IFRS 3, IFRS 15, IAS 18 and IAS 37: Contingent Consideration in an Asset Sale

Extract, IFRS Discussion Group Report on Meeting – September 11, 2014

IFRS 3 *Business Combinations* is clear that contingent consideration payable in a business combination should be recognized at fair value as part of the purchase price. However, IFRSs do not contain explicit guidance on the accounting for contingent consideration if the assets acquired do not constitute a business as defined in IFRS 3, nor does that standard address contingent consideration from the seller's standpoint.

Fact Pattern:

Entity A sells one or more assets that do not constitute a business to Entity B. The assets are property, plant and equipment that will be accounted for in accordance with IAS 16 *Property, Plant and Equipment*. Entity B pays Entity A cash consideration at the time of the purchase and agrees to pay additional amounts in one year's time based on a combination of factors, including whether Entity B is able to achieve production milestones with the assets and how profitable the operations are.

Issue: How should Entity A account for the contingent consideration receivable?

View A – Contingent consideration receivable should be measured at fair value and recorded as part of the proceeds on the sale of the asset(s).

IAS 18 *Revenue* requires revenue to be recorded at the fair value of the consideration received or receivable. The contractual agreement with the buyer to pay additional amounts is part of the consideration receivable.

As discussed in IFRS 3, contingent consideration in a business combination will often meet the definition of a financial instrument. Contingent consideration that is contractually agreed upon in an asset sale is no different. It is appropriate to record contingent consideration receivable at fair value at the time of the sale. There may be considerable judgment in determining the fair value, which would need to factor in the probability that contingent consideration will in fact be paid. However, this uncertainty does not negate the fact that a financial instrument exists and should be recorded as part of the proceeds on the sale of the asset(s).

View B – Contingent consideration receivable should be measured and recorded at some other point (for example, when the conditions associated with the contingency are met).

Consistent with the principles of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, it would seem that consideration receivable is similar to a contingent asset, which should not be recognized in accordance with paragraph 31 of IAS 37.

In addition, in 2013, the IASB considered an IFRS Interpretations Committee paper titled "Variable Payments for the Separate Acquisition of Property, Plant and Equipment and Intangible Assets." Two alternatives were put forward in that paper. One alternative was consistent with View A above. The other alternative held that contingent consideration payments that are dependent on actions of the buyer do not meet the definition of a financial liability until those actions are performed. Proponents of View B may analogize to the latter alternative and conclude that if the buyer does not have a liability, then the seller does not have an asset.

View C – IFRS guidance is unclear and, therefore, there is an accounting policy choice.

There is little guidance in this area. The IFRS Interpretations Committee was unable to reach a consensus on a related topic of whether a buyer has a liability in a situation where variable payments exist for the acquisition of property, plant and equipment or intangible assets outside of a business combination. In July 2013, the IASB observed that variable payments were being considered in both the Leases and Conceptual Framework projects, and concluded that the issue should be reconsidered after the redeliberation of the proposals in its May 2013 Exposure Draft, "Leases."

The concept of contingent consideration is contemplated in the new revenue standard, IFRS 15 *Revenue from Contracts with Customers*. In accordance with IFRS 15, the amount of revenue recognized should be based on the consideration expected to be received, including variable payments to the extent it is highly probable that a significant reversal in the amount recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. It is unclear if this measurement guidance is similar to the less explicit guidance in IAS 18 concerning consideration receivable.

The Group's Discussion

Group members expressed diverse views on this issue.

Some Group members supported View B because, in their view, a contingent consideration receivable is a contingent asset, which is not recognized in the financial statements. One Group member pointed out that when it is virtually certain that an inflow of economic benefits will arise, the asset is no longer considered a contingent asset but rather an asset that is appropriate for recognition. However, this appears to conflict with guidance in IFRS 15, under which recognition occurs when it is "highly probable" that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Some Group members questioned the applicability of IFRS 15 given the standard deals with revenue from contracts with customers. It was also noted that IFRS 15 is not effective until on or after January 1, 2017, although earlier application is permitted.

Group members supporting View A noted that the transaction meets the definition of an asset because the contingent consideration is a financial instrument given it is contractually agreed upon. However, measurement uncertainty exists if there are concerns that the seller will not receive the amount. Principles in IAS 18 should be applied when considering the probability that revenue will be received and whether it can be measured reliably. Some group members noted that if measurement uncertainty resulted in a value of zero, View A and View B would have the same outcome. Guidance in IAS 16 on derecognition of an asset may also be relevant. Circumstances in which risks and rewards have been transferred and there is a contractual right to receive cash flow in the future could lead to the recognition of a gain or loss on the sale of the asset.

One Group member supported View C because when IFRSs are unclear or there is conflicting guidance, entities must decide on an accounting policy to apply consistently. Some Group members suggested it may be a matter of analyzing facts and circumstances more carefully, rather than making an accounting policy choice. Entities entering into transactions for which there is no explicit IFRS guidance should disclose the method of accounting applied in their notes to the financial statements.

The Group recommended that the AcSB monitor the activities of the IASB/FASB Joint Transition Resource Group for Revenue Recognition to determine if there is an opportunity for this type of issue to be added to its agenda. It was also suggested that a useful topic for future discussion by the Group might be whether there are common types of revenue transactions in Canada where it is unclear if they are within the scope of IFRS 15.