



IFRS IN PRACTICE

Common Errors in Financial Statements -
Share-based Payment (December 2013)

TABLE OF CONTENTS

Introduction	5
1. Limited recourse loans granted to directors to enable them to subscribe for shares	6
<i>Example 1.1: Limited recourse loans arrangements</i>	7
2. Share-based payments embedded in convertible notes	8
<i>Example 2.1: Share-based payment in a convertible note</i>	9
3. Shares given to executives by owners	10
<i>Example 3.1: Shares given to employees by owners</i>	11
4. Share arrangements with directors of subsidiaries	12
<i>Example 4.1: Parent's shares given to directors of subsidiaries</i>	13
5. Acquisitions of listed shell companies by unlisted operating companies	14
<i>Example 5.1: Acquisition of a listed shell company by an unlisted trading company</i>	15
6. Accounting for a cash-settled share-based payment as equity settled	16
<i>Example 6.1: Cash-settled share-based payment</i>	17
7. Share-based payments granted to vendors of an acquired business that require post acquisition services from the former owners	18
<i>Example 7.1: Deferred consideration in a business combination that requires continued service</i>	19

INTRODUCTION

Share-based payments are transactions in which an entity pays for goods or services either by transferring its own (or another group entity's) equity instruments to the counterparty, or by paying an amount of cash that is based on its own (or another group entity's) share price.

Errors arise from both the failure to identify share-based payments and inappropriate accounting.

Common examples of these include:

Failure to identify share-based payments:

1. Limited recourse loans granted to directors to enable them to subscribe for shares
2. Share-based payments embedded in convertible notes
3. Shares given to executives by owners
4. Share arrangements with directors of subsidiaries
5. Reverse acquisitions of listed shell companies.

Inappropriate accounting for share-based payments:

6. Accounting for a cash settled share-based payment as equity settled
7. Share-based payments granted to vendors of an acquired business that require post acquisition services from the former owners.

These common examples are discussed in the following sections.

1. LIMITED RECOURSE LOANS GRANTED TO DIRECTORS TO ENABLE THEM TO SUBSCRIBE FOR SHARES

It is common practice in certain jurisdictions for limited recourse loans to be granted to directors to enable them to buy shares in their company. There is no movement of funds on inception of the arrangement and, typically, the shares are legally issued to the directors but kept in trust (or in escrow) until the loan (effectively a receivable for the share issue price) has been repaid.

The loans are limited recourse, meaning that the loan is secured against the shares issued to the director. The practical effect of the limited recourse is that if the shares fall in value, the director will not settle the loan and instead the company will take ownership of its own shares and eliminate them against the 'forgiveness/settlement' of the debt.

These arrangements give rise to a share-based payment within the scope of IFRS 2.

This is because the substantive effect of the structure described above is that of a *share option*.

Although in legal form the shares have been issued and a loan has been granted, the holder of the shares (i.e. the director) has an option of whether to settle the loan:

- If the share price falls, the director will not settle the loan and the arrangement will 'collapse', and
- If the share price rises, the director can choose to settle the loan and benefit from the capital gain.

Consequently, the arrangement is the same as if the director had been granted a share option, exercisable at a price equal to the amount of the limited recourse loan.

This means that the fair value of the option will need to be determined, using an option pricing model, with this amount being accounted for as a share-based payment.

EXAMPLE 1.1: LIMITED RECOURSE LOANS ARRANGEMENTS

Director A acquires 1,000 shares from Company Z at CU1 each, using a CU1,000 limited recourse loan advanced by Company Z.

The loan can be settled at any time at the director's option.

Up until the point at which the limited recourse loan is settled, the shares are held on trust/escrow by Company Z's legal advisers.

If director A leaves Company Z's employment, the loan has to be settled by director A otherwise the shares will be forfeited.

Incorrect journal entry

Dr	Receivable	CU1,000	
	Cr	Liability/Equity	CU1,000

The effect of the arrangement is equivalent to granting the director option to purchase 1,000 shares at a price of CU1 each. Therefore, assuming that the fair value of the share option is CU200, the correct journal entry is as follows:

Correct journal entry

Dr	Share-based payment expense	CU200	
	Cr	Equity (e.g. Share-based payment reserve)	CU200

No entries are recorded for the (legal form) issue of shares and granting of the limited recourse loan.

When (if) the limited recourse loan is settled, the issue of shares will be recorded as follows:

Correct journal entry

Dr	Cash	CU1,000	
	Cr	Equity	CU1,000

If an entity has previously recognised amounts in a *Share-based payment reserve* in equity, it can choose subsequently to transfer these amounts into retained earnings.

2. SHARE-BASED PAYMENTS EMBEDDED IN CONVERTIBLE NOTES

This type of arrangement is often entered into by a company with its directors and/or key management personnel.

The way in which these arrangements are structured means that it is not always apparent that:

- There are in fact **two** instruments being issued (i.e. a loan and a share-based payment), not one, and
- The proceeds received are less than the fair value of the instrument.

In these cases, the embedded equity option typically constitutes an embedded share-based payment.

This is because the entity is receiving the benefit of services from its executives/directors, with payment being made through the issue of a loan and a share option at a discount from their combined fair value.

A typical example is where a convertible note is issued, which pays a rate of interest that is the same as the market rate of interest that would apply to a loan with no conversion (or other) feature attached. Following the approach required by IAS 32 *Financial Instruments: Presentation*, the fair value of the liability component is deducted from the fair value of the instrument as a whole to arrive at the fair value of the conversion feature.

For financial instruments within the scope of IAS 32, the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* mean that the transaction price is considered to be the fair value of the instrument as a whole. Consequently, the instrument would appear to have no equity component (despite having a conversion feature) because the fair value of the liability component is the same as the transaction price.

However, this analysis fails to recognise that the arrangement contains two contracts, being a loan and a share-based payment, with no consideration having been received for the share-based payment component.

EXAMPLE 2.1: SHARE-BASED PAYMENT IN A CONVERTIBLE NOTE

The managing director (MD) of Company A subscribes for 1,000 convertible notes in Company A at CU1 each.

Each note converts into 10 shares on maturity and the note pays a coupon of 15%.

If Company A had simply borrowed CU1,000, the market rate of interest would have been 15%.

Because a convertible note has been issued, it would appear that the appropriate accounting approach is to apply IAS 32. Under the requirements of IAS 32, the arrangement would be analysed as the issue of a compound financial instrument.

This would result in the fair value of the liability component being determined to be CU1,000, with this amount being deducted from the fair value of the instrument as a whole (i.e. the transaction price of CU1,000) to arrive at an equity component amount of zero.

However, as noted above, this approach fails to recognise that in addition to the loan, there is an embedded share-based payment. Therefore the transaction has in fact resulted in the issue of a loan with a fair value of CU1,000 together with an embedded zero cost share option.

The appropriate accounting approach is therefore to account for the financial instrument (i.e. the loan) in accordance with IAS 32 and IAS 39. This results in the loan being recorded at its transaction price of CU1,000. The share option would then be valued in accordance with IFRS 2; because it is a zero cost option, the fair value of the option will typically be equal to the intrinsic value of the shares at grant date (that is, their market value at that date).

As noted above, the calculated fair value of the liability component is typically the same as the transaction price.

It is unusual for there to be a difference between the fair value of the liability component and the transaction price, however where this does occur, in our view, the appropriate accounting treatment would be as follows:

- Determine the fair value of each of the two components (the fair value of the loan and of the share-based payment).
- If the transaction price is equal to or less than the calculated fair value of the loan, then the transaction price will be the amount recognised for the loan on initial recognition.

This is because the entire transaction price is viewed as being attributable to the loan (the share-based payment is a zero cost option) and IAS 39.AG76 does not permit a gain or loss to be recognised on the initial recognition of a financial instrument, unless that financial instrument is quoted on an active market which is not the case here.

- If the amount payable on maturity of the liability component is greater than its carrying amount on initial recognition, there will be an additional adjustment required to increase the liability to its maturity value.

This will result in an additional debit entry to be charged to profit or loss. While this would typically be included within finance expenses, for the structure being analysed here consideration would be needed of whether the accretion amount effectively represents additional remuneration.

- If the transaction price is greater than the calculated fair value of the loan, then the difference is regarded as being payment for the share option.

3. SHARES GIVEN TO EXECUTIVES BY OWNERS

In some cases, instead of an entity issuing new shares under a share-based payment arrangement, existing shareholders agree to transfer some of their shares instead.

This approach might apply in cases where an entity has restrictions over the issue of new shares, and existing shareholders agree to transfer their own shares in proportion to each of their shareholdings. In others, it may be more tax efficient for an individual who owns 100% of a start-up entity to transfer ownership of some existing shares instead of the entity issuing new shares.

Some believe that, because new shares are not being issued, these arrangements do not fall within the scope of IFRS 2. However, IFRS 2 is clear that in addition to shares being issued by the entity itself, any transfer of shares by a shareholder gives rise to a share-based payment, unless the transfer is for something other than goods or services. IFRS 2.3A notes that:

'A share-based payment transaction may be settled by another group entity (or a shareholder of any group entity) on behalf of the entity receiving or acquiring the goods or services'

IFRS 2 does note that transactions with an employee (or other party) in their capacity as a holder of equity shares of an entity are not share-based payment transactions. Such an arrangement might arise in a family owned business, in which share transfers are made among family members in order to move the ownership from one generation to another. However, care is still needed because certain types of these transactions are still viewed as being compensation for services (such as a large transfer of shares to a family member who is the only family member to have worked for the related business during a period up to the point at which the entity is listed on a public market).

EXAMPLE 3.1: SHARES GIVEN TO EMPLOYEES BY OWNERS

Entity A is 100% owned by Mr B, who owns 100 shares in Entity A.

Mr B gives the managing director of Entity A one share.

This falls within the scope of IFRS 2, because the share-based payment (the award of one share to the managing director) is being settled by the **sole** shareholder.

If the fair value of Company A was CU1million, the accounting entry would be:

Correct journal entry

Dr	Share-based payment expense	CU10,000	
	Cr Equity		CU10,000

4. SHARE ARRANGEMENTS WITH DIRECTORS OF SUBSIDIARIES

Ultimate parent companies of groups (in particular when those parent companies are listed) are often involved in share-based payment schemes that are set up to incentivise and reward senior management at subsidiaries. This is because:

- The parent company does not wish shares of its subsidiaries to be awarded to senior staff (because this could create non-controlling interest), and
- It is unattractive for the individuals to be awarded shares in the subsidiaries, because there is no market on which they can sell those shares.

Consequently, a common approach is for senior management (and sometimes other staff) of a listed entity's subsidiaries to be granted a share-based payment, under which they will receive equity instruments of the (listed) ultimate parent entity.

Other similar arrangements involve a share-based payment being granted by the subsidiary entity, with a second arrangement being entered into at the same time under which any shares that are awarded by the subsidiary will immediately either be:

- Swapped for equity shares of the ultimate parent, or
- Purchased by the ultimate parent for cash (with the amount paid being calculated to approximate the fair value of shares in the subsidiary).

These arrangements can be more attractive to the ultimate parent, as the amount of any reward can be linked more closely to the operating performance of each individual subsidiary company.

It is necessary to analyse each of these share-based payment arrangements carefully. This is because although they all involve the award of equity shares, some are in fact cash settled share-based payments which are accounted for differently from equity settled awards. In particular, the expense associated with an equity settled share-based payment is based on the grant date fair value of the award, whilst the expense associated with a cash settled share-based payment is remeasured at each reporting date. This adjustment is required so that the carrying value of the liability reflects the amount of cash that will need to be paid when the share-based payment vests.

For the share-based payment arrangements described above, the classification in the parent's consolidated financial statements is as follows:

- Share-based payment granted by a subsidiary, to be settled in the ultimate parent's shares – equity settled
- Share-based payment granted by a subsidiary, with the subsidiary's shares being swapped for equity shares of the parent – equity settled
- Share-based payment granted by a subsidiary, with the parent purchasing any shares that vest at fair value – cash settled.

EXAMPLE 4.1: PARENT'S SHARES GIVEN TO DIRECTORS OF SUBSIDIARIES

Entity X is a listed company located in Country X.

On 1 January 20X1 Entity X establishes a subsidiary in Country Y (Subsidiary Y) which has authorised share capital of one million shares with a nominal value of CU1 each. Entity X contributes an existing business to Subsidiary Y and provides funding by way of direct loans and guarantees over Subsidiary Y's borrowings from local banks. The fair value of Subsidiary Y is CU3 million.

Entity X receives 900,000 shares in return for the contributed business and financial guarantee contracts. The new local managing director (MD) subscribes for the remaining 100,000 shares through a non-recourse loan (see above), with the shares being held on trust until the loan has been repaid.

Should the MD leave on any terms other than being a 'bad leaver', Entity X will buy his shareholding from him at fair value. The mechanism is that the non-recourse loan will be waived, with a cash payment being made for the incremental increase in fair value of the shares.

This arrangement is accounted for by Subsidiary Y as a cash-settled SBP in accordance with IFRS 2.3A, with the movement in the fair value of the award being recognised in its income statement.

Because the cash payment will be made by Entity X (i.e. the parent), the credit entry is made directly to equity and is recorded as a capital contribution.

Assume on 31 December 20x1 the value of the local subsidiary is CU3.5m the entry recorded by Subsidiary Y is as follows:

Correct journal entry in Subsidiary Y			
Dr	Share-based payment expense	CU50,000 ⁽ⁱ⁾	
	Cr	Equity contribution from Parent (Entity X)	CU50,000

⁽ⁱ⁾ = [CU3.5m - CU3.0m] x 10%

In addition, because Entity X has an obligation to pay an amount equal to the incremental increase in fair value of the shares in its subsidiary, Entity X records a liability of CU50,000.

Because this represents a gift to Subsidiary Y which (effectively) increases the value of that entity, Entity X adds an equivalent amount to its investment in its subsidiary in its separate financial statements.

Correct journal entry in Entity X (Parent)			
Dr	Investment in Subsidiary Y	CU50,000	
	Cr	Share-based payment liability	CU50,000

In circumstances in which a parent entity settles a share-based payment on behalf of a subsidiary, the parent may require the subsidiary to compensate it for the expense (whether this is a cash expense, or an equity-settled share-based payment expense).

In these cases, the parent entity will reduce the amount added to the cost of investment in its subsidiary and record a financial asset, with the subsidiary reducing the amount of the capital contribution credit to equity and recording a financial liability.

On consolidation, these inter-company amounts will eliminate.

5. ACQUISITIONS OF LISTED SHELL COMPANIES BY UNLISTED OPERATING COMPANIES

It is often efficient for unlisted trading companies that wish to list on a market to obtain a listing by entering into an arrangement with a listed shell company (for example, a listed company that has sold its trading activities, or has ceased trading – such as an exploration entity in the natural resources sector which has used all of the funds raised through a previous IPO and has been unsuccessful in its exploration efforts). This is often a less expensive approach in comparison with the listing of an existing, unlisted entity.

Under these arrangements, the listed shell company issues new shares which are exchanged for shares in the unlisted trading company; legally the listed company acquires the unlisted company.

Due to the large number of shares that the shell company issues to buy the unlisted company, once the transaction has taken place the shareholders of the unlisted company typically hold the majority of the shares in the listed parent entity. In addition, because the only operating activities of the new group are those of the legal subsidiary, a new board is appointed to the listed company which typically contains a majority of directors from the unlisted company.

The effect of the arrangement is that, for accounting purposes, the unlisted company (the legal subsidiary) is the accounting acquirer and the shell company (the legal parent) the acquiree.

Some entities assume that, because the transaction involves the acquisition of one entity by another, the arrangement falls within the scope of IFRS 3 *Business Combinations*. This would result in the transaction being accounted for as a reverse acquisition which, because the unlisted company typically issues shares with a fair value which is greater than the identifiable assets of the listed shell company, gives rise to goodwill. This is because the benefit of a less expensive listing is typically shared between the unlisted company and the former owners of the listed shell company.

However in many cases, the listed shell company:

- Will only have a cash balance
- Will have no employees, other assets (tangible or intangible) or liabilities.

This means that the unlisted company has not acquired a *business* as defined by IFRS 3, meaning that the arrangement is not within the scope of that accounting standard.

The question which then follows is whether there is another IFRS which deals specifically with this transaction. This is because, under the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, it is first necessary to consider whether an IFRS deals with a particular transaction or event. If there is not, then it may be appropriate to look at guidance in an IFRS which deals with similar transactions or events which implies that, in the absence of guidance elsewhere, it might be possible to apply IFRS 3 by analogy.

However, in this case, because the acquisition of the listed shell company is in return for shares issued by the unlisted company, the arrangement falls within the scope of IFRS 2 and it is accounted for as a share-based payment in return for the assets acquired (the cash) and a listing.

This was confirmed in an agenda rejection statement issued by the IFRS Interpretations Committee in March 2013.

The March 2013 IFRIC Update notes that:

'If the listed non-operating entity qualifies as a business on the basis of the guidance in paragraph B7 of IFRS 3, IFRS 3 would be applicable to the transaction. However, if the listed non-operating entity is not a business, the transaction is not a business combinations and is therefore not within the scope of IFRS 3. ... it is therefore a share-based payment transaction which should be accounted for in accordance with IFRS 2. ...

... any difference in the fair value of the shares deemed to have been issued by the accounting acquirer and the fair value of the accounting acquiree's identifiable net assets ... should be considered to be payment for a service of a stock exchange listing for its shares, and that no amount should be considered a cost of raising capital. ... the cost of the service received is recognised as an expense.'

EXAMPLE 5.1: ACQUISITION OF A LISTED SHELL COMPANY BY AN UNLISTED TRADING COMPANY

Entity X is a listed shell company with 1 million shares on issue. On 31 December 20X2 Entity X issues an additional 19 million shares to acquire 100% of the issued share capital of Entity Y, a private trading company, which has 9.5 million shares in issue. At the date of the transaction, Entity X has a cash balance of CU80,000. Entity X has no other assets or liabilities. The fair value of Entity Y has been determined by an independent valuer to be CU1.9 million, equating to a value per share of CU0.20.

The new board of Entity X will consist of four directors from Entity Y and one non-executive director from Entity X. Entity Y's shareholders now hold 95% of the issued share capital of Entity X (19 million of the total of 20 million shares), with the remaining 5% held by Entity X's existing shareholders. Because Entity Y obtains control of the combined entity after the transaction, from an accounting perspective the transaction is not an acquisition of Entity Y by Entity X, and is instead the acquisition of Entity X by Entity Y. Consequently, Entity Y is the continuing entity and all comparative information in the consolidated financial statements will be that of Entity Y.

If Entity Y incorrectly accounts for the transaction as a reverse acquisition in accordance with IFRS 3, goodwill will be recorded in the consolidated financial statements. The amount of goodwill would be determined as follows. The previous 100% existing shareholders of Entity X now have a five per cent interest in the combined entity. Based on the number of shares that Entity X has issued after completion of the transaction, Entity Y would need to have issued 500,000 shares for the ratio of ownership interest in the combined entity to be the same. Based on the fair value of an Entity Y's share of CU0.20, the fair value of that equity is CU100,000. This would result in goodwill of CU20,000 being recorded, being the difference between the purchase consideration (CU100,000) less the fair value of Entity X (CU80,000).

However, because Entity X is not a business as defined in IFRS 3 (because it has only a single cash asset), it is inappropriate to account for this transaction as a reverse acquisition and recognise goodwill. The difference between the purchase consideration less the cash from Entity X is instead accounted for as a listing expense in accordance with IFRS 2.

The correct accounting is as follows:

Correct journal entry			
Dr	Cash received	CU80,000	
Dr	Listing expense (charged to profit or loss)	CU20,000	
	Cr Issued capital		CU100,000

6. ACCOUNTING FOR A CASH-SETTLED SHARE-BASED PAYMENT AS EQUITY SETTLED

IFRS 2 distinguishes how to measure share-based payments that are settled in equity (equity-settled share-based payments) compared with those share-based payments that are settled in cash or another asset (cash-settled share-based payments).

An *equity-settled* share-based payment transaction is defined in Appendix A of IFRS 2 as being:

'A share-based payment transaction in which the entity:

- (a) Receives goods or services as consideration for its own equity instruments (including shares or share options); or*
- (b) Receives goods or services but has no obligation to settle the transaction with the supplier.'*

A *cash-settled* share-based payment transaction is defined in Appendix A of IFRS 2 as being:

'A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or options) of the entity or another group entity.'

A cash-settled share-based payment results in the recognition of a liability rather than the recognition of a credit directly to equity.

The incorrect classification of a share-based payment as equity settled instead of cash settled can lead to significant errors in the related financial statements. This is because equity settled and cash settled share-based payments are measured differently.

The amount of an equity settled share-based payment is determined (and fixed) as being the fair value of the goods or services received or (if the fair value of the goods or services cannot reliably be determined) the fair value of the equity instrument at the grant date. Because of the difficulty in determining the fair value of services received from an employee, equity settled share-based payments granted to employees are always measured with reference to the fair value of the share-based payment. This is reflected in IFRS 2.10 and 11:

'...the entity shall measure the goods or services received, and the corresponding increase in equity, directly at the fair value of the goods or services received...' [IFRS 2.10]

'To apply the requirements of paragraph 10 to transactions with employees and other providing similar services, the entity shall measure the fair value of the service received by reference to the fair value of the equity instrument granted...The fair value of those equity instruments shall be measured at grant date.' [IFRS 2.11]

For cash-settled share-based payment transactions, the liability is remeasured to fair value at each reporting date with any changes in fair value being recognised as a share-based payment expense in profit or loss. IFRS 2.30 notes that:

'...the entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity shall remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period.'

Consequently, whilst the value attributed to an equity-settled share-based payment is fixed at the fair value of the instrument at the grant date, cash-settled share-based payments result in the recognition of a liability which must be remeasured at each reporting date until the liability is ultimately settled in cash (or another asset).

This means that for share-based payment arrangements in which the share price increases over time, an incorrect classification of cash-settled share-based payments as equity-settled may result in the following material misstatements:

- The understatement of the related share-based payment expense during the vesting period with a subsequent true-up at the point at which the share-based payment vests and is settled (i.e. as there would be no corresponding and equal liability to offset the required cash payment at vesting date)
- The credit entry associated with the share-based payment charge would be incorrectly recognised within equity rather than as a liability to be settled by an outflow of cash.

EXAMPLE 6.1: CASH-SETTLED SHARE-BASED PAYMENT

On 1 January 20X1, the managing director (MD) in Entity A, a family owned business, is awarded a share-based payment of 1,000 shares which represents 10% of Entity A's share capital.

On the date on which the share-based payment is granted, Entity A is valued at CU1 million. The majority owners of Entity A, although happy to have the MD as a shareholder of the company, do not want 'outside investors' other than whoever happens to be the current MD. The MD, although pleased to have an equity stake, is concerned that because Entity A is not listed, he will not be able to convert his shares into cash when he retires or if he leaves the company. For these reasons, the shares are issued with the condition that the company will buy the shares back at fair value on the MD's retirement or death, or if he is a 'good leaver' (that is, his departure is not due to incompetence or because he has been convicted of a serious crime, in which case the shares will be forfeited for nil consideration).

Entity A incorrectly classifies the arrangement as an equity settled share-based payment and recognises an expense of CU100,000.

Incorrect journal entry

Dr	Share-based payment expense	CU100,000	
	Cr Equity		CU100,000

However, the buyback clause means that IFRS 2 requires the transaction to be classified as a cash settled share-based payment, because the company would have to settle the transaction by making a cash payment. The outstanding liability would be remeasured to fair value at the end of each reporting period, with any changes in fair value recognised in profit or loss.

Assume that, at 30 June 20X1, the fair value of Entity A has risen to CU2m. Entity A would recognise a share-based payment expense, and record a liability, of CU200,000.

Correct journal entry

Dr	Share-based payment expense	CU200,000	
	Cr Liabilities		CU200,000

The liability would be remeasured to fair value at each reporting date with an associated charge (or, if the share price fell, credit), being recorded in profit or loss.

7. SHARE-BASED PAYMENTS GRANTED TO VENDORS OF AN ACQUIRED BUSINESS THAT REQUIRE POST ACQUISITION SERVICES FROM THE FORMER OWNERS

When companies acquire owner-managed businesses, it is common for the purchase consideration to include a deferred element which is designed to encourage the previous owner manager to stay on as an employee for a period after the acquisition. In some cases, these arrangements are also entered into because the purchaser and vendor are unable to reach agreement on the purchase consideration, and so a proportion is deferred with a variable amount being payable, dependent on the future performance of the acquired business.

Many acquirers have incorrectly accounted for the deferred payment arrangements as deferred consideration in accordance with IFRS 3 *Business Combinations*, and have added an amount equal to the fair value of the deferred consideration element to the acquisition date purchase consideration.

This has the effect of increasing goodwill.

In some cases, when the deferred consideration amount is variable, acquirers have also failed to take account of the requirement in IFRS 3 for changes in the amount of contingent consideration after the acquisition date to be recorded in profit or loss, and have continued to adjust goodwill.

However, IFRS 3.B55(a) notes that:

'...a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services...'

Consequently, such arrangements are not deferred consideration for the acquisition of the business. This was confirmed in a rejection statement issued by the IFRS Interpretation Committee in its January 2013 IFRIC Update:

'Arrangements in which contingent payments are automatically forfeited if employment terminates would lead to a conclusion that the arrangement is compensation for post-combination services rather than additional purchase consideration.'

In circumstances in which consideration, payment of which is contingent on the former owner manager staying in employment for a specified period, is in the form of shares of the acquirer, there is a share-based payment. Such arrangements are common when the acquirer is listed, meaning that there is an active market on which any shares that are transferred to the vendor can be sold.

EXAMPLE 7.1: DEFERRED CONSIDERATION IN A BUSINESS COMBINATION THAT REQUIRES CONTINUED SERVICE

Listed Entity A acquires Entity B, a private company from Mr S (the owner-manager of Entity B).

Consideration paid/payable to Mr S is CU1.0 million on the acquisition date and a variable number of Entity A's shares (with a value of between CU0.5 m and CU5.0 m) in three years' time. The value of shares depends on whether Entity B achieves certain profit targets and requires that Mr S, who has been appointed managing director of Entity B, remains in that position for three years after the acquisition date. At the acquisition date, the fair value of the contingent settlement is CU3.0 million. In addition to any contingent payment of shares, Mr S is paid a market salary throughout the period.

If the deferred payment in shares was incorrectly accounted for as part of the business combination, the following entry would be made:

Incorrect journal entry

Dr	Goodwill	CU3 m	
	Cr Liability		CU3 m

However, the deferred payment arrangement in shares should instead be accounted for as a share-based payment expense in accordance with IFRS 2. Because the arrangement gives rise to an equity settled share-based payment, the grant date fair value of CU3 million is expensed over the three year vesting period as below (i.e. CU1 m each year):

Correct journal entry (at the end of years 1, 2 and 3)

Dr	Share-based payment expense	CU1 m	
	Cr Liability		CU1 m

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1311-08