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ACCOUNTING FOR CONTINGENT CONSIDERATIONS IN BUSINESS COMBINATIONS

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Abstract

According to IFRS 3 Business Combinations contingent considerations must be included in the total consideration given for the acquired entity along with cash, other assets, ordinary or preference equity instruments, options, warrants. The contingent consideration is the determined amount which acquiring entity has to pay to acquired entity provided, that certain conditions will be fulfilled in the future. In case the provisions are not satisfied, we will get the situation when the amount of contingent consideration has been included in the total consideration given in the business combination, but in fact, the acquirer has not paid that amount. In its turn, the acquired entity will recognize the contingent consideration as a financial asset according to IFRS 9 Financial Instruments. In that case, it would be appropriately to recognize the contingent consideration as a contingent asset applying IAS 37. In the Article the author will explore the challenges of contingent consideration accounting and suggest the ways of solving the above mentioned problems.

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INTRODUCTION

Business combinations are an important range of modern economy. Their abundance in different countries of the world is conditioned with the important economic priorities of business combinations, such as achievement of synergy effect, growth of market share, improvement of technological processes. Therefore, investigating the problems in financial reporting of business combinations and discussing solutions for them is actual task.
Subject to IFRS 3 Business Combinations an economic operation is qualified a business combination if assets acquired and liabilities assumed by an investor constitute a business. The acquirer gives a consideration to the former owners of the acquired entity which comprises cash, other assets, the business of the acquiring entity or its subsidiary, equity interests or contingent consideration.
In the Article we will discuss the issues of improving contingent consideration accounting both from the perspective of the acquirer and the seller. Particularly, we will consider the appropriateness of adjustment of contingent consideration, which was included in the total consideration given according to IFRS 3 Business Combinations, in case the events and circumstances stipulated in contingent consideration agreement do not occur. Besides that, we will examine the propriety of recognizing the contingent consideration as a contingent asset which has to be qualified by acquired entity as a financial instrument subject to IFRS 9 Financial Instruments.

CONTINGENT CONSIDERATION – ACQUIRER ACCOUNTING

Contingent consideration represents an arrangement between the acquirer and the acquiree which implies the acquirer to transfer determined assets to acquiree in case events stipulated in the contingent consideration agreement has been occured. Contingent consideration can also take form of a right of the acquirer to the return of previously transferred assets or equity interests from the sellers of the acquired business. It is often used to enable the buyer and seller to agree on the terms of a business combination, even though the ultimate value of the business has not been determined. Any payments made or shares transferred to the sellers of the acquired business should be evaluated to determine whether they should be accounted for separately from the business combination. Contingent consideration that is paid to sellers that remain employed and linked to future services is generally considered compensation cost and recorded in the post combination period.
According to IFRS 3 Business Combinations, the acquirer has to include the fair value of the contingent consideration in the total consideration transmitted for the acquired entity. An acquirer's contingent right to receive a return of some consideration paid is recognized as an asset and measured at fair value. Subsequently it is possible, that an event stipulated in the contingent consideration agreement will not occur and in that case the acquirer won't have to pay contingent consideration amount to the acquired entity's shareholders.
As a result, we get a situation when the contingent consideration amount was included in the total consideration given for the acquired business, but in fact, the acquirer has not paid it. Based on the following, it will be reasonable if adjustments will be made in IFRS 3 Business Combinations and the acquirer would be able to adjust the consideration given (to reduce the amount of consideration given) in case the provisions of contingent consideration agreement had not been occurred.
According to IFRSs, an acquirer's commitment to pay contingent consideration should be recognized as a liability or equity proceeding from the definition of an equity instrument and a financial liability in IAS 32 Financial Instruments: Presentation. As it is pointed in IAS 32 „an equity instrument is a contract that evidences a residual interest in the assets of an entity after deducting all its liabilities". As for a financial liability, according to IAS 32 it is „a contractual obligation to deliver cash or another financial instrument or exchange financial assets or liabilities under conditions that are potentially unfavourable or a contract that will or may be settled in its own equity instruments and it is a:

- Nonderivative for which an entity is or may be obliged to deliver a variable number of its own equity shares; or
- Derivative that will or may be settled other than by exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments".

We should account for contingent consideration in the period following the combination based on the fact how we had classified that contingent consideration: as an asset, a liability or equity. Excluding adjustments to contingent consideration that qualify as measurement period adjustments, accounting for contingent consideration in the postcombination period is as follows:

Contingent consideration classified as a liability or an asset: Contingent consideration recognized as an asset or a liability should be reassessed to fair value at each reporting date and changes in fair value should be included in profit or loss in accordance with IAS 39 or IFRS 9.

Contingent consideration classified as equity: Equity-classified contingent consideration is measured initially at fair value on the acquisition date and is not remeasured subsequent to initial recognition. Settlement of the equity-classified contingent consideration is accounted for within equity. In other words, the initial value recognized for an equity contingent consideration arrangement on the acquisition date is not adjusted, even if the fair value of the arrangement on the settlement date is different.

Contingent consideration may be linked with a scientific project of acquired entity. More precisely, the acquiring entity will pay the determined amount (contingent consideration) provided that current project will be accomplished successfully. In that case, the contingent consideration is directly linked with scientific project intangible asset.

Therefore, it will be more reasonable if the changes in fair value of the contingent consideration will be accounted for with adjustment of related intangible asset (in case contingent consideration is linked with an intangible asset) instead of recognizing the changes in profit or loss, as it is required in IFRSs.

CONTINGENT CONSIDERATION – SELLER ACCOUNTING

According to IAS 39 Financial Instruments: Recognition and Measurement (or IFRS 9 Financial Instruments if an entity has started applying it), contingent consideration arrangement which gives a seller right to receive cash or other assets, meets the definition of a financial asset. When the contingent consideration arrangement meets the definition of a financial asset, it should be included as part of consideration received and should be measured using one of the four measurement categories specified in the IAS 39. Determining the contingent consideration arrangement's classification will require judgment and will be based on the specific facts and circumstances of each arrangement.

It should be noted that events or circumstances stipulated in the contingent consideration arrangement may not occur and in that case acquired entity will not receive part of the consideration.

Therefore, we think that it would be appropriately if the seller classifies the contingent consideration arrangement as a contingent asset and applies the requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets for these purposes. The Standard defines a contingent asset as a possible asset (contingent consideration) that arises from past events (settlement of contingent consideration agreement) and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events (provision of contingent consideration agreement) not wholly within the control of the entity.

CONCLUSION

An acquiring entity should recognize the fair value of the contingent consideration as part of the total consideration given for the acquired entity. An acquirer's contingent right to receive a return of some consideration paid is recognized as an asset and measured at fair value. It is possible, that an event stipulated in the contingent consideration agreement will not occur and in that case the acquirer won't have to pay contingent consideration amount to the acquired entity's shareholders. As a result, we get a situation when the contingent consideration amount was included in the total consideration given for the acquired business, but in fact, the acquirer has not paid it. Based on the following, it will be reasonable if adjustments will be made in IFRS 3 Business Combinations and the acquirer would be able to adjust the consideration given.

The acquired entity should account for contingent consideration contract, which gives it right to receive cash or other assets in case of fulfillment of provisions, as a financial asset. We think that it would be appropriately if seller classifies the contingent consideration arrangement as a contingent asset and applies the requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets for these purposes.

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