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# MFRS Hot Topics

## Share-based contingent consideration

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue addresses the following aspects of accounting for contracts to issue share-based contingent consideration in a business combination:

- the presentation (as a liability or equity) of the estimated number of shares to be issued
- the measurement of post-acquisition adjustments to the estimated number of shares to be issued.

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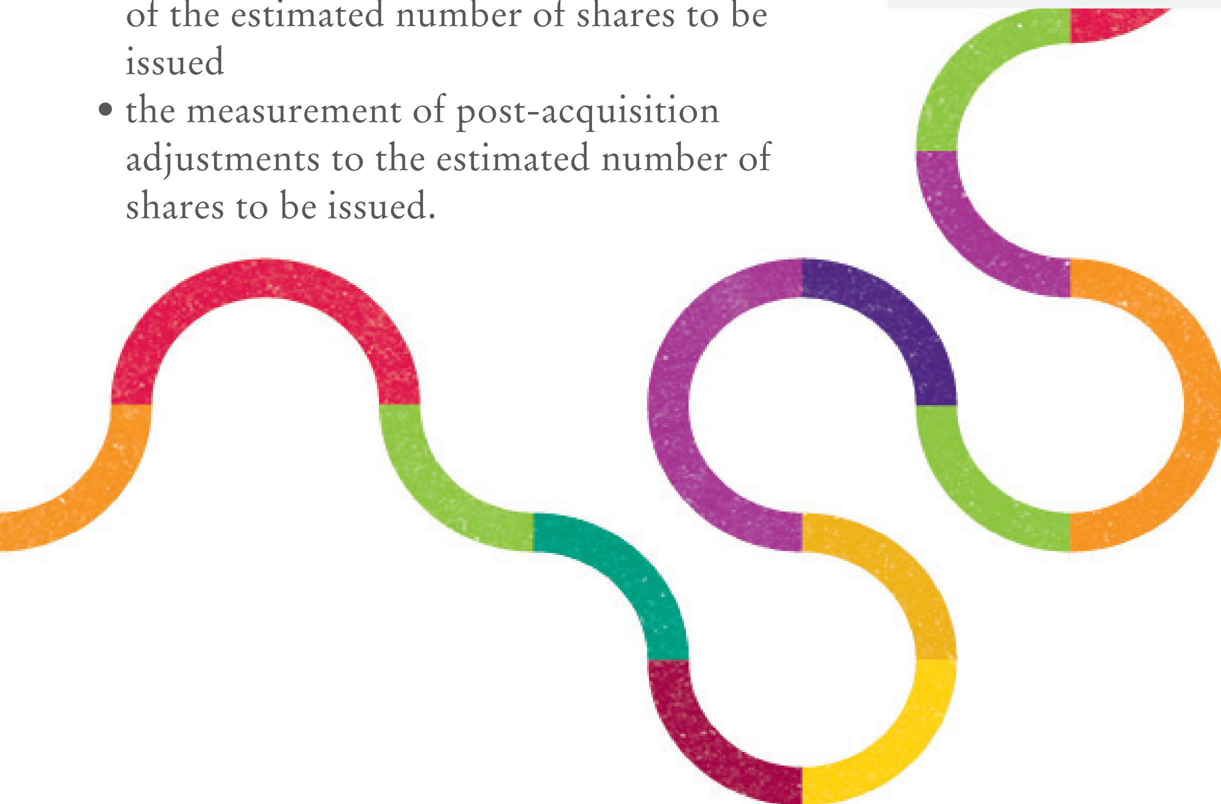


# Introduction

A contract to issue share-based contingent consideration (shares) should be measured at its fair value on the acquisition date for the purpose of determining the consideration transferred in exchange for the acquiree. It should be presented as:

- a liability, if the contract requires the issuance of a variable number of shares equal to a fixed or contingent monetary amount or
- equity, if at the date of the business combination, the contract requires a fixed number of shares or the number of shares to be issued is predetermined based on the outcome of a contingency or
- for arrangements that include more than one contingency or performance target, it must be determined whether the unit of account is the overall contract or separate contracts for each contingency or performance target within that overall contract. If separable, these contracts may then individually result in the delivery of a fixed number of shares and as a result be classified as equity. If not separable, the arrangement is viewed as one contract that results in the delivery of a variable number of shares (and would be classified as a liability) because the number of shares that will be delivered depends upon which performance target is met.

Any subsequent adjustment to the number of shares expected to be issued should be measured based on the fair value at the acquisition date. Accounting for changes in fair value will depend on how the contingent consideration is presented (i.e. equity or liability). Paragraph 58 of MFRS 3 Business Combination provides that:

- contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity
- contingent consideration classified as an asset or a liability within the scope of MFRS 139 Financial Instruments: Recognition and Measurement shall be measured at fair value, with any resulting gain or loss recognised in profit or loss or, for financial assets classified as available for sale, in other comprehensive income. Any liability not within the scope of MFRS 139 shall be accounted for in accordance with MFRS 137 Provisions, Contingent Liabilities and Contingent Assets or other MFRSs as appropriate.

In certain situations where the determination of the fair value of the contingent consideration is provisional (and the entity has stated such fact in the notes to its financial statements) and where the change in the fair value of contingent consideration is a result of additional information that the acquirer obtained after the acquisition date about facts and circumstances that existed at such date, this is considered as a measurement period adjustment. Accordingly, the corresponding adjustment to the fair value of the contingent consideration is either charged or credited to goodwill. MFRS 3.45 to 3.49 provides guidance on measurement period adjustments.

Contingent consideration arrangements (including share-based and cash-based arrangements) should be assessed to determine if, in substance, they include consideration for post-acquisition employment or other services. This issue is considered in more detail in the following sections.

# Share-based contingent consideration in a Business Combination

Appendix A of MFRS 3 defines contingent consideration as follows:

> "Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met."

Typically, contingent consideration arrangements involve the payment of more or less consideration dependent on (for example):

- the outcome of identified contingencies such as litigation against the acquiree or
- the financial performance of the acquiree over a specific period (sometimes referred to as 'earn-out' arrangements).

In a business combination, MFRS 3.39 requires that *"the acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree."*

The effect of MFRS 3.39 is that the acquirer estimates, at the acquisition date, the fair value of the contingent consideration. This estimate is based on the expected future outflow, which should reflect the probability of whether such outflows will be made and can be determined generally using a valuation technique. Contingent consideration might include cash, shares, other assets or a mixture. When the arrangement may result in a variable number of shares being issued to the vendor, a question arises as to whether the contract should be classified by the acquirer as equity or as a financial liability. MFRS 3.40 provides that contingent consideration shall be classified either as an equity instrument or as a financial liability based on the definitions of an equity instrument and a financial liability in Paragraph 11 of MFRS 132 Financial Instruments: Presentation. Once shares have been issued, they will be classified as equity.

In our view, a contract that provides for the issuance of a predetermined number of shares that is dependent on the outcome of a single contingency (such as meeting a financial or non-financial target) should be classified as equity by the acquirer, so long as the number of shares to be issued does not vary depending on the value of the shares.

An example of such an arrangement is a contract that requires the acquirer to issue 1,000 additional shares if profits of the acquiree meet at least 50% of a certain performance target. Such a contract does not include any obligation to transfer cash or another financial asset and does not include any requirement to exchange financial assets or liabilities under potentially unfavourable conditions to the acquirer. Thus, the conditions in MFRS 132.16(a) are met.

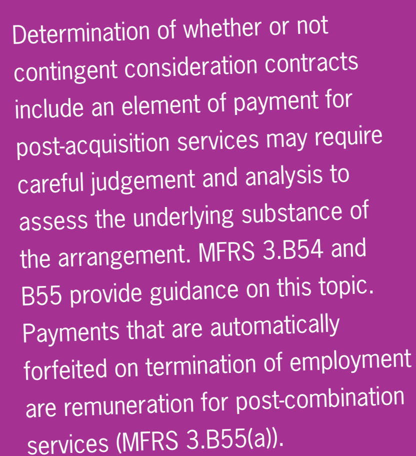
MFRS 132.16(b)(i) states however that the instrument should not contain an obligation to deliver a variable number of shares. Due to the varying number of shares (nil or 1,000) that can be issued, it can be argued that such criterion is not met. However, in our view, it is reasonable to regard the terms of the arrangement as meeting the fixed-number criterion. The number of shares to be issued is fixed and predetermined (ie known in advance) at any time and will only change based on the outcome of the contingency, ie it will be nil or 1,000, depending on the performance results. However, the number will not vary depending in relation to the share value.

By contrast, a contract that provides for the issuance of a variable number of shares equal to a fixed or contingent monetary amount should in our view be classified as a financial liability. An example of such an arrangement is a contract that requires the acquirer to issue shares to the value of CU1,000 if profits of the acquiree meet a certain target. Such a contract again contains no obligation to transfer cash. However, this contract does not evidence a residual interest in the net assets of the acquirer. The acquirer is, in effect, using its own shares as 'currency' to settle a financial liability.

A more difficult assessment arises in arrangements where there are multiple performance targets and a fixed number of shares will be issued when each of those performance targets are met. In these situations, an understanding of the terms of the arrangement is necessary to determine whether the unit of account is the overall contract or whether the overall contract can be separated into multiple contracts for each performance target. If the performance targets are readily separable and independent of each other and relate to different risk exposures then they should be treated as separate contracts (MFRS 139. AG29). In this case, each separable target is assessed to determine its classification as equity or liability. Conversely, if the unit of account is the contract as a whole, it will be classified as a liability because the number of shares to be issued varies depending on which target is met.

# Payments for post-acquisition services

Some contingent consideration arrangements may, in substance, include an element of payment for post-acquisition services. This can apply, for example, when the acquiree retains the services of a vendor who is also a manager of the acquired business. An arrangement that results in additional payment to that vendor based on post-acquisition performance might in substance represent post-acquisition management compensation (bonus or profit share) rather than additional payment for the acquired business. To the extent that contingent consideration includes an element for post-acquisition services, that element should be recorded as an expense in the post-acquisition period rather than as an adjustment to the cost of the combination. If part of the arrangement is, in substance, a share-based payment for services, it should be accounted for in accordance with MFRS 2 Share-based Payment.



# Examples

**Example 1: Fixed number of shares based on single performance target**

On 31 Dec 20X1, acquirer A agrees with vendor V to acquire business B. The consideration is 80,000 shares of A, plus an additional 20,000 shares if the average profits of B in 20X2 and 20X3 exceed a target level. The additional shares will be issued on 31 March 20X4, if applicable. There are no other costs of the combination. The fair value of B's assets, liabilities and contingent liabilities is determined to be CU750,000. At the acquisition date, A's management consider that it is 40% probable that B will achieve its average profit target. However, during 20X2, B's performance exceeds forecasts such that, at 31 Dec 20X2, A's management considers that it is 80% probable that B will achieve its target.

At 31 Dec 20X1 the fair value of A's shares is CU10. At the same date, A estimates that the current fair value of a contract to issue a share on 31 Mar 20X4 is CU9.

At 31 Dec 20X2, the fair value of A's shares has increased to CU15. At that date, A estimates that the fair value of a contract to issue a share on 31 Mar 20X4 is CU14.

On 31 Dec 20X3 it is confirmed that B has achieved its target. At that date, the fair value of A's shares has increased to CU17 and A estimates that the fair value of a contract to issue a share on 31 Mar 20X4 is CU15.

The additional 20,000 shares are issued on 31 Mar 20X4. The fair value of A's shares on 31 Mar 20X4 is CU16.

## *What is the reported consideration transferred in exchange for the acquiree?*

At 31 Dec 20X1, the contingent consideration should be included in determining the total consideration transferred related to the purchase of B. The reported consideration is equal to CU872,000 which consists of the fixed amount of shares to be issued of CU800,000 (80,000 x CU10) plus the fair value of the contingent consideration of CU72,000* (20,000 x CU9 x 40%). The contingent consideration is based on a fixed number of shares and is only contingent on the outcome of the single future event; as such, it is classified as equity.

*The determination of acquisition-date fair value of the contingent consideration should take account of the expected outcome of the contingency. The example illustrates one possible approach to estimating the fair value of the arrangement.

The entry to record the acquisition of B is as follows:

| 31 Dec 20X1 | Debit | Credit |
|---|---|---|
| B's assets, liabilities and contingent liabilities | CU750,000 | |
| Goodwill | CU122,000 | |
| Equity | | CU872,000 |

At 31 Dec 20X2, the fair value of the contract to issue additional shares has changed from 40% to 80%. Since, the contingent consideration is classified as equity, subsequent remeasurement of such consideration is not permitted.

When the shares are issued on 31 Mar 20X4, the shares to be issued may be reclassified within equity, for example into issued share capital.

**Example 2: Variable number of shares of a fixed monetary value based on single performance target**
The facts are the same as in Example 1 except that the consideration is 80,000 shares of A, plus an additional number of shares equivalent to CU100,000 (based on the fair value of A shares) if the average profits of B in 20X2 and 20X3 exceed the target level.

The additional 6,250 (CU100,000 / CU16) shares are issued on 31 Mar 20X4.

### *What is the reported cost of the business combination?*

At 31 Dec 20X1, the contingent consideration should be included in determining the total consideration transferred related to the purchase of B. The reported consideration is equal to CU836,000 which consists of the fixed amount of shares to be issued of CU800,000 (80,000 x CU10) plus the fair value of the contingent consideration of CU36,000* (CU100,000 /CU10 x CU9 x 40%). The contingent consideration requires the issuance of shares equal to a fixed monetary amount, as such, it is classified as a financial liability.

*The determination of acquisition-date fair value of the contingent consideration should take account of the expected outcome of the contingency. The example illustrates one possible approach to estimating the fair value of the arrangement.

The entry to record the acquisition of B is as follows:

| 31 Dec 20X1 | Debit | Credit |
|---|---|---|
| B's assets, liabilities and contingent liabilities | CU750,000 | |
| Goodwill | CU86,000 | |
| Liability | | CU36,000 |
| Equity | | CU800,000 |

At 31 Dec 20X2, the probability of the issuance of shares has changed from 40% to 80%. Since the contingent consideration is classified as a financial liability, it should be remeasured at each reporting date. The fair value of the contingent consideration is CU74,667 (CU100,000 /CU15 x CU14 x 80%).

The entry to record the remeasurement of the contingent consideration on 31 Dec 20X2 is as follows:

| 31 Dec 20X2 | Debit | Credit |
|---|---|---|
| Expense (74,667 - 36,000) | CU38,667 | |
| Liability | | CU38,667 |

The change in estimate results from changed circumstances during 20X2 (B's performance was better than anticipated) rather than arising from additional information relating to conditions at the combination date. Consequently, the adjustment is recognised in profit or loss (MFRS 3.58).

At 31 Dec 20X3, it was confirmed that the shares will be issued. At that date, the fair value of A's shares has increased to CU17 and A estimates that the fair value of a contract to issue a share on 31 Mar 20X4 is CU15. Since the contingent consideration is classified as liability, it should be remeasured at each reporting date. The fair value of the contingent consideration is CU88,235 (CU100,000 /CU17 x CU15 x 100%).

The entry to record the remeasurement of the contingent consideration on 31 Dec 20X3 is as follows:

| 31 Dec 20X3 | Debit | Credit |
|---|---|---|
| Expense (88,325 - 74,667) | CU13,568 | |
| Liability | | CU13,568 |

The adjustment of the contingent consideration is after the measurement period; as such the change in the fair value of the contingent consideration is recognised in profit or loss.

When the shares are issued on 31 Mar 20X4, the number of shares issued is determined by dividing CU100,000 by the fair value of the shares.

The entry to record the issuance of shares at fair value of CU100,000 on 31 Mar 20X4 is as follows:

| 31 Mar 20X4 | Debit | Credit |
|---|---|---|
| Expense (100,000 - 88,325) | CU11,675 | |
| Liability | CU88,325 | |
| Equity | | CU100,000 |

### Example 3: Fixed number of shares based on multiple performance targets in the same period

On 31 Mar 20X1, acquirer A agrees with vendor V to acquire business B. The consideration is 80,000 shares of A, plus an additional 20,000 shares if the average profit of B in 20X2 and 20X3 exceeds CU2m or an additional 50,000 shares if the average profit exceeds CU3m. The additional shares will be issued on 31 Mar 20X4, if applicable. Depending on which profit target is met, A could issue zero, 20,000 or 50,000 additional shares.

#### *Is the contingent consideration classified as equity or liability?*

The arrangement must be assessed to determine whether each of the profit targets represents a separable contract. Since the number of A's shares that could be issued under the arrangement is variable and relates to the same risk exposure (ie the number of shares to be delivered will vary depending on which performance target is achieved in the two-year period following the acquisition), the contingent consideration arrangement would be considered one contractual arrangement under MFRS 139.AG29. Since the arrangement will result in the issuance of a variable number of shares, it should be classified as a financial liability in accordance with MFRS 132.11.

### Example 4: Fixed number of shares based on multiple performance targets in different periods

On 31 Dec 20X1, acquirer A agrees with vendor V to acquire business B. The consideration is 80,000 shares of A, plus an additional 20,000 shares if the profits of B exceed CU2m in 20X2 and a further 30,000 shares if the profits of B exceed CU3m in 20X3. The additional shares will be issued on 31 Mar 20X4, if applicable. The achievement of the profit-targets are independent of each other (ie A could issue zero, 20,000, 30,000 or 50,000 additional shares).

#### *Is the contingent consideration classified as equity or liability?*

The arrangement must be assessed to determine whether each of the profit targets represents a separable contract. Since the 20X2 and 20X3 arrangements are independent of each other and relate to different risk exposures under MFRS 139.AG29, each profit target can be viewed as a separate contract that would individually result in the issuance of a fixed number of equity shares of Company A. Therefore, each individual contract within the contingent consideration arrangement would be classified as equity under MFRS 132.

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