Each individual contract within the contingent consideration arrangement is therefore classified as equity under IAS 32.16 in this circumstance, as there is no contractual obligation to deliver a variable number of shares. Subsequent changes in fair value are not remeasured to the income statement.
Example 1.4 – initial classification of arrangement settled in a variable number of shares with a single contract

Entity A purchases Entity B in a business combination by issuing 1 million of Entity A’s common shares to Entity B’s shareholders. Entity A also agrees to issue additional common shares to the former shareholders of Entity B as follows:
- 100,000 shares if revenues equal or exceed C100m in the 12 months following the acquisition;
- 100,000 shares if revenues equal or exceed C150m in months 13 to 24 following the acquisition; and
- 100,000 shares if revenues equal or exceed C300m in the cumulative two-year period year following the acquisition.

How should the arrangement to issue additional shares be classified?

Simplifying assumption(s): Assume the arrangement is not linked to providing services.

Solution

Management assesses the contingent consideration arrangement to determine whether each of the performance targets represents a separate contract. The arrangement is considered a single overall contract with multiple performance targets in this circumstance.

The performance target for the cumulative two-year period largely depends on achieving the revenue targets in the first year and second year, given the overlap between the periods. The unit of account is therefore the overall contract rather than the individual performance targets because the arrangement (or multiple performance targets) relates to the same risk exposure. The arrangement will result in the issuance of a variable number of shares; it is therefore classified as a liability in accordance with IAS 32.11.

Complex situations – additional insights

Contingent consideration paid in cash can create volatility in the income statement. Are there any structures that can share profits between the buyer and the seller without creating volatility?

A buyer and a seller may seek to structure an arrangement so that any future cash payments become dividends or distributions rather than taking the form of a financial liability. The seller, in these arrangements, must assume more risk before the arrangement can be classified as an equity instrument. An unconditional promise to pay cash on events outside the control of the buyer will result in liability classification. A promise to pay cash on conditions that are within the control of the buyer may be an equity instrument, but the seller takes on the risk that the buyer may choose not to pay or be unable to pay.

A perpetual preferred share, for example, accumulates dividends from one period to the next. Perpetual preferred shares pay dividends only when dividends are paid on common shares. These will often be classified as an equity instrument. A seller who accepts perpetual preferred shares is accepting the risk that the holder of the common shares will never declare dividends.

There may be a structuring opportunity if a buyer intends to resell the acquired business within an identified time frame. The seller could accept a form of non-controlling interest in the vehicle that owns the acquired business. The vehicle itself would be liquidated and all proceeds distributed if the acquired business is sold.

Payments that take the form of dividends or distributions result in the seller assuming more risk but may allow the buyer to avoid recording a financial liability. These structures are complex; we highly recommend consulting accounting advisors.
2. Measuring fair value

Contingent consideration often involves the buyer transferring additional consideration to the seller if certain performance targets are met in the future. This allows the buyer to share the risk associated with the future of the business with the seller by making some of the consideration contingent on future performance. What factors should be considered in determining the fair value of this type of arrangement?

Valuation methods for contingent consideration range from discounted cash flow analyses to more complex Monte Carlo simulations. The terms of the arrangement and the payout structure will influence the type of valuation model the acquirer uses.

Most valuation methods require an approach incorporating some form of option pricing techniques to incorporate the potential variability in outcomes.

Buyers may consider a best estimate discounted cash flow methodology for cash-settled arrangements. The key issue for a discounted cash flow is: what discount rate best represents the risks inherent in the arrangement? There is, in reality, more than one source of risk involved. For example, both projection risk (the risk of achieving the projected performance level) and credit risk (the risk that the buyer may not have the financial ability to make the arrangement payment) need to be considered. Each of these risks may be quantifiable in isolation. Factors such as the potential correlation between the two risks and the relative impact of each risk upon the realisation of the arrangement need to be analysed when the two risks exist in tandem.

An alternative approach would be to develop a set of discrete potential scenarios for future performance. Each of these discrete payout scenarios could then be assigned a probability, and the probability-weighted average payout could be discounted based on market participant assumptions.

Equity-settled arrangements have more complex valuation aspects than cash-settled arrangements. A best-estimate or probability-weighted approach will rarely capture the potential variability in outcomes. 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 and therefore the arrangement is 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.

It may be necessary to calculate the expected future share price of the buyer (after consolidation of the acquiree) to calculate the fair value of more complex contingent consideration arrangements. The estimate of the future share price should consider various factors, including the relative size of the acquisition, impact on operational results, further market analysis of the acquisition strategy and others if this information is not public at the acquisition date. There may well be a correlation between share price and the performance targets used to determine the contingent outcome. This could be factored into a probability-weighted expected return model. It may also be necessary to consider dilution in the share price as a result of the new shares that will need to be issued.

Each arrangement has its own specific features that may lead to different modelling techniques and assumptions, as illustrated in the following examples. A valuation using an option pricing model may be appropriate for some arrangements because this type of model can incorporate additional complexities. Additionally, for liability-classified arrangements, the model will need to be flexible enough to handle changing inputs and assumptions that need to be updated each reporting period. We highly recommend consulting valuation experts.
Example 2.1 – fair value using acquisition-date share price of arrangement with fixed number of shares based on performance

Entity A acquires Entity B in a business combination. The consideration transferred is 10 million Entity A shares at the acquisition date, and 2 million additional Entity A shares 2 years after the acquisition date if a performance target is met. The performance target is for Entity B’s revenues (as a wholly owned subsidiary of Entity A) to be greater than C500m in the second year after the acquisition. The market price of Entity A’s shares is C15 at the acquisition date. Entity A’s management assesses a 25% probability that the performance target will be met. Entity A’s cost of equity is 15%. A dividend of C0.25 per share is expected to be paid at the end of year 1 and 2, which the seller will not be entitled to receive.

How should the fair value of the arrangement be determined?

Simplifying assumption(s): The arrangement is not linked to providing services. The share price is the same in each revenue scenario. This is unlikely to be the case, as the future share price might be correlated to revenue and might change as revenue from the acquired business increases or decreases. Other potentially important issues such as dilution from issuance of new shares, statistical probability distribution of revenue scenarios, potential difference in distribution of share prices and the correlation of the different risks are also ignored.

Solution

The fair value is estimated at C7,296,786 (see solution calculation).

The fair value of the contingent consideration at the acquisition date in this example is based on the acquisition-date fair value of the shares and incorporates the probability that Entity B will have revenues in 2 years greater than C500m. The value excludes the dividend cash flows in year 1 and 2 and incorporates the time value of money. The discount rate for the present value of dividends should be the acquirers cost of equity 1 because returns are available to equity holders from capital appreciation and dividends paid. Those earnings are all sourced from net income of the acquirer.

The following entry is recorded on the acquisition date for the fair value of the contingent consideration:

Dr. Consideration  C7,296,786
Cr. Equity  C7,296,786

There are no remeasurements of the fair value in subsequent periods.

<table>
<thead>
<tr>
<th>Revenue forecast (C millions)</th>
<th>Probability</th>
<th>Payment in shares</th>
<th>Probability weighted number of shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>350</td>
<td>30%</td>
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<td>0</td>
</tr>
<tr>
<td>450</td>
<td>45%</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>550</td>
<td>20%</td>
<td>2,000,000</td>
<td>400,000</td>
</tr>
<tr>
<td>650</td>
<td>5%</td>
<td>2,000,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>500,000</td>
</tr>
</tbody>
</table>

C = sum of (A x B)  
D = 0.25 x C  
E = G / (1+F) + G / (1+F)^2  
I = E - H

1 The required rate of return on dividends would likely be less than the cost of equity in many cases
Example 2.2 – fair value using the future price of arrangement with variable number of shares based on performance

Entity A acquires Entity B in a business combination. The consideration is 1 million Entity A shares at the acquisition date and 100,000 additional shares if Entity B’s revenues (as a wholly owned subsidiary of Entity A) are greater than C2m during the one-year period following the acquisition. If Entity’s B’s revenues exceed C2m, Entity A will issue an additional 10,000 shares for each C2m increase in revenues in excess of C2m, not to exceed 0.1 million additional shares (that is, 0.2 million total shares for revenues of C4m or more). Entity A’s cost of equity is 15%. A dividend of C0.25 per share is expected at the end of year 1, which the seller will not be entitled to receive.

How should the fair value of the arrangement be determined?

Simplifying assumption(s): The arrangement is not linked to providing services. The 40% probability of revenue between C2m and C4m is evenly spread within the range. The share price is the same in each revenue scenario. This is unlikely to be the case, as the future share price may be correlated to revenue and change as revenue from the acquired business increases or decreases. The share price will grow at the cost of equity less dividend yield. Other potentially important issues such as dilution from issuance of new shares, statistical probability distribution of revenue scenarios, potential difference in distribution of share prices and the correlation of the different risks are also ignored.

Solution

Since the number of Entity A’s shares that could be issued under the arrangement is variable and relates to the same risk exposure (that is, the number of shares to be delivered will vary depending on which performance target is achieved in the one-year period following the acquisition), the contingent consideration arrangement would be considered one contractual arrangement under IAS 39.AG29; it should be classified as a liability in accordance with IAS 32.11.

The fair value of the contingent consideration is C1,182,609 (refer to solution calculation).

This arrangement is slightly more complex than the previous example. A valuation method using the future price has been used – in contrast to the previous example, where acquisition-date price was used. Entity A can estimate the fair value of the contingent consideration at the acquisition date based on the future estimated fair value of the shares, and incorporate the probability of the different number of shares to be transferred at different revenue levels. The model to estimate the future expected share price of Entity A should consider various factors, including the relative size of the acquisition, impact on operational results, further market analysis of the acquisition strategy, dilution from the share payout and others.

The following entry is recorded on the acquisition date for the fair value of the contingent consideration:

Dr. Consideration   C1,182,609
Cr. Liability          C1,182,609

Remeasurements of the fair value will be required each reporting period, with fair value change recognised in the income statement.
### Complex situations – additional insights

The buyer may promise to issue the seller additional shares if the share price of the combined business falls below a specified level. This amount is agreed at the acquisition date in the event that the entity’s shares are trading below a set amount at a future date. Valuations for this type of arrangement are highly complex. A best-estimate or a probability-weighted approach will rarely be sufficient to estimate the fair value of this type of arrangement.

The following factors are some points to consider in developing a valuation approach. This may not be a complete list:

- What are the potential outcomes for the buyer’s financial results next year?
- What are the potential outcomes for the buyer’s share price changes over the coming year?
- How are the distributions of the financial results and share price returns correlated, and how can this correlation be quantified and modelled?
- What are the potential outcomes for other market events that could impact the overall stock market?
- What discount rate adequately reflects all of the risks (for example, projection risk, share price return estimation risk, the buyer’s credit risk) inherent in a valuation of this kind?

An option-pricing model may be appropriate in these situations, as it can incorporate the correlation between various factors such as the correlation of share price with different cash flow outcomes.

### 3. Differentiating consideration from payments for post-combination employee services

Contingent arrangements payable to former shareholders that continue in employment may be linked to the different future performance metrics of the acquired business. What indicators help differentiate consideration from remuneration of post-combination services?

Contingent arrangements payable to selling shareholders that continue providing services should be assessed to determine if there is an element of payment for post-combination services (‘remuneration’). This assessment requires management to understand why the contingent arrangement is included in the agreement, which party (the seller or the buyer) initiated the arrangement and when the parties entered into the arrangement [IFRS 3.B54].
The nature of the arrangement will dictate whether contingent payments to employees (or selling shareholders) are (i) contingent consideration in a business combination or (ii) separate transactions for remuneration. Separate transactions for remuneration are typically expensed in the post combination period. IFRS 3.B54–B55 provides indicators that should be considered if it is unclear whether an arrangement for payments to employees or selling shareholders is part of the consideration in exchange for the acquire or is a separate transaction for remuneration. These criteria need to be applied to all arrangements for payments to employees or selling shareholders, including cash payments and share-based arrangements.

The contingent payment will be recognised in the income statement over the service period if it is deemed to be remuneration. A contingent payment that is deemed to be consideration becomes part of the acquisition and increases goodwill at initial recognition.

Some of the important considerations are:

- Continuing employment;
- Duration of continuing employment;
- Level of remuneration (excluding contingent payment);
- Incremental payments to employees;
- Number of shares owned;
- Linkage to the valuation (that is, is the contingent payment compensating for low upfront consideration?); and
- Formula for determining consideration.

Management should consider all of the indicators in IFRS 3.B54–B55. However, not all indicators have equal weight. Contingent payments that are forfeited if employment ceases are accounted for as remuneration regardless of whether other indicators point towards the payment being classified as consideration. Contingent payments that are not automatically forfeited if employment ceases may be remuneration but require further analysis. The conclusions in the examples that follow may change as factors indicating consideration are changed to indicators of remuneration. Management needs to exercise judgement where there are factors indicating both consideration and remuneration.

**Classification determination framework**

The flow chart and table of indicators below illustrate the framework to determine whether a payment to shareholders is consideration, remuneration or both. This analysis should be applied to all arrangements with selling shareholders, including both cash payments and share-based arrangements. All of the indicators in IFRS 3.B54–B55 should be considered when analysing whether arrangements are consideration or are remuneration for post-combination services. An arrangement may contain both consideration and remuneration for post-combination services and therefore the payments should be allocated between consideration and remuneration.
### Remuneration versus contingent consideration factors

<table>
<thead>
<tr>
<th>Indicative of remuneration</th>
<th>Factor</th>
<th>Indicative of consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Period of employment same as, or longer than, contingent payment period.</td>
<td>Duration of continuing employment.</td>
<td>Period of employment is less than the contingent payment period.</td>
</tr>
<tr>
<td>Unreasonably low compared to other key employees.</td>
<td>Level of remuneration (excluding contingent payment).</td>
<td>Reasonable or high compared to other key employees.</td>
</tr>
<tr>
<td>Selling-shareholders who do not become employees receive fewer contingent payments (on a per-share basis).</td>
<td>Incremental payments to employees.</td>
<td>Selling-shareholders who do not become employees receive similar contingent payments (on a per-share basis).</td>
</tr>
<tr>
<td>Selling-shareholders owned substantially all of the shares in the acquiree (profit sharing in nature).</td>
<td>Number of shares owned.</td>
<td>Selling-shareholders owned a small part of the business, and all shareholders receive the same contingent payments (on a per-share basis).</td>
</tr>
<tr>
<td>Acquisition-date consideration is at high end of valuation range, and contingent formula is consistent with profit-sharing.</td>
<td>Linkage to the valuation and formula for determining consideration.</td>
<td>Acquisition date consideration is at low end of valuation range, and contingent formula relates to valuation approach.</td>
</tr>
</tbody>
</table>
**Example 3.1 – profit sharing**

Entity A, an advertising agency, is owned by a single shareholder, X, who is also the chief executive officer (CEO). Entity A is acquired by Entity B (the buyer) for cash consideration of C25m. X will become a key account manager of the advertising agency within Entity B after the acquisition.

An independent valuation performed at the time of the acquisition placed a value on the business of C20m - C25m, based on a multiple of earnings before interest, taxes, depreciation and amortisation (EBITDA).

X will receive additional payments from Entity B based on the following terms:

- During year 1: X will receive cash of 20% of the new contract margin for any new contracts he negotiates in Year 1.
- During Year 2: X will receive cash of 10% of the new contract margin for any new contracts he negotiates in Year 2.

Are the additional payments consideration or remuneration?

**Solution**

The contingent payments are not automatically forfeited if employment of X ceases, so management should analyse the additional indicators.

The commercial substance of the arrangement incentivises X to remain employed to negotiate new contracts and appears to compensate for services in the post-combination period. The contingent payment does not appear to compensate for low upfront consideration because the purchase price of C25m was at the high end of the independent valuation. The formula for the contingent payment does not relate to the valuation approach. All these factors indicate that the arrangement is consistent with a profit share or an incentive paid to a sales person rather than a payment made to X as part of the exchange for Entity A. It is therefore accounted for as remuneration to reflect the post-combination employee services of X.

**Example 3.2 – client retention**

Entity A, a cable television company, is owned by a single shareholder, X, who is also the chief executive officer (CEO). Entity A is acquired by Entity B (the buyer) for cash consideration of C20m.

Entity B will make additional payments to X based on the percentage of customers of Entity A retained, as follows:

- C3m paid if 90% of Entity A’s customers at the acquisition date are retained for the 3 years following the acquisition.
- C2m paid to X if 80% of Entity A’s customers at the acquisition date are retained for the 3 years following the acquisition.
- C1m paid to X if 70% of Entity A’s customers at the acquisition date are retained for the 3 years following the acquisition.

There is no requirement for X to remain employed with Entity A in order to receive additional payments under the contingent arrangement.

There will be a new CEO in charge of the acquired operations to make all major operating decisions. X will be a vice-president of operations and will not have responsibilities that directly affect Entity A’s customer retention.

X will receive remuneration that is reasonable in relation to other senior management personnel (excluding the additional payments) if X remains employed.

An independent valuation performed at the time of the acquisition placed a value on the business of C20m - C25m, based on a number of customers.

Is the additional payment consideration or remuneration?
Solution

The contingent payments are not automatically forfeited if employment of X ceases, so management should analyse the additional indicators.

The commercial substance of the arrangement does not incentivise X to remain employed because X will have little influence on the retention of customers. The contingent payment does not appear to be remuneration because X is receiving reasonable remuneration for the employment services in relation to other senior management personnel (excluding the additional payments). The contingent payment appears to be additional consideration because the purchase price of C20m is at the low end of the independent valuation range. The formula for the contingent payment relates to the valuation approach. There are no other factors that indicate remuneration. All this indicates that the arrangement is consideration paid to X as part of the exchange for Entity A. It is therefore included in the purchase price at fair value.

Example 3.3 – contingent payment accelerated if employee does not resign

Professional services firm Entity A is owned by a single shareholder, X, who is also the chief executive officer (CEO). Entity A is acquired by Entity B (the buyer) for cash consideration of C20m.

Entity B believes that retaining the services of X for at least 3 years is helpful to transitioning Entity A’s ongoing business. Entity B will pay X an additional C5m in 3 years if X remains employed for the 3 years and the acquired Entity A business achieves its EBITDA target. If the EBITDA target is achieved but X resigns before the end of the 3-year period, the C5m will still be paid but in 5 years’ time (that is, deferred for an additional 2 years). If the acquired Entity A business does not achieve its EBITDA target, there will be no payment; X’s employment status is irrelevant. X will have limited influence on EBITDA by providing services during the 3 years because X will focus on transitioning Entity A’s ongoing business rather than growing the business.

An independent valuation performed at the time of the acquisition placed a value on the business of C20m - C25m, based on a multiple of EBITDA.

Is the additional payment consideration, remuneration or both? Can the payment be allocated between consideration and remuneration?

Simplifying assumption(s): C5m has a 3-year discounted present value of C4.4m, and a 5-year discounted present value of C4m.

Solution

The contingent payments are not automatically forfeited if X’s employment ends, so management should analyse the additional indicators.

X has limited influence on the outcome of the EBITDA target and so has fewer incentives to remain employed. The contingent payment appears to compensate for lower upfront consideration because the purchase price of C20m is at the low end of the range of valuations. The formula for the contingent

Contingent arrangements may include a period of employment that differs from the contingent consideration period. How should the amount of contingent consideration or remuneration be determined?

The arrangement is likely to be remuneration if the employment period is the same as, or longer than, the contingent payment period. There may be a combination of remuneration and consideration when the period of employment is less than the contingent payment period. The present value of the payment at the end of the required employment may be compared to the present value of a payment at the end of the contingent arrangement period to determine the amount that is linked to post-combination services. This issue may arise when the contingent payment is made sooner if the employment continues.
payment relates to the valuation approach. These factors indicate that the arrangement is consideration paid to X as part of the exchange for Entity A.

The timing of the payment is sooner if X remains employed over the 3-year period. The commercial substance of the accelerated payment creates an incentive for X to remain employed and indicates post-combination remuneration. The arrangement therefore contains both remuneration and consideration.

It is reasonable for the discounted present value of the payment that X will receive, irrespective of whether X remains employed, to be considered consideration for the business. The amount that is linked to service, C0.4m, would be accounted for as remuneration. This is calculated as the difference between the discounted present value of the C5m to be paid in 3 years time (that is, C4.4m), and the discounted present value of the C5m to be paid in 5 years’ time (that is, C4m).

The C5m payment is accounted for as follows:
- C4m as consideration on acquisition;
- C.4m as post-combination remuneration expense over the 3-year period;
- C.6m to be accreted as interest expense over the 3-year period.

This assumes that the EBITDA target is expected to be achieved and X is expected to remain as an employee of the combined business for the 3-year service period following the acquisition. In practice, a range of outcomes would be taken into account using a probability weighted average – see Section 2, ‘Measuring fair value’. The impact of using a probability-weighted average approach would typically result in a lower amount being recognised on the acquisition date and income statement volatility in the post-acquisition period.

To the extent that this estimate changes over the period, the present value of the C5m liability is revised based on the revised expectation of the timing and probability of the payment.

A contingent cash pool to be shared among the individual selling shareholders may change in amount or in amounts allocated to the shareholders when shareholders leave employment. Does the forfeit of the payment by one or more of the shareholders upon leaving employment make the contingent payment is remuneration?

Management should assess all indicators to determine whether the purpose is consideration for the business acquired or to remunerate the selling shareholders for performance in the post-combination period. Scenarios where the contingent payment will be made regardless of whether the selling shareholders remain employed should have commercial substance in order to be considered an indicator that the arrangement is consideration. Contractual terms that lack commercial substance, should not result in the desired accounting outcome.

Example 3.4 – no link to continuing services

Entity A is acquired by Entity B for cash consideration of C100m. C10m is payable by the buyer to the selling shareholders if Entity A achieves pre-determined sales volumes each year for the 3 years following the acquisition. The payment would be made at the end of the 3-year period and would be paid to all of the previous shareholders of the seller in proportion to their relative previous ownership interests. The shareholders were all key employees of Entity A prior to the acquisition and continue as employees of the combined business with similar salary levels as the other employees at their level. The shareholders do not have the ability to influence the sales volume target even if they continue as employees. None of the shareholders are required to remain employed by the combined business during the 3-year period following the acquisition date in order to receive their portion of the additional payment.

An independent valuation performed on Entity A at the time of the acquisition placed a value on the business of between C100m – C110m based on a multiple of EBITDA.

Is the additional payment consideration or remuneration?
Example 3.5 – cash distributed among multiple shareholders linked to retention

Entity A is owned by four shareholders as follows:

- Shareholder 1: 40% holding;
- Shareholder 2: 30% holding;
- Shareholder 3: 20% holding; and
- Shareholder 4: 10% holding.

Entity A is acquired by Entity B (the buyer) for cash consideration of C250m. Entity B must pay additional amounts to the selling shareholders in the event that Entity A achieves pre-determined sales volumes each year for the 3 years following the acquisition, as follows:

- 5% of gross sales if Entity A achieves sales revenue of C50m during year 1 following the acquisition;
- 5% of gross sales if Entity A achieves sales revenue of C60m during year 2 following the acquisition; and
- 5% of gross sales if Entity A achieves sales revenue of C70m during year 3 after the acquisition.

Any additional amounts payable will be made at the end of the 3-year period and will be paid to all of the four previous shareholders in proportion to their relative previous ownership interests. The four shareholders were all key employees of Entity A before the acquisition date and continue as employees of the combined business following the acquisition by Entity B, with low salary levels compared to other employees. The four shareholders will be able to influence the sales revenue if they continue as employees.

Is the additional payment consideration or remuneration?

Simplifying assumption(s): There are no other factors that indicate remuneration.

Solution

The contingent payments are not automatically forfeited if all the selling shareholders cease employment, but each individual selling shareholder controls their ability to earn their portion of the additional payment by continuing employment.

The 4 shareholders receive low salary levels compared to other employees at their level and have the ability to influence the sales revenue if they continue as employees.

The commercial substance of the agreement incentivises the shareholder to continue in employment. The scenario where all shareholders cease employment lacks commercial substance because the last shareholder remaining in employment would not likely forfeit the entire pool of additional payment. Therefore, the additional payment would be accounted for as remuneration reflecting the post-combination employee services of the shareholders due to the combination of factors.
4. Escrow arrangements

How should the buyer account for funds placed in escrow?

Amounts paid to a third party or the seller’s escrow account may be contingent consideration if the release of the funds is contingent on whether specified future events occur or conditions are met. The arrangement may be remuneration for post-combination services if the payment has the indicators discussed in Section 3, ‘Differentiating consideration from payments for post-combination employee services’. The escrow amount is not contingent consideration if the release of the funds is contingent on verifying conditions that existed at the acquisition date. An escrow arrangement is accounted for as a measurement period adjustment if the payment relates to new information about circumstances that existed at that acquisition date [IFRS 3.45].

Example 4.1 – Consideration held in escrow for general representations and warranties

Pharma Group A acquires a laboratory, which is a business under IFRS 3. The laboratory’s head-scientist and sole owner is Z. All the employees working in the laboratory, including Z, sign new employment contracts with Pharma Group A.

The contractual acquisition price consists of two components:

- A fixed amount of C1,000 is paid to Z on the closing date; and
- An additional amount of C200 is transferred to an escrow account.

Z has the legal title to the escrow account. The escrow amount will be paid to Z only if the general warranties and representations (that is, the laboratory has been withholding income tax from its employees and remitting that money to the government, etc.) contained in the purchase agreement are satisfied. The whole amount is released to Pharma Group A if the general warranties and representations contained in the purchase agreement are not satisfied.

Is the escrow payment treated as upfront consideration or contingent consideration?

Simplifying assumption(s): The arrangement is not linked to providing services.

Solution

The general warranties and representations are verifying conditions that existed at the acquisition date. The escrow payment would be included in the upfront acquisition consideration because it is expected that the general warranties and representations would be satisfied, at which point the escrow funds would be released to the Z.

The following journal entry is recorded on the acquisition date for the transfer of consideration and escrow payment:

Dr. Net assets and goodwill  1,200
Cr. Cash  1,200

To record consideration paid for business combination.

Example 4.2 – Consideration held in escrow for working capital adjustments

Pharma Group A acquires a laboratory, which is a business under IFRS 3. The laboratory’s head scientist and sole owner is Z. All the employees working in the laboratory, including Z, sign new employment contracts with Pharma Group A.

The contractual acquisition price consists of two components:

- A fixed amount of C1,000 is paid to Z on the closing date; and
- An additional amount of C200 is transferred to an escrow account.

Z has the legal title to the escrow account. The escrow will be used to give Pharma Group A a working capital adjustment so that the acquisition date working capital is at the level specified in the purchase agreement.

Is the escrow payment treated as upfront consideration or contingent consideration?
Simplifying assumption(s): The arrangement is not linked to providing services. Pharma Group A expects that the full amount of the escrow will be provided to Z.

Solution

A working capital adjustment is typically included in a purchase and sale agreement as a means of agreeing on the amount of working capital that existed (and was acquired) on the acquisition date. The subsequent determination of working capital that existed on the acquisition date does not relate to future events or conditions (that is, events occurring or conditions being met after the acquisition date). This escrow payment would be included in the upfront acquisition consideration similarly to general representation and warranty provisions. Payments or receipts for changes in provisional amounts for working capital would therefore adjust consideration transferred by the buyer in its acquisition accounting.

The following journal entry is recorded on the acquisition date for the transfer of consideration and escrow payment:

Dr. Net assets and goodwill  1,200  
Cr. Cash  1,200  

To record consideration paid for business combination.

Example 4.3 – Escrow arrangement with contingent consideration

Pharma Group A acquires a laboratory. The laboratory’s head-scientist and sole owner is Z. The laboratory is integrated into Pharma Group A.

The contractual acquisition price consists of two components:

- A fixed amount of C1,000 is paid to Z on the closing date; and
- An additional amount of C200 is transferred to an escrow account.

Z has the legal title to the escrow account. The escrow amount will be paid to Z only if EBITDA increases by at least 5% per year over the 2 years following the acquisition. The whole amount is released to Pharma Group A if the EBITDA target is not met.

Is the escrow payment treated as upfront consideration or contingent consideration?

Simplifying assumption(s): The arrangement is not linked to providing services. The fair value of Pharma Group A’s right to the C200 escrow based on EBITDA is C150 at the acquisition date. Ignore the time value of money impact. The laboratory is a business under IFRS 3.

Solution

The fixed amount of C1,000 is consideration transferred to Z for obtaining control over the acquired laboratory. The additional C200 of the acquisition price is contingent consideration regardless of the fact that the funds have already been transferred to an escrow. The contingent right to the funds placed in Z’s escrow account is a financial asset of the acquirer because the escrow arrangement represents a contract that provides the buyer with a right to receive cash or other financial assets when a contingency is resolved. Future changes in the fair value of the contingent consideration based on expectations of meeting the target are recognised in the income statement (see the discussion on financial assets in Section 7, ‘Contingent proceeds from the seller’s perspective’).

The following journal entry is recorded on the acquisition date for the transfer of consideration and escrow payment:

Dr. Net assets and goodwill  1,050  
Dr. Financial asset  150  
Cr. Cash  1,200  

To record consideration paid for business combination and a financial asset.
5. Optional investments

Are optional payments to acquire non-controlling interest upon contingent events contingent consideration?

An option within the control of the buyer to acquire a non-controlling interest in the future may not be contingent consideration. Payments that the buyer can avoid do not meet the definition of a financial liability under IAS 32.19; they are not therefore recorded as a liability at the acquisition date. The purchase of the non-controlling interest is accounted for in equity under IAS 27.30 if the option is later exercised.

Example 5.1 – Options on non-controlling interest

Entity A contributes £5m cash in exchange for a 52% interest in Entity C at the acquisition date. The remaining interests of Entity C are owned by Shareholder D. Entity A has the option to acquire additional interests of up to 100% in Entity C from Shareholder D for the fair value on the date of exercise.

Is the option to buy the non-controlling interest contingent consideration?

Simplifying assumption(s): The arrangement is not linked to providing services.

Solution

The option to buy the non-controlling interest is not contingent consideration at the signing of the agreement; it is a separate transaction. The optional investments are within the buyer’s control, as Entity A can avoid the payments. The fair value of the options at the acquisition date is likely to be nil because the price is the fair value at the date of exercise.

6. Royalty arrangements

Companies in the extractive industry often acquire properties that are subject to a royalty payable to the seller of such property. Are the royalty arrangements contingent consideration?

A royalty payable to the seller of the property in a business combination is almost always contingent consideration. However, arrangements may be described as royalties that are actually the retention of a working interest. A retained working interest may well be accounted for as an undivided interest. Management needs to exercise judgement as to whether an arrangement is a royalty or a retained working interest. This has represented a change in practice for many entities in the extractive industry that may have treated vendor-type royalties as period costs prior to the adoption of IFRS 3 (2008). Any royalties, subsequent payments or transfer of shares to the seller should be scrutinised to determine if these are contingent consideration.

The terms of these types of arrangement in the extractive industry vary widely. Some legal frameworks do not allow undivided interests in the title to a property to be held. Royalty arrangements are the only way that the market participants can share in undivided interests.

Some of the key terms which vary between royalty arrangements are:

- Perpetual versus time limited royalties;
- Royalties subject to a volumetric cap, floor or collar;
- Royalties that are based on gross sales or payable net of extraction costs;
- Royalties that are at a fixed price or variable price;
- Royalties settled in physical product, in cash at the spot rate, or in cash at a fixed price subject to a cap, floor or collar; and
- Royalties subject to monetary caps or floors in aggregate.

Each of these terms can have an impact on the substance of the royalty arrangement. The arrangement is likely
to be contingent consideration if the acquirer has taken control of the entire property or business and cannot avoid making future payments to the seller. Some arrangements might share attributes of ownership with the previous owners, such as the following risks:

- Reserve risk – the risk that physical reserves are less than expected;
- Extraction risk – the risk that extraction costs are higher than expected; and
- Price risk – the risk relating to proceeds from selling the extracted minerals.

It becomes less clear whether contingent consideration or a retained working interest exists when all the risks of ownership are shared with the previous owners. However, retained interests with capped volume, fixed price or for a limited duration are almost certainly contingent consideration.

**Example 6.1 – contingent consideration royalties**

Entity A agrees to purchase a gold producing property from Entity B for £50m in cash plus an additional payment at a fixed per-ounce price of gold produced from the property for the 2 years following the acquisition. The additional payment contains a cap of 6,000 ounces and a floor of 5,000 ounces. The mine plan indicates production over the 2-year period between 4,500 to 6,500 ounces.

Is the royalty arrangement contingent consideration?

**Simplifying assumption(s):** The arrangement is not linked to providing services. The fair value of the payment stream is estimated at £10m. The property meets the definition of a business under IFRS 3. This is not a joint arrangement.

**Solution**

The buyer has acquired 100% of the property, subject to a royalty to pay part of the volume of gold produced. The royalty is not a retention of a working interest because the seller has limited price, reserve and extraction risk. The arrangement is contingent consideration that will be settled based on a formula that is volume based.

The following journal entry is recorded on the acquisition date for the consideration:

| Dr. Net assets and goodwill | 60 |
| Cr. Cash | 50 |
| Cr. Contingent consideration | 10 |

*To record Entity A’s initial purchase of property*

Future changes in the fair value of the contingent consideration based on changes in the expected production are recognised in the income statement each reporting period until the arrangement is settled.

**Companies in the pharmaceutical industry often acquire smaller start-ups or biotech entities. The acquisition may include a royalty payment determined in future periods, based on a percentage of drug sales from the acquired intellectual property. Are the royalty arrangements contingent consideration?**

Intellectual property (IP) in the form of licences is common within the pharmaceutical industry. The IP is transferred between deal-making partners in order to pursue research, development and/or commercialisation of technology, compounds or other licensed products. These strategic alliances are established through contracts involving the transfer of legal rights and may give rise to out-licensing deals. Out-licensing involves the sale or granting of exclusive or non-exclusive access rights by the party who owns or controls the IP (licensor) to an alliance partner (licensee). A typical out-licensing deal structure includes many contingent payments such as development milestones (for example, upon approval by regulatory agency), commercial milestones (for example, upon reach a certain sales level) and royalties (for example, based on the sale of products that use its IP – usually expressed as a percentage of the sales).

Amounts due to the seller of a business in the form of a milestone payment or royalty are part of the consideration transferred for the business acquired. The amount of the consideration that will be contingent on a milestone or future
sales should be measured at fair value at the acquisition date, with subsequent changes in the estimated out flows measured through the income statement.

Not all royalties are contingent consideration. Licensed intellectual property may represent an executory contract. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent (IAS 37.3). An executory contract for a market-rate royalty arrangement could be asserted to be a separate transaction and accounted for on a ‘pay as you go’ basis. This assertion requires a continuing involvement of the licensor, such as continuing to provide research or development services each time a sale is made by the licensee. Lump sum payments on sales milestones should be evaluated to determine if the seller has any further obligations; the arrangement might therefore be classified as an executory contract.

Most royalty arrangements seem to be contingent consideration and are treated in a way similar to development milestones, absent this continuing involvement. The determination of whether a contract is executory is an area of judgement.

Example 6.2 – Accounting for royalties in the pharmaecutics industry

Pharma Co acquires Biotech Co for C200m cash, plus a percentage of cumulative sales from any drug based on Biotech Co’s main IP comprised as follows:

- 5% sales up to C100m; and
- 10% of sales > C100m.

The acquisition includes Biotech Co’s IP. Pharma Co estimates actual sales of the drug will be C200m if successfully approved and there is a 70% probability of successful approval at the acquisition date. By the end of the year 1 after the acquisition date, management believes that actual sales of the drug will be C300m if successfully approved, and that there is a 90% chance of successful approval.

Is the royalty arrangement contingent consideration?

Simplifying assumption(s): Biotech Co meets the definition of a business under IFRS 3. The royalty rates are market value royalty rates for the industry. Ignore the time value of money.

Solution

The sellers of Biotech Co have no further obligation to deliver further services. No licence or executory contract is therefore involved.

The royalty arrangement is contingent consideration that should be measured at fair value as a component of the consideration transferred to acquire a business.

At the acquisition date:

<table>
<thead>
<tr>
<th>Sales forecast (C millions)</th>
<th>Royalty rate</th>
<th>Royalty payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>5%</td>
<td>5</td>
</tr>
<tr>
<td>100</td>
<td>10%</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>15</td>
</tr>
</tbody>
</table>

\[ C = A \times B \]

Dr. Net assets and goodwill \( 210.5 \)
Cr. Cash \( 200 \)
Cr. Contingent consideration \( 10.5 \)

At year 1 after the acquisition date:

<table>
<thead>
<tr>
<th>Sales forecast (C millions)</th>
<th>Royalty rate</th>
<th>Royalty payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>5%</td>
<td>5</td>
</tr>
<tr>
<td>200</td>
<td>10%</td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>25</td>
</tr>
</tbody>
</table>

\[ C = A \times B \]

Dr. Income statement \( 12 \)
Cr. Contingent consideration \( 12 \)

To record the increase in the fair value of the royalty payment.

Future changes in the fair value of the contingent consideration based on expectations of sales continue to be recognised in the income statement at each reporting period.
7. Contingent proceeds from the seller’s perspective

How should the seller of the business account for contingent proceeds?

The accounting treatment of contingent receivables is generally the same whether the party with the contingent receivable is the buyer or the seller. Contingent consideration receivable from the buyer’s perspective is illustrated in Section 4, ‘Escrow arrangements’. The seller’s accounting for contingent proceeds is addressed in the following section, but the concepts are applicable to the buyer’s accounting for contingent consideration receivable as well.

Contingent proceeds to be paid by the buyer to the seller are a contract to receive cash or shares in the future from the seller’s perspective. A contract that provides the seller with a right to receive cash or other financial assets when a contingency is resolved meets the definition of a financial asset in IAS 32.11. A contract is classified under the four IAS 39 measurement categories when it meets the definition of a financial asset. Contingent proceeds based on the performance of the seller’s business do not meet the definition of a derivative in IAS 39.9a because the non-financial variable (underlying) is specific to a party to the contract. The four categories are loans and receivables, fair value through profit and loss, held to maturity and available for sale. The classification should be determined according to the specifics of each arrangement.

A contingent arrangement that is variable is likely to be categorised as an available-for-sale debt asset. The contingent amount is not readily determinable and cannot therefore be classified as loans and receivables. Interest is calculated using the effective interest method and recognised in the income statement for available-for-sale debt instruments [IAS 39.55]. The guidance in IAS 39.AG8 on the effective interest rate applies because IAS 39.55(b) requires the use of the effective interest method. The estimate of the future cash flows is revised if there is a change in the expected level of consideration to be received [IAS 39.AG8]. Management recalculates the carrying amount of the available-for-sale debt instrument by discounting the revised estimated cash flows using the original effective interest rate. The resulting adjustment to the carrying amount of the available-for-sale debt asset is recognised immediately in the income statement as a gain or loss. Other fair value movements on available-for-sale debt instruments (for example, those caused by changes in market interest rates) are recognised in other comprehensive income in accordance with IAS 39.55(b).

IFRS 3 is not explicit about the treatment of contingent consideration arrangements that are classified as financial assets from the buyer’s perspective. Management could either apply the liability guidance by analogy or classify the contingent consideration arrangement as an available-for-sale financial asset, accounted for at fair value, with changes in estimates of cash flows in the income statement.

Contingent proceeds in the form of rights to a non-financial asset (for example, an intangible asset or an item of property, plant and equipment) are a contingent asset within the scope of IAS 37; it is not recognised until it is virtually certain that the seller will receive that asset [IAS 37.31, IAS 37.33]. These arrangements are rarely seen in practice.

Example 7.1 – Seller’s contingent proceeds

Parent P has wholly owned subsidiary X. P decides to sell a 70% controlling stake to Investor A. The proceeds for the sale include €150m cash paid upfront, plus contingent proceeds of 5% of revenue for the next 3 years. The fair value of contingent proceeds on date of sale is €10m (assessed based on expected sales over the coming 3 years of €70m in year 1 with a 15% annual growth rate). The carrying value of the 70% interest sold is €70m. The carrying amount of the 30% retained interest is €30m.

How should the seller account for the contingent proceeds?

Simplifying assumption(s): The appropriate discount rate of 10% does not change over the period of the arrangement. Revenue estimates for
year 1 are accurate but the growth assumption increases to 30% at the end of year 1. The fair value of the retained 30% interest is relative to the sale price of the 70% interest disposed. In practice, the non-controlling interest would be valued independently.

Note: In practice, the determination of the appropriate discount rate will be complex; we recommend consulting a valuation expert.

Solution

The fair value of consideration

\[ A = \text{Revenue} \times \text{Discount rate} \]

The gain on the 70% interest sold; an increase in fair value of retained interest of $128.6m is recognised in profit in accordance with IAS 27.

The contingent consideration instrument is categorised as an available-for-sale debt asset because the contingent amount is not readily determinable. Interest income is recognised using the effective interest method. Interest calculated using the effective interest method is recognised in the income statement.

The change in the expected revenue growth following year 1 will change the estimate of the future consideration to be received. Former Parent P will recalculate the carrying amount of the debt instrument by discounting the revised estimated cash flows using the original effective interest rate. The resulting adjustment to the carrying amount of the debt is recognised in the income statement.

The following are example journal entries at inception and the end of year 1. Similar journal entries will be recorded in years 2 and 3.

At inception:

Dr. Investment in associate 68.6
Cr. Cash 150
Cr. AFS debt asset 10
Cr. Net assets and goodwill 100
Cr. Gain on sale 128.6

Sale of 70% interest and recognition of gain on loss of control

At the end of year 1:

Dr. Cash 3.5 A
Cr. AFS debt asset 3.2
Cr. Interest income 0.3 B

Year 1 contingent consideration

Dr. AFS debt asset 0.7 C
Cr. Interest income 0.7C

Year 1 effective interest

Dr. AFS debt asset 1.5 D
Cr. Gain 1.5 D

Remeasurement of contingent consideration

Expected revenues at inception:

Revenue growth rate 15%
Discount rate 10%

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>5% of revenue</th>
<th>Present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>70.0</td>
<td>3.5</td>
<td>3.2</td>
</tr>
<tr>
<td>Year 2</td>
<td>80.5</td>
<td>4.0</td>
<td>3.3</td>
</tr>
<tr>
<td>Year 3</td>
<td>92.6</td>
<td>4.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Total</td>
<td>162.5</td>
<td>9.0</td>
<td>9.0</td>
</tr>
</tbody>
</table>

Expected revenues the end of year 1:

Revenue growth rate 30%
Discount rate 10%

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>5% of revenue</th>
<th>Present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 2</td>
<td>91.0</td>
<td>4.6</td>
<td>4.1</td>
</tr>
<tr>
<td>Year 3</td>
<td>118.3</td>
<td>5.9</td>
<td>4.9</td>
</tr>
<tr>
<td>Total</td>
<td>105.3</td>
<td>9.5</td>
<td>9.5</td>
</tr>
</tbody>
</table>

A = 70 x 5
B = 3.2 x 10%
C = (3.3+ 3.5) x 10%
D = 9 – (10-3.2+0.7)