

Mr. Bruce Mackenzie
Chair of the IFRS Interpretation Committee
International Accounting Standards Board
Columbus Building, 7 Westferry Circus,
Canary Wharf, London E14 4HD
United Kingdom

By e-mail to commentletters@ifrs.org

20 November 2023

Re: Tentative Agenda Decision and comments letters: Payments Contingent on Continued Employment during Handover Periods (IFRS 3)

Dear Mr. Mackenzie,

On behalf of RSM International Limited, a worldwide Network of independent audit, tax and consulting Firms, we are pleased to comment on the IFRS Interpretation Committee (“the Committee”)’s tentative agenda decision relating to “Payments Contingent on Continued Employment during Handover Periods – IFRS 3”.

We agree with the conclusion reached, based on the current wording in IFRS 3, particularly Paragraph B55(a). However, we would request that the Committee consider either additional guidance, or referring the matter to the IASB for consideration of amendment to IFRS 3, with respect to the following matters:

- Further guidance as to what would make a service condition “not substantive”.
- Amendments to address situations where application of the current requirements may lead to inappropriate outcomes (see example provided).

Application of the requirements of IFRS 3 to the fact pattern

The fact pattern in the request described a situation where vendors of a business continued as employees of the acquiring entity. For this, they received both remuneration comparable to other executives, and additionally, payments based on the future performance of the business.

We note that Paragraph B55 of IFRS 3 presents a list of 8 indicators that users should consider in determining whether the payments are part of the business combination, or remuneration for post-acquisition employment. However, B55(a) contains the sentence “*A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services.*”

Most of the language of Paragraph B55 is indicative, using phrases such as “may indicate” or “may suggest.” However, the sentence quoted above uses prescriptive language, suggesting that once there is an automatic forfeiture on termination of employment, the remaining indicators become

irrelevant, and that the arrangement should always be treated as remuneration for post-combination services.

We believe there is a potential contradiction in Paragraph B55. The initial sentence suggests that all of the listed indicators should be considered. However, the language in B55 (a) suggests that, if certain criteria are met, then the accounting is conclusively determined, and the factors in (b) to (h) are irrelevant.

Based on the use of such prescriptive language in B55 (a), we agree that the requirements of existing IFRS are clear, and that conclusions reached in both the IFRIC agenda decision of January 2013, and the IFRIC's tentative agenda decision on this matter are consistent with the requirements of IFRS 3.

We raise the following matters below, as we are concerned that the language in B55(a) may lead to counter-intuitive results in some instances.

Meaning of “not substantive”

The IFRIC agenda decision of January 2013 suggested that a service condition would not always lead to the payment being treated as remuneration if it was “not substantive.” We believe users would benefit from additional guidance on what would make a service condition “not substantive.” This might include:

- Situations where a service condition may not be legally or practicably enforceable.
- Situations where a service condition exists, but there are no or minimal duties to be performed by the vendor during their employment period.
- Whether a condition is substantive if the vendor receives payment if they leave during the service period as a “good leaver”, and what sort of “good leaver” conditions would make a service condition not substantive.

Example – situations where application of IFRS may lead to counter-intuitive results

This example is based on a real-life transaction, although the dollar values, and some non-critical details have been changed to preserve confidentiality. We are concerned that, in situations like the one described below, existing IFRS requirements may not accurately capture the substance of the transaction.

Company Z acquires 100% of the shares of VendorCo for a sum of \$30m in cash. The transaction is at arm's length. VendorCo was previously owned by three individuals, A, B and C, who each owned one third of the shares on issue. The fair value of the net assets acquired, including any identifiable intangibles, was \$16m.

As part of the acquisition agreement:

- Vendor A, who has reached retirement age, will receive \$10m in cash immediately on completion of the transaction. He is subject to a non-compete restriction.
- Vendors B and C will also receive \$10m in cash each. However, the cash will be placed in escrow for 12 months.
- During the 12 months, B and C must work for Company Z to facilitate the transition. Should either B or C choose to leave Company Z for any reason other than incapacity or termination without cause by Company Z, they will forfeit the \$10m.
- Should B and C complete 12 months of service, they will receive the \$10m cash and any interest accrued during the 12 month escrow period.
- B and C each receive no other compensation for their sale of their share of VendorCo.
- Under their employment contracts, B and C each receive remuneration of \$600,000 per year for their employment with Company Z. This is above-market remuneration for individuals with their skill and experience.
- Should both parties agree, B or C may extend their employment at Company Z beyond one year. At acquisition date, both parties have expressed that this is likely to occur.

If the requirement in B55(a) were interpreted prescriptively, then the entire \$20m paid to B and C would be treated as remuneration for employment. The effects of this would be:

- For accounting purposes, B and C would be deemed to have effectively handed their share of VendorCo to Company Z for nil consideration, even though Vendor A received \$10m for the same number of shares.
- No goodwill would be recognised. Indeed, with \$10m consideration being paid for \$16m of identifiable net assets, an immediate bargain purchase gain of \$6m would be recognised by Company Z.
- Individuals B and C would be shown as receiving remuneration of \$10.6m each. This would also be the published figure of their remuneration in any required Key Management Personnel compensation disclosures.

In our view, the treatment above would not represent the substance of the transaction. Given that all three vendors received the same amount, the \$10m each one received is clearly consideration for the sale of shares. The lack of goodwill, and the presence of a substantial bargain purchase gain in an arms-length transaction involving a non-distressed business, suggests that the consideration paid in the transaction is not being measured appropriately. Indeed, the ability to generate such a bargain purchase gain by such a transaction may have the potential to be used for earnings management purposes, or to avoid the recognition of goodwill, by any party acting in bad faith.

Given the potential for outcomes such as the one above, we would suggest that the IFRIC consider making a recommendation to the IASB concerning the prescriptive language in Paragraph B55(a) of IFRS 3. We would agree that automatic forfeiture of post-acquisition payments on termination of employment is a strong indicator that the arrangement is not part of the business combination. However, we believe that there may be exceptions to this, and that IFRS 3 should allow preparers to consider all the relevant factors listed in Paragraph B55 when reaching a conclusion.

We would suggest that the language in B55 could be softened to suggest a rebuttable presumption, rather than an absolute requirement to treat such arrangements as remuneration for post-combination services.

If it would be helpful, we would be pleased to discuss our views further with you. To do this please contact either Monique Cole (Monique.Cole@rsmus.com) or Marion Hannon (Marion.Hannon@rsm.global).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Marion Hannon', written in a cursive style.

Marion Hannon
Global Leader, Quality & Risk
RSM International