Educational material 7

APPLICATION OF IFRS STANDARDS IN LIGHT OF THE CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY

Potential implications on contingent consideration in a business combination where all conditions may not be met by year end due to COVID- 19

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1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS that are relevant for entities considering how the pandemic affects their accounting, for financial periods ending on or after 31 December 2019 with a specific focus on the potential implications on contingent consideration in a business combination where all conditions may not be met by year end due to COVID-19, specifically considering the principles of IFRS 3 *Business Combinations.*

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements.

This guidance does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

2. Potential implications on contingent consideration in a business combination where all conditions may not be met by year end due to COVID-19.

Contingent consideration is "usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met." (IFRS 3 Appendix A).

The consideration transferred in a business combination should be measured at fair value, which is calculated as the sum of the acquisition-date fair values of the assets transferred, the liabilities incurred and the equity interests issued by the acquirer. Examples of potential forms of consideration include cash, other assets, a business or a subsidiary of the acquirer, *contingent consideration* and ordinary or preference equity instruments (IFRS 3 paragraph 37).

The acquirer should recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree (IFRS 3 paragraph 39). Contingent consideration is recognised at acquisition date, whether it is probable that a payment will be made or not, or in the case of a refund, whether it is probable that a refund will be made or not. The likely timing, amount and probability of settlement would be inputs into the fair value measure.

Some changes in the fair value of contingent consideration may be as a result of additional information about facts and circumstances that existed at the acquisition date, that the acquirer obtained only after the acquisition date. Such changes are measurement period adjustments requiring the acquirer to retrospectively adjust the provisional amounts recognised at the acquisition date to reflect the new information obtained about facts and circumstances that existed at the acquisition date, that, if known would have affected the measurement of the contingent consideration at the acquisition date (IFRS 3 paragraph 58 and 45).

However, changes in the fair value of contingent consideration resulting from events after the acquisition date that are not indicative of facts and circumstances that existed at the acquisition date are not measurement period adjustments. The acquirer should account for these changes in fair value as follows:

- Contingent consideration classified as equity should not be remeasured.
- All other forms of contingent consideration are subsequently measured at fair value at each reporting date and changes in fair value should be recognised in profit or loss (IFRS 3 paragraph 58).

Example:

Company A with a 31 March 2020 year-end acquired a business during the year with a determined acquisition date of 1 October 2019. As part of the business combination, there is contingent consideration payable of R20mil that will be settled in cash on 1 December 2020 provided the EBITDA of the acquiree for the period from acquisition date until 31 October 2020 is above a certain threshold.

At the acquisition date, Company A determined that the fair value of the contingent consideration is R15mil based on a probably-weighted average calculation incorporating different probabilities that the acquiree will meet the EBITDA threshold at 31 October 2020.

The probability of the acquiree meeting the EBITDA threshold has significantly declined following the COVID-19 crisis and the impact it has had and is expected to have on the acquiree's operations.

Company A updated the probabilities assigned to the different scenarios to determine the fair value of the contingent consideration at 31 March 2020. After taking into consideration the significant uncertainties associated with the economic consequences of the COVID-19 crisis, the fair value of the contingent consideration liability reduced significantly to R2,5mil at 31 March 2020.

Illustration of timeline of events:

01-Apr-19	01-Oct-19	30-Jan-20	05-Mar-20	6 March 2020 or	11-Mar-20	15-Mar-20	23-Mar-20	31-Mar-20	09-Apr-20
Beginning of the year	**Acquistion date**	WHO announces COVID-19 as a Public Health Emergency of International Concern	First positive COVID-19 case is announced in South Africa	Number of confirmed COVID-19 cases increase	WHO declares COVID-19 as a pandemic	South Africa declares a national state of disaster with a partial travel ban, closing of schools and prohibiting gatherings of more than 100 people	South Africa declares a national lockdown of 21 days from 26 March 2020 to 16 April 2020	**Year-end**	Lock-down has been extended by two weeks until end of April

Based on the principles of IFRS 3, Company A should determine the fair value of the contingent consideration payable at the acquisition date based on the information available at the acquisition date. Therefore, Company A cannot consider any of the COVID-19 implications to determine the fair value of the contingent consideration liability at the acquisition date as the COVID-19 conditions did not exist at the acquisition date. As a result, the contingent consideration liability at 1 October 2019 should be recognised at the fair value of R15mil.

Subsequent to acquisition date, Company A should remeasure the contingent consideration liability at fair value. With reference to IFRS 3 paragraph 58, it is important that Company A distinguish whether the change in the fair value of the contingent consideration liability is triggered by:

- Additional information about facts and circumstances which existed at acquisition date, i.e. measurement period adjustments; or
- Changes resulting from events after the acquisition date that are not measurement period adjustments.

The additional information obtained subsequent to the acquisition date is new information that did not exist at the acquisition date and therefore are not measurement period adjustments. As a result, the remeasurement of the contingent consideration liability (as it is settled in cash) should be recognised through profit and loss.

In determining the fair value of the contingent consideration liability at year-end, 31 March 2020, Company A should take into consideration all available information, taking into consideration all the uncertainties surrounding the economic impact of COVID-19 (refer to Educational material 1 - *Application of IFRS Standards in Light of the Coronavirus Disease (Covid-19) Uncertainty - Events after the Reporting Period and Going Concern* for more information). Therefore, the fair value of the contingent consideration liability is reduced to R2.5mil at 31 March 2020 with the resultant movement being recognised as a gain in profit or loss.

To determine whether changes to the fair value of the contingent consideration is as a result of information that existed at the acquisition date is a matter of judgement and would be based on the specific facts and circumstances of the contingent consideration arrangement. This should be carefully considered for business combinations with an acquisition date after December 2019. If this judgement is considered significant, disclosures required by IAS 1 paragraph 122 should be included in the financial statements.

In addition, the fair value determination of the contingent consideration liability involves estimation uncertainty and if this represents a key source of estimation uncertainty, should also be disclosed by reference to IAS1 paragraph 125.