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Brasília, Distrito Federal - Brazil

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International Accounting Standards Board

30 Cannon Street

London EC4M 6XH

United Kingdom

RE: Interpretations Committee potential agenda item request - IFRS 3.B55

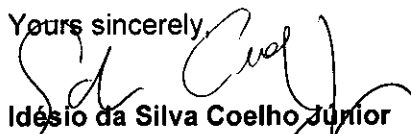
Dear Sir/Madam,

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)¹ welcomes the opportunity to respond the Interpretations Committee potential agenda item request - IFRS 3.B55

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies.

If you have any questions about our comments, please let us know.

Yours sincerely,


Idésio da Silva Coelho Junior
Deputy coordinator of international affairs
Brazilian Accounting Standards Board (CPC)

¹ The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), BMFBOVESPA (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

Interpretations Committee potential agenda item request - IFRS 3.B55

The issue

Is IFRS 3.B55(a) conclusive in determining that an arrangement in which payments to an employee that are forfeited upon termination is remuneration for post-combination services and not part of the consideration for an acquisition?

B55 introduces (a) to (h) with the following words: "If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators."

This wording might be read by some to suggest that no item in the list that follows is necessarily conclusive. However, B55(a) states, "... A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates *is* remuneration for post-combination services" (emphasis added). Unlike B55(b)-(h), which use inconclusive language such as 'indicate', 'suggest', 'might' and 'may', B55(a) uses the conclusive language, 'is'. The issue is whether that provision of B55(a) is, on its own, conclusive that a payment that it describes is remuneration for post-combination services or, like B55(b)-(h), is not necessarily conclusive.

View 1: B55(a) is conclusive

From a plain reading of B55(a) it is hard to see it as anything other than conclusive. While it is included in a list of indicators, the words used express a conclusive principle: if this indicator is met, then the payment 'is' a post-acquisition expense. It is still an indicator, but an individually conclusive one.

In addition, this view is consistent with IFRIC's approach to a question it discussed in July 2009 related to the meaning of significant and prolonged in IAS 39: "Paragraph 67 of IAS 39 requires an entity to recognise an impairment loss on available-for-sale equity instruments if there is objective evidence of impairment. Paragraph 61 of IAS 39 states: "A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment. [emphasis added] Consequently, the IFRIC concluded that when such a decline exists, recognition of an impairment loss is required."

View 2: B55(a) is not conclusive

B55(a) gives a strong direction that payments contingent on post-acquisition employee service should be treated separately from acquisition consideration. However, the introduction to B55 describes (a)-(h) as indicators, thereby making clear that this is one of a number of indicators and, accordingly, is not, on its own, conclusive.

Had the IASB wished to make B55(a) conclusive, then it could have separated this paragraph and then followed it with a set of indicators to be applied if B55(a) was not met. The fact that the words are included in a list of indicators implies that it is intended to be given a similar prominence to the other indicators and applied together with them. On the other hand, if the IASB had wanted it not to be determinative, then the IASB could have written it differently, using 'may indicate' or perhaps 'a strong presumption' instead of 'is'.

Furthermore, B55(a) is the only place in the standard that this conclusive statement appears. If it were intended to be determinative, then it could be referred to elsewhere; the fact that it isn't might suggest that the use of the word 'is' is an anomaly.

Current practice

Current practice under IFRS is mixed (see, for example, the four largest networks' guidance). This difference in views implies diversity in practice that is significant if the amounts involved are material: are the amounts in question part of the consideration for the business combination (thus becoming goodwill in the statement of financial position) or compensation expense?

IFRS 3 was one of the convergence projects undertaken jointly with the US Financial Accounting Standards Board and ASC 80510-55-25 (originally FAS 141R.A87) contains the same language. It is our understanding that under US GAAP View 1 is applied consistently. We understand that the FASB staff was consulted on this question in the early days of applying FAS 141R and that the FASB staff was in agreement with View 1.

CPC's Comments

Apparently there is diversity in application of the concept amongst the large audit firm networks, as demonstrated in the IFRS interpretation guidance of each firm.

The CPC particularly believes that paragraph B55 (a) is conclusive, considering that if the indicator of the mentioned paragraph is met, then, at least part of the contingent consideration should be treated as a post-acquisition expense. However, the purpose of paragraphs 55 (b) to (h) if the indicator in paragraph 55 (a) is met is not clear. Should these paragraphs suggest that it could be appropriate for the contingent consideration to be allocated between purchase consideration and remuneration for post-combination services? The CPC believes that this question should be clearly addressed by the Board,

CPC would also like to include the following numerical example for the Board's analysis:

Market value (fair value) of the acquired net assets	\$100.000
Total consideration	\$150.000
Goodwill	\$50.000
Payment arrangement:	
Cash amount paid at the date of the transaction	\$90.000
Contingent consideration to be paid in 5 years ahead (*)	\$60.000
Contractual term that the executive (former owner of the business acquired) should stay in the business	5 years
Annual compensation paid to the former owner, which is similar to the amount paid to other non-sellers directors and with the average market	" \$120

(*) If the company does not achieve a target profit or if the executive (former owner) quits or leaves the business prior to the end of the contractual term of 5 years, he is not allowed to receive any contingent consideration of \$60.000. Executive will be paid a market salary and bonus during this period.

In light of paragraph IFRS3.B55 (a), the total contingent consideration amount that is forfeited upon termination of the executive should be considered as post-combination expense, and therefore, as compensation paid to the executive.

Considering the above scenario, CPC would like to request clarification in the following items:

- 1) Will the Board allow use of judgement in the allocation of the amount treated as contingent consideration (purchase consideration) and post-combination compensation expense?
- 2) Should the \$60,000 be treated as post-combination compensation expense, and linearly allocated to the annual results (\$12,000 per year)?
- 3) Should the \$60,000 be considered as contingent consideration, and included in the purchase consideration given that the executive will receive a annual compensation comparable to the market?

In addition, we have noted the following issues in practice -

- a) We have seen situations in which not all vendor shareholders are required to stay in the business post combination but all vendor shareholders will lose an earn out payment if one of the "locked in" vendors leaves during the earn out period. In this case it is not clear whether all contingent payments should be considered to be relating to post acquisition services following paragraph B55 (a)
- b) A highly literal reading of paragraph B55 (a) ("*... A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services* ") could be argued to lead to a different conclusion. We are aware that a number of companies have argued that payments under their arrangements are not "automatically" forfeited, as the company has discretion to make the payment following the departure of the employee. While we do not believe this is relevant (as a party to a contract will normally have discretion as to whether to enforce its contractual rights) clarification in this area would be welcome.
- c) We would also note that contracts are often negotiated by parties without knowledge of the applicable accounting standards. It will be in the acquirers' interest to have as many restrictions over the payment of an earn out as possible. Therefore, an employee lock in clause may be included in a contract even if it is not deemed to be a significant condition on the part of the acquirer, because there would be no commercial reason to remove it. In many situations the vendor will want to continue employment as s/he considers this the best way to ensure future profitability and thus the payment of any earn out, and so they will not object to such a clause.