Raymond Chabot Grant Thornton

IFRS Adviser Alert

Insights into IFRS 3 *Business Combinations*

November 2023

Executive summary

The Grant Thornton International IFRS team has published three *Insights into IFRS 3*:

- *Recognising and measuring non-controlling interests;*
- *Consideration transferred;*
- *Determining what is part of a business combination transaction.*

Mergers and acquisitions (business combinations) can have a fundamental impact on the acquirer's operations, resources and strategies. For most entities, such transactions are infrequent and each one is unique. IFRS 3 *Business Combinations* contains the requirements for these transactions, which are challenging in practice. The standard itself has been in place for more than 10 years now and has undergone a post-implementation review by the IASB.

The *Insights into IFRS 3* series summarizes 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.

The next three publications in the *Insights into IFRS 3* series present guidance on IFRS 3's requirements for recognizing and measuring non-controlling interests (NCI), determining and measuring the amount of consideration transferred, and determining what is part of a business combination in cases where there are other transactions and arrangements between parties:

- *Insights into IFRS 3 – Recognising and measuring non-controlling interests;*
- *Insights into IFRS 3 – Consideration transferred;*
- *Insights into IFRS 3 – Determining what is part of a business combination transaction.*

Resources

The publications mentioned above follow this *IFRS Adviser Alert*.

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Insights into IFRS 3

Recognising and measuring non-controlling interests

Acquisitions of businesses can take many forms and can have a fundamental impact on the acquirer's operations, resources and strategies. These acquisitions are known as mergers or business combinations, and the accounting and disclosure requirements are set out in IFRS 3 'Business Combinations'.

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.

This article sets out the requirements for recognising and measuring any non-controlling interest (NCI).

"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."

Definition of NCI

NCI is the term used in IFRS 3 and IFRS 10 'Consolidated Financial Statements' to describe equity instruments of a subsidiary not held directly or indirectly by a parent. In a business combination, a NCI arises when an entity acquires less than 100% of the equity of the acquiree.

IFRS 3 defines NCI as 'the equity in a subsidiary not attributable, directly or indirectly, to a parent'

The simplest and most common form of NCI is shares in the acquiree held by non-selling shareholders. However, all instruments issued by the acquiree that meet the definition of equity set out in IAS 32 'Financial Instruments: Presentation' – such as some share options, preferred shares, equity component of convertible bonds, etc – are also NCI if they are not owned or acquired by the acquirer. It is therefore important to identify and distinguish the acquiree's equity instruments from its financial liabilities based on the definitions in IAS 32. This is because NCI is presented as a separate component of equity in the acquirer's post-combination consolidated financial statements and is subsequently accounted for in accordance with IFRS 10.

Category of NCI and measurement option

Depending on the nature and the rights those equity instruments entitle their holders, NCI can be grouped into two broad categories, which in turn determine the available measurement options at initial recognition. Determining whether a NCI measurement option is available is key when accounting for a business combination, since the measurement of NCI can affect the amount of goodwill and subsequent accounting.

Category	Description	Measurement option
Present ownership instruments	Acquiree's shares held by non-selling shareholders that are present ownership interest and entitle them to a proportionate share of the acquiree's net assets in the event of liquidation (eg common or ordinary shares).	Measured either at fair value (fair value model) or proportionate share of recognised amount of assets and liabilities of the acquiree (proportionate interest model). The choice between the two measurement options is to be made for each business combination on a transaction-by-transaction basis, rather than being a policy choice applicable to all business combinations.
All other equity instruments not held directly or indirectly by the acquirer	Financial instruments issued by the acquiree other than those covered by the first category above that meet IAS 32's definition of equity (eg warrants or stock options on 'fixed-for-fixed' terms and non-mandatorily redeemable preferred shares that do not entitle its holder to a proportionate share of the acquiree's net assets in the event of liquidation).	Measured at fair value, unless another measurement basis is required by IFRS eg share-based payment awards classified as equity and held by parties other than the acquirer are measured in accordance with IFRS 2 'Share-Based Payment'.

These measurement options are only available on initial recognition of a NCI, as part of a business combination transaction, in order to determine the amount of goodwill. Once initially recognised in accordance with IFRS 3, IFRS 10 guidance on subsequent accounting should be applied.

Present ownership instruments – NCI measurement options impact

The basis on which NCI of which are present ownership instruments is initially measured, affects goodwill at the acquisition date but could also have a financial impact on subsequent impairment and transactions with those NCI. When the fair value model is used, 100% of the goodwill in the acquiree is recognised (both the acquirer's and the NCI's share). This is sometimes described as the full goodwill model. Under the proportionate interest model only the acquirer's interest in the goodwill is recognised (a lesser amount).

The following example shows the basic effect of the two models:

Example – Measuring NCI

Entity A pays CU800 for an 80% interest in Entity B. Entity A does not have any previously held equity interest in Entity B. The fair value of Entity B's identifiable net assets is estimated to be CU750. Using a valuation technique, the fair value of the remaining 20% in Entity B (the NCI) on the acquisition date is determined to be CU180. The NCI gives right to a present ownership interest in the acquiree's equity.

Analysis

The amount of NCI and goodwill recognised under the alternative methods is as follows:

	Fair Value Model CU	Proportionate interest model CU
Cash consideration	800	800
NCI at fair value	180	–
NCI at 20% of identifiable net assets*	–	150
Total	980	950
Fair value of 100% of identifiable net assets	750	750
Goodwill	**230**	**200**
Recognised amount of NCI	**180**	**150**

* The proportionate share of NCI in the identifiable net assets is determined as follows: CU750 * 20 % = CU150.

Apart from the effect on goodwill, other factors that may influence the measurement model choice are:

- a lower goodwill amount under the proportionate interest model can lead to lower impairment charges later. This is explained by the fact that if a cash-generating unit (CGU) is subsequently impaired, any resulting impairment of goodwill recognised through profit or loss is likely to be lower than it would have been if the NCI had been measured at fair value. Under IAS 36 'Impairment of Assets', goodwill is grossed up to include the NCI's portion when NCI is measured as its proportionate share of the acquiree's identifiable net assets. The gross amount is compared to the recoverable amount to determine any impairment but only the impairment loss relating to the parent's goodwill is recognised, ie the impairment loss attributable to NCI is not recognised in the parent's consolidated financial statements.
- estimating the fair value of NCI may increase costs and complexity when the shares of the acquiree are not quoted, and
- the measurement model chosen can have a different financial impact when accounting for a subsequent transaction with NCI in accordance with IFRS 10. IFRS 10 requires transactions with NCI that do not result in a loss of control of a subsidiary to be recognised as equity transactions. In a transaction where a parent subsequently purchases all the share held by the NCI in its subsidiary, applying the guidance of IFRS 10 means that any difference between the consideration paid for acquiring a NCI and the carrying amount of the NCI derecognised is recognised in equity. In this latter situation, if a parent subsequently purchases some (or all) of the shares held by the NCI, presumably at fair value, and the amount of the consideration paid is higher than the carrying amount of the NCI derecognised, the equity of the consolidated group would be reduced for the difference between those two amounts. If the NCI is measured initially at its proportionate share of the acquiree's identifiable net assets, rather than at fair value, that reduction in the reported equity attributable to the parent is likely to be larger. This is explained by the fact that the carrying amount of the NCI initially recognised using the proportionate interest model is generally lower at the time it is subsequently purchased than if it had been initially recognised at fair value. Refer to our guide on IFRS 10 **Under control: A practical guide to IFRS 10** for examples of subsequent transactions and how the measurement of NCI can be impacted depending on the method used.

Determining the fair value of NCI

Fair value of NCI should be measured in accordance with IFRS 13 'Fair Value Measurement'. Refer to our article **Insights into IFRS 3 – How are the identifiable assets and liabilities measured?** which provides some guidance on how to determine fair value in accordance with IFRS 13.

IFRS 3 provides however some guidance on how the fair value of NCI is determined when applicable:

Fair value of NCI	
The fair value of NCI is based on the quoted price in an active market for the equity shares not held by the acquirer, if available. Otherwise, the acquirer would measure the fair value of NCI using other valuation techniques.	The fair value of the acquirer's interest and NCI in the acquiree on a per-share basis might differ and as such it might not be relevant to retain the acquirer fair value per share to determine the fair value of NCI as the fair value per share of the acquirer's interest in the acquiree is likely to include a control premium or conversely, the fair value of the NCI might include a discount for lack of control (also referred to as a NCI discount).

Call and put options on NCI

The acquirer may arrange with non-selling shareholders during the period of negotiation for the acquisition to acquire NCI shares after the acquisition date – eg by entering into put or call options or a forward contract over the remaining shares held by the non-selling shareholders of the acquiree. An analysis is then required to determine whether, in substance, the underlying shares still legally owned by the NCI are economically attributable to non-selling shareholders or to the acquirer. This analysis and its consequences on the acquisition accounting is discussed further in our article **Insights into IFRS 3 – Determining what is part of a business combination transaction**.

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.

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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?

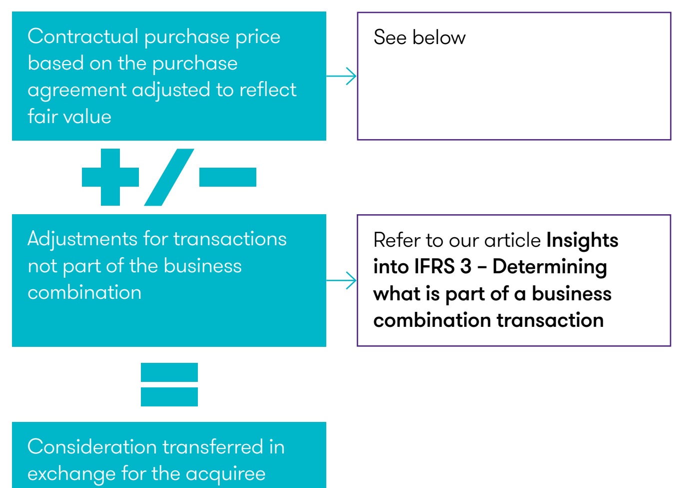
IFRS 3 refers to ‘consideration transferred’ rather than ‘purchase price’ or ‘cost of investment’. The key distinction is that consideration transferred comprises only what is transferred to the former owners of the acquiree in exchange for the acquiree. It therefore means that the consideration transferred 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.

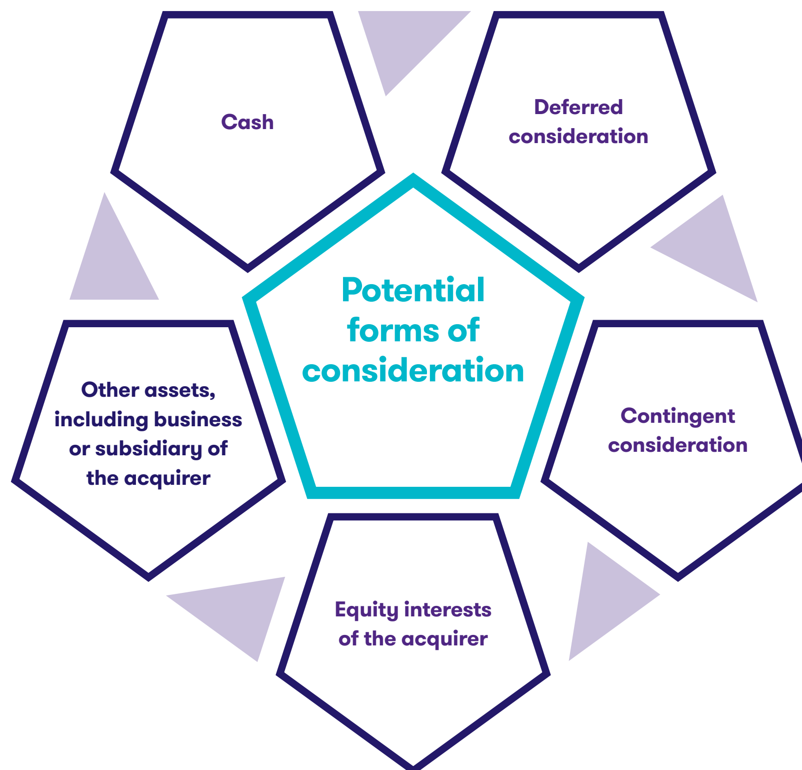
It is helpful to divide the process of determining consideration transferred into two key steps:



Contractual purchase price 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.

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Insights into IFRS 3

Determining what is part of a business combination transaction

Business combinations are infrequent transactions that are unique for each occurrence. IFRS 3 'Business Combinations' contains the requirements and despite being fairly stable in the fifteen years since it has been released, can still be challenging when accounting for these transactions 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.

In effecting a business combination, the acquirer may also enter into transactions and arrangements with the vendor and/or acquiree. Under IFRS 3, the acquirer should determine whether such a transaction is part of the exchange for the acquiree. If not, the transaction must be accounted for separately. Some transactions that should be accounted for separately (referred to here as separate transactions) are included in the purchase agreement, an example being an agreement by the vendor to reimburse the acquirer's transaction costs. More often, identifying a separate transaction and its accounting consequences requires a careful analysis of the overall arrangement and circumstances and their substance. Many transactions that, from a commercial perspective, are consequential or integral to a business combination are not necessarily part of the accounting for the combination for IFRS 3 purposes.

As mentioned in our article **Insights into IFRS 3 – Consideration transferred**, accounting for a separate transaction often involves adjusting the contractual purchase price in order to obtain the right amount of consideration transferred. Only consideration transferred in exchange for the acquiree is considered in the calculation of goodwill (or gain on a bargain purchase). Payments that, in substance, relate to separate transactions are not included in consideration transferred for the business combination transaction and may give rise to a separate gain, loss, liability or asset. This article discusses such transactions.

"Many transactions that, from a commercial perspective, are consequential or integral to a business combination are not necessarily part of the accounting for the combination for IFRS 3 purposes."

Identifying separate transactions

IFRS 3 provides a list of indicators to be considered when determining whether a transaction is part of the exchange for the acquiree or a separate transaction. The indicators are neither mutually exclusive nor individually conclusive:

Determining factor	Indicators
Reasons for the transaction	A transaction arranged primarily for the benefit of the acquirer or the combined entity (ie acquirer and acquiree) is less likely to be part of the exchange for the acquiree.
Who initiated the transaction	A transaction or other event initiated by the acquirer with the objective of providing future economic benefits to the acquirer or the combined entity is less likely to be part of the exchange for the acquiree.
Timing of the transaction	A transaction entered into between the acquirer and the acquiree during the negotiations of the terms of the business combination, with the objective of providing future economic benefits to the acquirer or the combined entity is less likely to be part of the exchange for the acquiree.

IFRS 3 provides three examples of transactions that should be accounted for separately from the business combination and provides guidance on how these transactions affect the calculation of the consideration transferred, if any:

- In effect settles pre-existing relationships between the parties
- Remunerates employees or former owners of the acquiree for future services
- Reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

In addition, transactions on the acquiree's share-based payment awards (replaced or not by the acquirer) may result in consequential adjustments to the contractual purchase price. This type of transactions is discussed later in our publication.

Another type of transaction that may occur at (or around) the same time as negotiating to acquire a controlling interest in the acquiree is when an acquirer enters into an arrangement with non-selling shareholders to acquire further acquiree shares at a later date. The types of arrangement that are commonly signed to reach that objective comprise:

- **purchased call options:** acquirer's right to purchase acquiree shares held by non-selling shareholders
- **written put options:** non-selling shareholders' right to sell acquiree shares to the acquirer
- **forward contracts:** binding agreement to buy or sell acquiree shares at a future date. These may be a combination of call and put options, the terms of which may be equivalent or may be different.

IFRS 3 has no specific guidance on these arrangements, which can vary considerably. Careful analysis and judgment may be required to determine the appropriate accounting treatment. Guidance set out in IFRS 10 'Consolidated Financial Statements', IAS 32 'Financial Instruments: Presentation' and IFRS 9 'Financial Instruments' should be considered. A detailed discussion of these types of arrangement and their analysis is beyond the scope of this article and is currently being debated as part of the International Accounting Standards Board (IASB's) larger on-going project on IAS 32 – Financial instruments with characteristic of equity.

Settlement of pre-existing relationships

The acquirer and acquiree may have an existing relationship, either through a contractual commercial arrangement (eg supplier and customer relationship) or a non-contractual relationship (eg litigation) before they entered into the business combination.
In such case, the business combination is viewed as effectively settling this pre-existing relationship. It is then assumed that the contractual purchase price includes an amount relating to the settlement. Consequently:

- on the acquisition date, the acquirer recognises a settlement gain or loss in the statement of profit or loss to reflect the results of this pre-existing relationship had the transaction been settled separately from the business combination. Measurement of the gain or loss depends on whether the pre-existing relationship is contractual or non-contractual (see below)
- the contractual purchase price is adjusted for the amount deemed to relate to the effective settlement in arriving at the amount of the consideration transferred in exchange for the acquiree.

Measurement of gain or loss on the settlement of a pre-existing relationship	
Non-contractual	• measured at fair value.
Contractual	• the lesser of the following: – the amount by which the contract is favourable or unfavourable from the acquirer's perspective when compared to market terms, and – the amount of any stated settlement provisions available to the counterparty by whom the contract is unfavourable • if the latter amount is lesser than the first amount, the difference is included as part of the accounting for the business combination. Note: any gain or loss on settlement will be affected by any related asset or liability previously recognised by the acquirer.

The following examples illustrate this guidance:

Example 1 – Settlement of pre-existing non-contractual relationship

Entity P is being sued by Entity C for an infringement of Entity C's patent. At 31 December 20X1, Entity P recognised a CU5 million liability related to this litigation.

On 30 June 20X2, Entity P acquired 100% of the equity of Entity C for CU120 million and obtained control of Entity C. On that date, the estimated fair value of the expected settlement of the litigation is CU8 million.

Analysis

Because of the acquisition, the litigation between the two parties is effectively settled. Entity P accounts for this settlement separately and recognises a settlement loss of CU3 million (difference between the fair value of the expected settlement and the previously recognised liability). In accounting for the business combination, the contractual purchase price of CU120 million is reduced by the amount of CU8 million attributable to the settlement resulting in a consideration transferred of CU112 million for determining the goodwill.

Example 2 – Settlement of pre-existing supply agreement

Entity A purchases raw materials from Entity B at fixed rates under a 5-year supply agreement. Entity A is able to early terminate the agreement by paying a termination fee of CU4 million.

Two years into the agreement, Entity A acquired 100% of the equity of Entity B for CU40 million. On that date, the terms of the supply agreement are unfavourable to Entity A since the contractual fixed rates are higher than current market prices (ie the purchase price that could be obtained from other market suppliers at the acquisition date). The estimated fair value of the contract for Entity B (determined from a market participant perspective) is CU5 million, with CU2 million representing the component that is 'at market' terms (which may represent the selling effort and the existence of a customer relationship) and a CU3 million component relating to the unfavourable pricing for Entity A (commonly referred to as the 'off-market' component).

Prior to the acquisition, Entity A has concluded that the supply agreement is not an onerous contract and no liability related to the agreement has been recognised in its financial statements.

Analysis

Entity A's acquisition of Entity B effectively indirectly settles the supply agreement. Entity A accounts for this settlement as a separate transaction and recognises a settlement loss of CU3 million* representing the 'off-market' component of the supply contract as this amount is lower than the termination fee.

In accounting for the business combination, the consideration transferred is therefore measured at CU37 million, being the contractual price of CU40 million reduced by CU3 million attributable to the loss identified on settlement of the supply agreement.

The CU2 million representing the 'at market' component of the fair value of the supply agreement is subsumed into goodwill. No separate intangible asset (ie any reacquired right) is recognised as the business combination does not represent the reacquisition of a previously right granted by Entity A to entity B to use Entity A's assets (refer to our article **Insights into IFRS 3 – Specific recognition and measurement provisions** for more details on recognition of reacquired rights).

* If Entity A had previously considered the supply agreement to be an onerous contract (under IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'), the loss on settlement would be reduced by any previously recognised liability for this onerous contract.

Example 3 – Settlement of pre-existing license agreement (including a reacquired right)

Entity Q granted a 5-year license to Entity S to use Entity Q's technology at a fixed annual rate. Entity Q and Entity S can both obtain an early exit from the license agreement by paying a termination fee of CU2 million. Two years into the agreement, Entity Q acquires Entity S for CU100 million. On that date, the fair value of the license agreement is CU6 million (fair value measured on the basis of its remaining contractual life). The terms of the license agreement are unfavourable to Entity Q when compared to market terms by CU1.5 million.

Analysis

The business combination leads to the effective indirect settlement of the licensor-licensee relationship. Entity Q accounts for this settlement as a separate transaction and recognises a settlement loss of CU1.5 million (the lower of the value of the unfavourable pricing and the contractual termination fee).

In accounting for the business combination, the consideration transferred is measured at CU98.5 million being the contractual price of CU100 million reduced by the CU1.5 million loss on settlement of the license agreement considering that a portion of the consideration transferred is attributable to the settlement of the pre-existing license agreement.

In this situation, the business combination includes a reacquired right (ie reacquisition of the right to use the technology previously granted by Entity Q to Entity S). The reacquired right is recognised separately from goodwill and measured at CU4.5 million in accordance with IFRS 3, being measured as the difference between the above fair value measurement and the off-market value of the license and representing the license's fair value at current market rates (refer to our article **Insights into IFRS 3 – Specific recognition and measurement provisions** for more details).

Employee compensation arrangements

In many business combinations, some or all of the selling shareholders may also be key employees in the acquired business (eg owner-managers). These individuals may remain employed with the acquired business after the business combination. In addition, the purchase agreement may include contingent payments that depend both on meeting a specified target and on these employee-shareholders' continued employment for a specified period. (Refer to our article **Insights into IFRS 3 – Consideration transferred** for more details on the concept of contingent consideration).

Such contingent payment arrangements must be analysed to determine whether some or all of the payments are, in substance, compensation for future employee services rather than payment for the acquired business. This determination will depend on the specific terms and conditions of the purchase and other related agreements and may require judgement.

IFRS 3 provides indicators (in addition to the general indicators discussed on page 2) to assist in this analysis. All of these indicators should be considered. However, IFRS 3 states that if a contingent payment is automatically forfeited upon termination of employment, the payment is always considered remuneration for post-combination services, without having to proceed with the analysis of the other indicators (ie the indicator is conclusive by itself). This was confirmed by an IFRIC agenda decision issued by the IFRS Interpretations Committee (IFRIC) in January 2013. This conclusion does not however mean that when the contingent consideration is not automatically forfeited upon termination, that is it automatically part of the consideration transferred. In this context, all the other indicators should be analysed to conclude whether it is consideration transferred or post-combination remuneration. In addition, contingent consideration clauses that are remuneration expenses (because they are forfeited if the selling employees resign) are often referred to as 'good leaver' or 'bad leaver' clauses and are part of complex agreements which may include put and call options. Such agreements need to be carefully assessed to determine whether the terms of the arrangement creates a service condition and results in a payment that is forfeited in case of termination of the employment under certain circumstances.

Indicators	Analysis and possible conclusions
Continuing employment	• if the contingent payment is automatically forfeited upon termination of employment, it is considered remuneration for post-combination services • if the payment does not require continued employment and is not affected by termination, the payment should nevertheless be assessed to determine whether it should be considered as part of the consideration transferred or as a post-combination remuneration expense based on the following additional indicators
Duration of employment	• if the period of required employment coincides with or is longer than the contingent payment period, it is likely to be considered remuneration
Level of remuneration of the selling shareholder employee	• if the remuneration (excluding the contingent payment) of the employee is reasonable compared to other key employees, the contingent payment is likely to be considered part of consideration transferred
Incremental payments to selling shareholder employees	• if the amount of contingent payment is the same for all selling shareholders regardless of their continued employment, the payments are likely to be part of consideration transferred • if the selling shareholder employee is paid a higher amount than those who did not become employees, any incremental amount paid to the selling shareholder employee is likely to be considered remuneration
Number of shares previously owned by a selling shareholder employee	• the contingent payment is likely to be a profit-sharing remuneration arrangement if the selling shareholder employee previously owned a substantial interest in the acquiree • alternatively, if the selling shareholder employee only owned a minimal amount of interest and all other selling shareholders receive the same contingent payment, the contingent payment is likely to be part of consideration transferred • when making this analysis, the ownership interests of parties related to the selling shareholder employee are also considered
Linkage of the formula for determining contingent payment to the valuation	• if the contractual purchase price is based on the low end of a range established in the valuation of an acquiree and the formula for determining contingent payment relates to that valuation, it suggests that the contingent payment is additional consideration • alternatively, if the formula for determining the contingent payment is consistent with prior profit-sharing arrangements, it suggests that the payment is intended as remuneration

Indicators	Analysis and possible conclusions
Formula for determining contingent payment	• if the formula is based on a multiple of earnings, it suggests that the formula is intended to establish or verify the fair value of the acquiree. In this case, the payment is likely to be part of consideration transferred • alternatively, if the formula is based on a specified percentage of earnings, it suggests that it is intended as a profit-sharing arrangement
Other agreements and issues	• the terms of other arrangements with the selling shareholders (eg not to compete agreements, executory contracts, consulting contracts and lease agreements) and the income tax treatment of contingent payments may indicate that the contingent payment could be a payment that is not consideration for the acquired business • for example, in conjunction with the acquisition, the acquirer may enter into a lease agreement with a selling shareholder (the lessor). If the payment terms of the lease are significantly below market, it is possible that part of the contingent payment is for payment of the lease and should be recognised as lease expense. Alternatively, if the lease payment terms are at market terms, the contingent payment is likely to be part of consideration transferred

Other employment compensation arrangements, such as key staff retention bonuses, are also post-combination expense items and not therefore part of consideration transferred (see Example 5 below). Replacement of an acquiree's share-based payment awards can also affect the amount of the consideration transferred as discussed on page 8.

The following examples illustrate IFRS 3's guidance on employee compensation arrangements:

Example 4 – Payments to selling shareholder who remains as an employee

Entity X acquires a 100% interest in Entity Z, a company owned by a single shareholder, for a cash payment of CU5 million and a contingent payment of CU1 million. The terms of the agreement provide for the contingent payment two years after the acquisition, if the following conditions are met:

- the accumulated net earnings of Entity Z for the two-year period following the acquisition date exceed a certain amount.
- the former shareholder continues to be employed by Entity Z for at least two years after the acquisition, ie no part of the contingent payment will be paid if the former shareholder does not complete the two years employment period.

Analysis

In this situation, the former shareholder is required to be continuously employed in order to be eligible for the contingent payment. This is because the contingent payment will be forfeited upon termination of employment within the contingent payment period. The CU1 million contingent payment is deemed to be payment for future services and is recognised in the post-combination statement of profit or loss as compensation expense.

In accounting for the business combination, only the cash payment of CU5 million is treated as consideration transferred in accordance with IFRS 3.

Example 5 – Compensation arrangements with employees

Entity A acquired Entity B for a cash payment of CU30 million. In conjunction with the business combination, Entity A entered into an arrangement with certain key employees (who are not shareholders) of Entity B to provide for incentive payments to employees if they remain employed for at least two years after the acquisition date. The employees will continue to receive performance bonuses under their existing employment contracts.

Analysis

In this situation, Entity A will make the incentive payments to the key employees for performing additional services post acquisition. Although the transaction is associated with the business combination, it is accounted for separately from the business combination as:

- the incentive payments are in contemplation of post-acquisition services to be performed by key employees. While not linked to performance, they are designed to encourage the employees to stay for a specified period. Accordingly, the payment is recognised as remuneration in the post-combination statement of profit or loss.
- Even if the agreement is entered into as at the acquisition date and is a condition to the business combination, the incentive payment does not form part of the consideration transferred because such payment is made in contemplation of future services expected to be received after the acquisition date. It is not possible to argue that the incentive payments represent an identifiable assumed liability (contingent) of the acquired business, because it is not an obligation of the acquiree at the acquisition date.

  The treatment would however be different if the incentive payments were already part of the employment contracts of the employees. In this situation, the contractual obligation to make the payments would represent a possible obligation of the acquiree until the business acquisition became probable, being the time at which the contractual obligation satisfies the definition of a liability. This is on the basis that the incentives were contractually agreed by the acquiree and the employees a long time before the acquisition (refer to Example 6) and before the acquirer and the seller entered into negotiations to effect the business combination.

  Alternatively, Entity B may also have entered into similar agreements with its key employees at the request of Entity A during negotiations to conclude the business combination. In this latter situation, the incentive payments would be considered Entity B's post-combination remuneration as Entity A and Entity B entered into these agreements to in order to retain Entity B's key employees (ie the agreement was entered into by the parties in order to benefit the combined entity).

Example 6 – Compensation arrangements with employees

Entity A acquired Entity B for a cash payment of CU30 million. Prior to Entity A entering into discussions with Entity B's shareholders to acquire Entity B and in anticipation of a possible change of control, Entity B amended the employment contracts it had previously signed with its CEO and CFO, to include a clause stipulating that in the event of a change of control of Entity B, the CEO and the CFO would each be eligible for a cash payment of CU1 million (change of control bonuses) if they remain employed until the date of acquisition. The CEO and CFO are not however required to remain employed after the transaction is completed to be eligible for these change of control bonuses.

Change of control bonuses must be paid 30 days after the closing of the transaction.

Analysis

In this example, Entity A must determine whether the incentive payments to be made by Entity B upon closing of the transaction represent a present obligation satisfying the definition of a liability of Entity B assumed by Entity A at the acquisition date or if they represent a post-combination remuneration expense.

This results from this fact pattern is the obligation to make the incentive payments is part of the identified liabilities of Entity B assumed by Entity A at the acquisition date. This is because it:

- was included in the employment contracts of the CEO and CFO before Entity A entered into negotiations to acquire Entity B.
- was arranged by entity B with the CEO and CFO with the objective to create incentives to to remain employed by Entity B only until the closing of the business combination and therefore to primarily benefit the acquiree or its former owners before the combination.

Acquisition costs

In most situations, the acquirer pays its own acquisition-related costs. IFRS 3 provides that such acquisitions costs are recognised as an expense when incurred in the statement of profit or loss. The only exception is the treatment of costs to issue debt or equity, which are treated as a reduction of proceeds of the related instruments. This treatment also applies to acquisition costs paid by the acquiree or its former owners that are reimbursed by the acquirer.

A purchase agreement may specify that acquisition costs are paid by the vendor and may be separately reimbursed by the acquirer or included in the amount of the purchase price specified in the purchase agreement. For instance, the vendor may pay these expenses as a way of facilitating the negotiations and moving forward the sale if the total amount of the consideration of the business combination will cover the vendor for these expenses paid on the acquirer's behalf. In both cases the acquirer recognises these costs as an expense. If costs are not reimbursed directly, the applicable portion of the contractual price should be treated as an in-substance reimbursement and excluded from the consideration transferred.

Example 7 – Acquisition costs paid by the vendor

Entity Q acquired Entity S for CU20 million from Vendor V. The purchase agreement provides that Vendor V pays all costs related to the transaction such as legal, due diligence and other professional fees. Entity Q is not explicitly required to reimburse these costs (ie the Share Purchase Agreement does not refer to such costs and to the fact that they should be assumed by the acquirer).

The acquisition related costs paid by Vendor V on behalf of Entity Q amounted to CU0.5 million. Vendor V incurred an additional CU0.1 million for its own legal fees related to the transaction.

Analysis

In this situation, the CU20 million paid by Entity Q effectively includes the reimbursement for the acquisition related costs. Entity Q should account for such costs separately from the business combination as an immediate expense.

In accounting for the business combination, the consideration transferred is measured at CU19.5 million (contractual purchase price reduced only by the acquisition costs paid on behalf of Entity Q) which represents the amount paid in exchange for the acquired business.

Replacement of acquiree share-based payment awards

In business combinations where an acquiree's existing share-based payment awards are replaced by the acquirer, special considerations apply when determining both consideration transferred and post-combination expenses. Acquiree awards are often replaced in order to, for example:

- avoid future dilution of the acquirer's ownership of the acquiree
- create a more effective employee incentive when the acquirer's shares will be more liquid than the acquiree's after the combination
- rationalise compensation arrangements within the expanded group, or
- harmonise the acquiree's and the acquirer's management packages and how these plans are granted.

Under IFRS 3, exchanges of share-based payment awards in conjunction with a business combination are accounted for as modifications of share-based payment awards in accordance with IFRS 2 'Share-based Payment'.

When the acquirer is obliged to replace the acquiree's share-based payment awards (the original awards) with its own awards (the replacement awards), either all or a portion of the value of the replacement awards forms part of the consideration transferred. Sometimes the acquirer is 'obliged' to replace the acquiree awards if the acquiree or its employees can enforce replacement, eg if replacement is required by:

- the terms of the acquisition agreement
- the terms of the acquiree's awards, or
- applicable laws or regulations.

The same guidance applies in situations where the acquirer replaces the original awards voluntarily. See below for guidance on situations where the acquirer chooses not to replace the original awards.

IFRS 3's objective in accounting for replacement awards is to allocate their value between the amounts attributable to:

- pre-combination service (treated as part of consideration transferred), and
- post-combination service (accounted for as compensation expense in the post-combination financial statements).

IFRS 3 provides specific guidance on how the allocation is determined. This requires the acquirer to measure both the replacement and original awards using a market-based measure (in accordance with IFRS 2) on the acquisition date. This is one of IFRS 3's measurement exceptions discussed in our article **Insights into IFRS 3 – Specific Recognition and Measurement Provisions** because IFRS 2's market-based measure is not fully equivalent to fair value.

When an unexpired award is replaced by the acquirer, part of the market-based value of the replacement award reflects the acquiree's obligation that remains outstanding at the date of the business combination (corresponds to the services rendered by the employees until that date and for which awards were issued but not yet exercised) and is accounted for as part of the consideration transferred in the business combination. The remaining balance of the market-based value of the replacement award is accounted for as a post-combination expense for the services to be received over the period to when the replacement award vests, in accordance with IFRS 2.

IFRS 3's guidance on the allocation of the value of the replacement awards is as follows:

Element	IFRS 3 guidance
Pre-combination service	• it is measured using the acquisition date market-based measure of the original awards multiplied by the ratio of the vesting period completed at acquisition date to the greater of: – the original vesting period of the acquiree awards, or – total vesting period resulting from the business combination (in case changes were made due to the business combination). • it is included in consideration transferred • the amount allocated to the pre-combination service cannot exceed the value of the original awards on the acquisition date
Post-combination service	• it is the difference between the acquisition date market-based measure of the replacement award and the amount allocated to pre-combination service • in effect, any excess of the value of the replacement awards over the value of the original awards is accounted for as employee compensation expense in post-combination earnings • post-combination compensation expense is recognised over the vesting period if it requires post-combination service (even if the original awards are already vested on the acquisition date). If no further service is required, it is recognised as an immediate expense.

Other situations:

Element	IFRS 3 guidance
Estimate of replacement awards expected to vest	• the allocation between the pre-combination and post-combination portion of the replacement awards should reflect the best available estimate of the number of replacement awards expected to vest • any changes in the estimate of vesting are recognised in post-combination earnings and not as an adjustment to consideration transferred • similarly, the effects of other events (ie modifications or revised estimates of the outcome of any performance conditions) occurring after the business combination are recognised in post-combination earnings in accordance with IFRS 2
Share-based payment awards that will expire as a consequence of a business combination	• if the acquirer voluntary replaces awards that are due to expire because of the business combination, all of the value of the replacement awards is treated as post-combination expense. No value is allocated to consideration transferred
Effect of the classification of share-based payment awards	• the same requirements apply regardless of whether a replacement award is classified as cash-settled or equity-settled in accordance with IFRS 2 • if classified as cash-settled (ie as liabilities), all subsequent changes in the value of the replacement awards and related income tax effects are recognised in post-combination earnings
Income tax effects	• income tax effects of the replacement awards are recognised in accordance with IAS 12 'Income Taxes'

The following example illustrates the accounting for replacement of share-based payment awards:

Example 8 – Replacement of acquiree share-based payment awards

Entity P purchases Entity S. Entity S has existing equity-settled share-based payment awards (original awards), which include a clause requiring replacement with an award of at least equivalent value by any future acquirer. The original awards specify a vesting period of four years. At the acquisition date, Entity S's employees have already rendered two years of service.

As required, Entity P replaced the original awards with its own share-based payment awards (replacement awards). Under the replacement awards, the vesting period is reduced to one year (from the acquisition date).

The value (market-based measure) of the awards at the acquisition date are as follows:

- original awards: CU100
- replacement awards: CU110

As at the acquisition date, all awards are expected to vest (ie the acquirer estimates that all the employees will meet the new service conditions at the acquisition date).

Analysis

The value of the replacement awards is allocated between consideration transferred and post-combination compensation expense.

The portion attributable to pre-combination service is CU50 (CU100 × 2/4 years) and is included as part of consideration transferred. That portion is calculated as the value determined at the acquisition date of the original award (CU100) multiplied by the ratio of the pre-combination service period (two years) to the greater of the total vesting period (three* years) or the original vesting period (four years). The CU50 is accounted for as a credit to the parent's equity on the basis that:

- it is Entity P's own shares that are to be issued; and
- the award satisfies the definition of an equity-settled share-based payment award.

The remaining CU60 (CU110 - CU50) is attributable to compensation for the employees' future services. This will be recognised as compensation expense in post-combination earnings over the remaining service period of one year (vesting period of the replacement award).

* two years rendered by employees as at the acquisition date plus one year vesting period of the replacement award.

Non-replaced share-based payment awards

In some business combinations, the acquiree's share-based payment scheme continues to exist post-acquisition. Under IFRS 3, the accounting of such situation will depend on whether the awards are vested or unvested at the acquisition date (see below). In both situations, the awards are measured at their market-based measure (in accordance with IFRS 2) at the acquisition date.

Element	IFRS 3 guidance
Vested awards	• recognised as part of non-controlling interest (NCI) (see note below)
Unvested awards	• allocated between amounts attributable to: – pre-combination service – forms part of NCI – post-combination service – accounted for as compensation expense in the post-combination financial statements (credits are also presented as part of NCI) • pre-combination service – calculated using the value of the award measured at the acquisition date and multiplied by the ratio of the vesting period completed at acquisition date to the greater of: – the original vesting period of the existing awards, or – total vesting period (in case changes were made due to the business combination) • post-combination service – remaining balance of the value of the award recognised over the remaining vesting period

Note – the measurement option under IFRS 3 that allows the acquirer to measure the NCI either at fair value or their proportionate share in the recognised amounts of the acquiree's identifiable net assets, is not available for this type of NCI as the instruments do not entitle their holders to a proportionate share of the entity's net assets in the event of liquidation.

The following example illustrates the accounting for non-replaced share-based payment awards:

Example 9 – Continuation of acquiree share-based payment awards

Entity Q purchases Entity S. Entity S has an existing equity-settled share-based payment scheme. The awards vest after four years of employee services. At the acquisition date, Entity S's employees have rendered two years of services. None of the awards are vested at the acquisition date.

Entity Q did not replace the existing share-based payment scheme but reduced the remaining vesting period from two years to one year. Entity Q determines that the market-based measure of the award at the acquisition date is CU100 (based on IFRS 2's measurement principles and conditions at the acquisition date).

Analysis

The market-based measure of CU100 is allocated between non-controlling interest and post-combination compensation expense.

The portion attributable to pre-combination service is CU50 (CU100 × 2/4 years) and is included as part of NCI. That portion is calculated as the value determined at the acquisition date of the award (CU100) multiplied by the ratio of the pre-combination service period (two years) to the original vesting period (four years) as this later period is greater than the total vesting period (three* years).

The remaining CU50 (CU100 - CU50) is attributed to the employees' future services. This amount will be recognised as an expense in post-combination earnings over the remaining service period of one year, with the credit recorded in NCI.

* two years rendered by employees as of the acquisition date plus one year vesting period after the acquisition date.

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.

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