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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **May 2006, London**

Project: **Are puts or forwards received by minority interests in a business combination contingent consideration? (Agenda Paper 10(v))**

Introduction

1 A parent entity sometimes enters into a commitment through a written put or a forward purchase to acquire shares in a subsidiary held by a third party as part of the purchase of a controlling interest in the subsidiary. The payment might be fixed, or based on the fair value of the shares at the settlement date or based on a formula, (e.g. a multiple of EBITDA or net income).

2 A constituent has asked whether any variability in the amount potentially payable to a [non-controlling] minority interest under a forward commitment or a put entered into as part of a business combination is contingent or deferred consideration under IFRS 3.

3 This matter was considered at the December 2005 and January and April 2006 meetings of the IFRIC Agenda Committee.

Analysis

4 IFRS 3.32 states that ‘when a business combination agreement provides for an adjustment to the cost of the combination contingent on future events the acquirer shall include the amount of that adjustment in the cost of the combination. IFRS 3.32 was carried forward without reconsideration from IAS 22, and IAS 22 does not provide a basis for conclusions on this matter.

5 The staff and the Agenda Committee agree that there are circumstances where a forward, or even a put, entered into at the time of a business combination constitutes contingent consideration, adjustments to which would be taken to goodwill.

6 Members of the Agenda Committee expressed differing views on precisely what those circumstances are. One suggestion is that the test should be whether the put or forward was still executory or whether it is so integral to the acquisition that it should be treated as one transaction. The staff would be concerned if this approach relied on assessing the intentions and motives of the parties. The staff would prefer to focus on the economics of the transactions. It could be that the transactions are integral in that the terms and conditions are related. Even so, it is the terms and conditions that should be accounted for rather than the incentives that generated those terms and conditions.

7 The staff believe that a put or forward that is exercisable at the fair value of the underlying [non-controlling] minority interest will result in the [non-controlling] minority interests sharing in the risks and rewards of the entity in proportion to their interest. In contrast, the staff believe that a forward or put that has an exercise price that is other than at fair value means that the [non-controlling] minority interests are receiving more or less than their ‘ownership’ interest in the entity. It is this difference that the staff characterise as contingent consideration.

8 The staff believe that a commitment to acquire additional shares in a subsidiary at fair value is not an adjustment to the ‘cost of the combination’, whether that commitment is by way of a forward agreement or by granting a put to the [non-controlling] minority interest. Such arrangements do have uncertainty associated with them. However, that uncertainty is primarily associated with what the exercise price will be and, in the case of a put, when, or whether, the [non-controlling] minority interest will exercise it. The staff also note that a put would not be a deferred settlement, because settlement is contingent on the option being exercised. And that event is outside of the control of the acquirer.

9 The staff have also considered the situation where the fair value of the option exceeds the fair value of the non-controlling interest at the acquisition date. The staff believe that this type of transaction does include a component of contingent consideration, equal to the difference between the fair value of the controlling interest acquired and the aggregate of the consideration transferred and the fair value of the put or forward.

10 A forward or put arrangement may well be an integral part of the acquisition in which the parent achieved control of the subsidiary. It is likely that for many of these transactions the [non-controlling] minority interest has a management role in the subsidiary and the deferred acquisition or put is designed to align the interests of the parent and that of the [non-controlling] minority interest. The staff believe that any excess of the fair value of the option over the fair value of the non-controlling interests at the acquisition date is likely to indicate the existence of either contingent consideration or a component of employee remuneration.

11 The staff also note that an entity might use a proxy for fair value in measuring the exercise price in a forward or put. This could include an exercise price based on an accounting number. The staff believe that a formulaic exercise price does not always mean that there is a contingent consideration component. It will take judgment to assess whether the exercise price mechanism is a

simplified proxy for fair value or contains a contingent consideration component.

12 To summarise, the staff accept that there is likely to be diversity in practice in the accounting for business combinations when puts or forwards are part of the transaction in which a controlling interest is acquired. That diversity should, however, be limited to cases where some of the components of the transaction are not at fair value.

Concurrent deliberations

13 The Board is currently redeliberating the proposed revised IFRS 3. The Board did consider the requirements on adjustments to the cost of a business combination contingent on future events in developing its proposals, but not the specific circumstances the IFRIC has been asked to examine.

14 The staff expect to take the first papers to the Board on contingent consideration in July 2006. The papers, for which drafting has begun, will include a commitment through a written put or a forward purchase to acquire shares in a subsidiary held by a third party as part of the purchase of a controlling interest in the subsidiary. The analysis will be available to observers when the Board discusses this topic.

15 The staff will also give consideration to the scope of the contingent consideration issue. That is to say, we will consider whether there are implications for the accounting for associates or joint ventures.

16 The staff believe that it is unlikely that an Interpretation could be published before the proposed revised IFRS 3 redeliberations are completed.

Recommendation

17 The staff believe any forward or put that has an exercise price that is different from the fair value of the [non-controlling] minority interest is likely to indicate the existence of either contingent consideration or a component of employee remuneration. Judgement might be required to ensure that the components are separated in an appropriate manner.

18 Notwithstanding the concerns the staff do have, the staff recommend that the IFRIC decline to takes this matter onto its agenda. The staff believe that authoritative guidance about contingent consideration is likely to emerge more quickly from the current redeliberation of the proposed replacement for IFRS 3 than it would from an IFRIC project. The staff propose that the following reasons be published for not taking the topic onto the IFRIC agenda: [deleted for observer notes purposes]