Grant Thornton

Insights into IFRS 3

Consideration transferred

Business combinations are infrequent transactions that are unique for each occurrence. IFRS 3 ‘Business Combinations’ contains the requirements which can be challenging when applying in practice.

Our ‘Insights into IFRS 3’ series summarises the key areas of the Standard, highlighting aspects that are more difficult to interpret and revisiting the most relevant features that could impact your business.

Determining the ‘consideration transferred’ is one of those critical steps that an acquirer has to go through when accounting for a business combination since it is a key component of the equation when measuring the goodwill acquired. This article discusses the main practical issues affecting consideration transferred, using examples to illustrate some of the requirements.

What is consideration transferred?

IFRS 3 refers to ‘consideration transferred’ rather than ‘purchase price’ or ‘cost of investment’. The key distinction is that consideration transferred comprises only what is transferred to the former owners of the acquiree in exchange for the acquiree. It therefore means that the consideration transferred excludes any payments that do not relate to what the acquirer has agreed to effect the acquisition of the acquiree (see our article **Insights into IFRS 3 – Determining what is part of a business combination transaction** for more details). For example, the consideration transferred excludes acquisition-related costs but includes contingent consideration.

Components of consideration transferred

Consideration transferred is the sum of the acquisition-date fair values of:

- the assets transferred by the acquirer
- the liabilities incurred by the acquirer to former owners of the acquiree
- the equity interests issued by the acquirer in exchange for the acquiree.

It is helpful to divide the process of determining consideration transferred into two key steps:

Contractual purchase price based on the purchase agreement adjusted to reflect fair value → See below

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Adjustments for transactions not part of the business combination → Refer to our article **Insights into IFRS 3 – Determining what is part of a business combination transaction**

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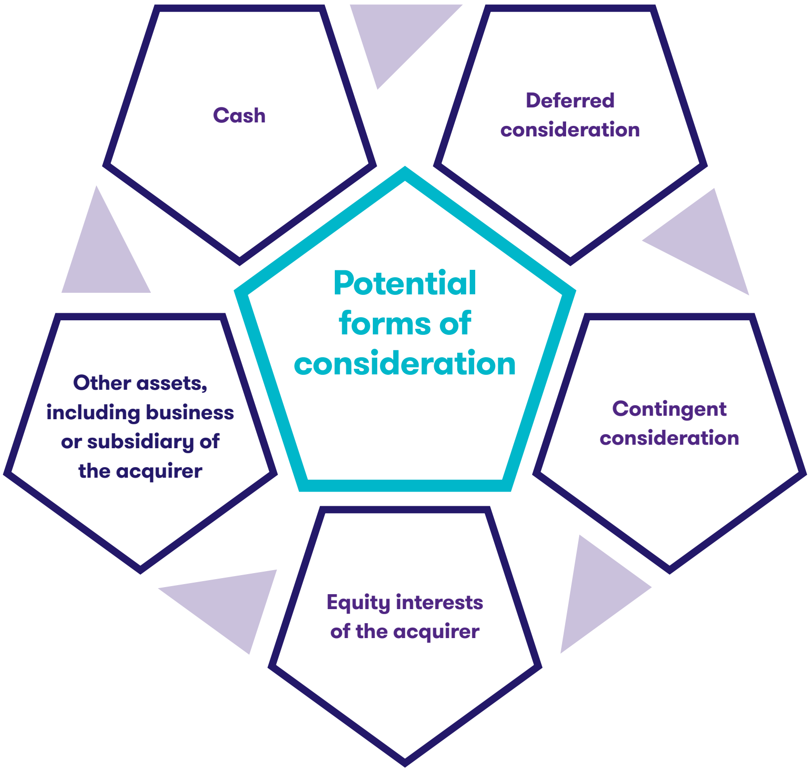
Consideration transferred in exchange for the acquiree

Contractual purchase price vs consideration transferred

Consideration transferred could differ from the contractual purchase price (ie the price stated in the purchase agreement) for different reasons. One of the reasons could be if the overall transaction or arrangement includes elements that (under IFRS 3's principles) are not part of the business combination. However, it could also be because the fair value of the consideration transferred at the date of acquisition is not the same as the amount stated in the contractual arrangement to determine the purchase price.

The contractual purchase price may include more than one type of consideration. Certain types of consideration could affect reported results at the acquisition date, as discussed further below.



Deferred consideration

Deferred consideration is an obligation to pay a certain amount at a specified date after the date of acquisition. In this case there is no uncertainty regarding whether the amount needs to be paid or the total amount to be paid. Deferred consideration is included in the consideration transferred and is recognised and measured at fair value at the date of the business combination. In determining the fair value of the deferred consideration, the acquirer adjusts the promised amount for the effects of the time value of money if the timing and amount of instalments agreed to by the parties (the acquirer and the seller) to the contract (either explicitly or implicitly) provides the acquirer with a benefit of financing for the acquisition of the acquiree. This could happen, for example, if the deferred consideration does not bear interest or bears a non-market interest rate. The unwinding of any discount of the deferred consideration is then recognised in the statement of profit or loss.

Contingent consideration

Many business combinations include contingent consideration, often referred to as an 'earn-out clause' and defined as an obligation of the acquirer to transfer additional assets or equity interests to the acquiree's former owners if specified future events occur or conditions are met. This can be a useful mechanism to enable the acquirer and the vendor to agree on terms of the business combination in the face of uncertainties that may affect the value and future performance of the acquired business. A contingent consideration arrangement is inherently part of the economic considerations in the negotiations between the buyer and seller. Such arrangements are commonly used by buyers and sellers to reach an agreement by sharing particular specified economic risks related to uncertainties about future outcomes of the acquiree. Differences in the views of the buyer and seller about those uncertainties are often reconciled by agreeing to share the risks so that favourable future outcomes generally result in additional payments to the seller and unfavourable outcomes result in no payments, lower payments, or in some cases it can result in consideration previously transferred being returned to the acquirer (ie contingent consideration classified as an asset).

IFRS 3 provides the following guidance on the recognition and measurement of contingent consideration:

	Guidance	Impact
Initial measurement and recognition	• Contingent consideration is recognised and measured at fair value on the acquisition date • Obligation to pay a contingent consideration that meets the definition of a financial instrument is classified as a financial liability or as equity on the acquisition date in accordance with IAS 32 'Financial Instruments: Presentation'	The amount recognised on the acquisition date directly impacts goodwill and reported assets, liabilities or equity depending on the characteristics or terms of the contingent consideration
Subsequent measurement and recognition	Except for adjustments during the measurement period to provisional estimates of fair values at the acquisition date, initial classification affects post-combination reported results as follows: • contingent consideration classified as equity is not remeasured and its subsequent settlement is accounted for within equity • Other contingent considerations are subsequently remeasured at fair value through profit or loss until settled.	Subsequent accounting for other contingent consideration liabilities will result in: a recognising a gain in profit or loss if the specified milestone or event requiring the contingent payment is not met. For example, the acquirer would recognise a gain on the reversal of the initial fair value of the liability if an earnings target in an earn out arrangement is not achieved. b recognising a loss in profit or loss if the combined entity is successful and the amount paid exceeds the fair value of the liability measured at the acquisition date. This is the consequence of entering into contingent consideration arrangements related to future changes in the value of a specified asset or liability or earnings of the acquiree after the acquisition date. For example, if a contingent consideration arrangement relates to the level of future earnings of the combined entity, higher earnings in the specified periods may be partially offset by increases in the liability to make contingent payments based on earnings because the acquirer has agreed to share those increases with former owners of the acquiree.

In addition, it is important to note that:

- Goodwill is not adjusted after the acquisition date to reflect changes in the fair value or settlement of contingent consideration except for adjustments qualifying as measurement period adjustments (see our article **Insights into IFRS 3 – Accounting when the business combination is incomplete at the reporting date** for more details, where we discuss that careful consideration should be given before the business combination is adjusted for items occurring after the date of acquisition) or arising from correction of errors.
- Some contingent consideration arrangements may include transactions that are accounted for separately from the business combination for instance where the additional payment is contingent on the seller remaining as an employee of the acquiree for a certain period after the combination (see our article **Insights into IFRS 3 – Determining what is part of a business combination transaction** for more details).

As stated above, the classification of a contingent consideration obligation that meets the definition of a financial instrument as either a financial liability or equity is to be based on the relevant definitions in IAS 32. It should be noted that IAS 32 includes in the definition of a financial liability a contract that will or may be settled in the entity's own equity instruments and is:

- a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments, or
- a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

The following examples illustrate the application of some of IFRS 3's key principles on contingent consideration:

Example 1 – Contingent consideration payable in fixed number of shares

An acquirer purchased a business in the pharmaceutical industry. The sale and purchase agreement specifies the purchase price payable as:

- cash of CU100 million to be paid on the acquisition date
- 1,000,000 shares of the acquirer to be issued to the vendor after two years from the acquisition date if a specified drug receives regulatory approval by the local authority in country X during this two-year period.

Analysis

The consideration transferred comprises the cash paid plus the fair value of the contingent obligation to issue 1,000,000 shares in two years' time. The fair value of the contingent element would be based on a two-year forward price and would be reduced by the effect of the performance conditions, ie the probability for the target of not obtaining the regulatory approval during this two-year period.

The initial classification of the contingent consideration (ie equity or financial liability) is based on the definitions provided in IAS 32. Because this obligation can be settled only by issuing a fixed number of shares, it is classified as an equity instrument. Accordingly, the initial fair value of the contingent consideration is credited to equity. There is no subsequent adjustment (although the credit might be reclassified within equity on settlement in shares or on expiry of the obligation).

Example 2 – Contingent consideration payable through the issue of a variable number of shares

On 31 December 20X1, Entity X acquired business Y. The consideration is CU800,000 in cash to be paid at the acquisition date, plus an additional number of shares equivalent to CU100,000 (based on the fair value of Entity X shares at the time they will be issued) if the average profits of business Y in 20X2 and 20X3 exceed a target level. The additional shares will be issued on 7 January 20X4, if applicable.

At the acquisition date, Entity X's management consider that it is 40% probable that business Y will achieve its average profit target. Also, the entity determines that the prevailing rate of return for the contingent consideration is 5%. The determination of a discount rate is a rigorous process and requires the use of judgment on a case-by-case basis.

Analysis

To account for the business combination, Entity X includes the fair value of the contingent consideration in the total consideration transferred related to the acquisition of Y. On the acquisition date, the consideration transferred will then be equal to CU836,281 which consists of:

- cash of CU800,000 plus
- the fair value of the contingent consideration of CU36,281 (CU100,000 / (1.05)2 × 40%†).

The contingent consideration requires the issuance of a variable number of shares equal to a fixed monetary amount. Accordingly, it is initially classified as a financial liability based on the definitions provided in IAS 32. The liability is subsequently remeasured at fair value until the uncertainty related to the contingent consideration is resolved.

Notes:

- The same accounting treatment applies in situations where contingent consideration is payable in cash.

† IFRS 3 does not specify a valuation technique for measuring fair value. For illustration purposes a probability weighted approach has been used. Other valuation methods might also be acceptable to the extent the method is aimed at determining the fair value (as defined by IFRS 13 'Fair Value Measurement') of the contingency.

Example 3 – Contingent consideration payable through the issue of variable number of shares – another example

The acquirer of target Entity X (business combination of which is affected in Year N) has accepted to issue additional shares, each issue being independent from the other, as part of the business combination in the following situations:

- 10,000 shares if the earnings of Entity X for Year N+1 exceed CU5M
- 15,000 shares if the earnings of Entity X for Year N+2 exceed CU10M

Analysis

As noted, each outcome is independent from the other. In other words, the fact that target Entity X meets the earnings objective in Year N+1 does not mean that the earnings objective in Year N+2 will also be met and result in issuing 15,000 additional shares. Therefore, each outcome (probability of issuing nil or 10,000 shares in Year N+1 and probability of issuing nil or 15,000 shares in Year N+2) should be considered independently as a distinct arrangement when assessing whether the contingent consideration meets the definition of an equity instrument or a financial liability. In the fact pattern described, since the number of shares is nil or a fixed number, we would probably conclude that each outcome gives rise to an equity instrument that should be measured at fair value at the acquisition date with no subsequent remeasurements.

Example 4 – Deferred and contingent consideration

Entity A acquires the entire equity of Entity B for a cash consideration of CU120,000. Entity A also agrees to pay an additional amount of cash that is the higher of CU1,500 and 25% of any excess of Entity B's profits in the first year after the acquisition over its profits in the preceding 12 months. This additional amount is due after two years. Entity B earned profits of CU20,000 in the preceding 12 months but Entity A expects Entity B to make at least CU30,000 in the year after the acquisition date.

Analysis

In this situation, contingent and deferred payments should be differentiated. Entity A agrees to pay an amount that is the higher of two amounts. The additional amount of CU1,500 is the minimum amount payable by Entity A and is not subject to any contingency. Accordingly, this amount is a deferred payment rather than a contingent payment. The contingent payment only relates to the portion that will be paid in excess of the minimum amount of CU1,500 if Entity B exceeds its profit target.

Considering the expected profits above, this would be (without the effect of discounting):

- CU30,000-CU20,000 = CU10,000 excess. 25% of the excess is CU2,500, which is split as:
  - Deferred consideration of CU1,500, and
  - Contingent consideration of CU1,000.

Consideration transferred consists of cash paid at the acquisition date together with both deferred and contingent considerations, which should be measured at their acquisition date fair values. Therefore the consideration is:

- cash at its face amount
- deferred consideration at its present value – determined by discounting it using an appropriate discount rate
- contingent consideration at its estimated fair value – determined taking into account the probability that Entity B will earn profits above the target that triggers additional payment using an appropriate valuation method
- contingent consideration included in the consideration transferred should be the excess of its estimated fair value over the fair value of the deferred consideration.

Equity interests of the acquirer

When equity interests of the acquirer, such as ordinary or preference shares, options, warrants and member interests of mutual entities, are issued as consideration, they should be measured using the guidance in IFRS 13 on determining the fair value of an entity's own equity. IFRS 3 clarifies that it is the fair value at the acquisition date that should be used instead of the fair value at the agreement date even though it is generally on that basis that the acquirer and the buyer negotiated the terms of the arrangement ie the amount of consideration to be paid and the fair value of the acquiree.

Other assets, including business or subsidiary of the acquirer

Transfer of acquirer's assets

When consideration transferred includes the transfer of non-cash assets of the acquirer to the vendor (eg property, plant and equipment or a business), these assets are remeasured at their fair value on the acquisition date. Any difference between their fair value and their carrying amount is recognised immediately in profit or loss.

However, IFRS 3 provides an exception to the remeasurement of these non-cash assets at fair value at the acquisition date in situations where they are transferred to the combined entity (ie acquirer and acquiree) rather than to the vendor. Effectively, the acquirer retains control of the assets in this situation, and the assets should continue to be measured at their pre-combination carrying amount in the consolidated financial statements of the parent.

Example 5 – Transfer of acquirer's non-cash assets to vendor as part of consideration

Entity X acquires the entire equity of Entity Y for a cash consideration of CU80,000, in addition the acquirer agrees to transfer a non-cash asset to the vendor as part of the consideration with a fair value of CU10,000. This asset is carried in the books of the acquirer at CU8,000.

Analysis

The total consideration for the business combination is CU90,000 (CU80,000 + CU10,000). The difference in the fair value compared to the carrying amount of CU2,000 (CU10,000-CU8,000) is recognised as a gain in profit or loss immediately in the parent consolidated financial statements.

Example 6 – Transfer of the acquirer's non-cash assets to the acquiree

Entity A acquires 80% of Entity B by contributing to Entity B its subsidiary Entity C whose fair value (FV) is CU200. The pre-combination carrying amount of Entity C's net assets is CU70 and the FV of Entity B's net identifiable assets is CU30. The FV of Entity B is CU50.

As a result of the transaction, Entity A has exchanged 20% of its subsidiary Entity C for acquiring 80% of Entity B. Since we expect this is an exchange of equal value, it does mean that 20% of the FV of Entity C (ie 20%*CU200 = CU40) equals the FV of the 80% interest in Entity B (ie 80%*CU50 = CU40).

Analysis

The amount of goodwill recorded is different depending on how the NCI is measured[1], as follows:

Calculation of goodwill	**NCI measured using…**	
	Proportionate method CU	**Fair value CU**
Consideration transferred (FV of Entity C of CU200*20%)	40	40
NCI (FV of Entity B's net identifiable assets of CU30*20%)	6	–
NCI (FV of Entity B of CU50*20%)	–	10
Total	**46**	**50**
Less: Net identifiable asset of Entity B	(30)	(30)
Goodwill	**16**	**20**

Effect of the transaction with NCI to recognise in equity – on Entity C interest[2]

Consideration received (FV of Entity B of CU50*80%)	40	40
Interest in Entity C given up (Carrying amount of Entity C of CU70*20%)	(14)	(14)
Difference to recognise in equity	**26**	**26**

Journal entry	**Dr (Cr)**	**Dr (Cr)**
Net identifiable asset of Entity B	30	30
Goodwill	16	20
NCI (CU6 + CU14) or (CU10 + CU14)	(20)	(24)
Equity	(26)	(26)

[1] See our article **Insights into IFRS 3 – Recognising and measuring non-controlling interests** for more details on this NCI measurement option.

[2] In accordance with IFRS 10 'Consolidated Financial Statements', transactions with NCI without loss of control of the subsidiary (Entity C in the example) are accounted for as equity transactions.

Specific considerations

Specific considerations apply to:
- share-for-share exchanges, including combinations of mutual entities
- combinations in which no consideration is transferred.

Share-for-share exchanges and combinations of mutual entities

A business combination can be affected through a share-for-share exchange (ie acquirer issues its shares to the vendors in exchange for the acquiree's shares). Under IFRS 3, consideration transferred is determined based on the fair value of the shares issued by the acquirer. However, IFRS 3 provides a mandatory alternative if the shares acquired are more reliably measurable. The consideration transferred is measured using the acquisition-date fair value of the acquiree's equity interests received if this fair value is more reliably measurable than the acquisition-date fair value of the acquirer's equity interests transferred.

This situation may arise, for example, when a private company acquires a public company whose shares are traded in an active market. The quoted price of the acquiree's shares is likely to provide a more reliable measure of fair value than an estimate of the value of the acquirer's shares using a valuation method.

Some specific issues arise in business combinations between mutual entities. These are commonly affected by an exchange of members' interests. IFRS 3's alternative in determining consideration transferred for share-for-share exchanges equally applies to such situations. If more reliably measurable, the fair value of the members' interest in the acquiree (or fair value of the acquiree) is used to determine consideration transferred instead of the fair value of the acquirer's members' interest transferred.

Business combinations with no consideration transferred

A business combination can be brought about without paying any consideration. Examples of these situations are the following:
- an investee repurchases its own shares held by other investors resulting in an existing shareholder becoming the majority shareholder
- cancellation or expiry of veto or similar voting rights of other shareholders that prevented the investor from exercising control
- business combinations achieved by contract alone (eg stapled arrangements or forming a dual-listed entity).

Even if no consideration is transferred in these situations, the acquisition method should still be applied for these business combinations. IFRS 3 provides specific guidance on how to determine goodwill.

Computing the amount of goodwill in a business combination, requires the acquirer to aggregate (i) the consideration transferred,(ii) the amount of any NCI in the acquiree; and (iii) the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree and to compare the total of these three amounts to the net of the acquisition date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with IFRS 3.

To determine the amount of goodwill when no consideration is transferred, the acquirer must substitute the fair value of any consideration transferred with the acquisition-date fair value of the acquirer's interest in the acquiree (determined using an appropriate valuation technique).

However, it should be careful not to double count the acquirer's interest in the acquiree with the acquirer's previously held equity interest in the acquiree in the two first scenarios above.

In a business combination achieved by contract alone the acquirer can hold no equity interest in the acquiree before or after the acquisition date. In such situations, the acquirer must attribute all of the equity interest held by parties other than the acquirer as non-controlling interest (NCI), even if this results in 100% NCI.

Example 7 – Business combinations achieved by contract alone

Entity S acquires Entity T through a business combination achieved by contract alone. Entity S had no equity interest before the business combination. The fair value of the identifiable net assets of Entity T is CU500. The fair value of the equity interest (100%) in Entity T is CU750.

Analysis

Entity S uses the fair value method to initially measure the NCI and therefore recognises the following amounts:

	CU
Net assets of Entity T	500
Goodwill	**250**
NCI – (credit to equity)	**750**

The amount of goodwill recognised in the transaction represents only the NCI's share in the subsidiary. This is because the acquirer does not own any ownership interest in the acquiree. Should the acquirer elected to apply the proportionate method for measuring the NCI, no goodwill would have been recognised.

Next steps

As mentioned in the flowchart on page 1, the determination of the amount of the consideration transferred cannot be finalised without looking at our article **Insights into IFRS 3 – Determining what is part of a business combination transaction**. The guidance provided in that article sets out the analysis to perform when determining the right amount of consideration transferred to attribute to the business combination.

How we can help

We hope you find the information in this article helpful in giving you some insight into IFRS 3. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.