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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 July 2006, London**

Project: **Business Combinations II**

Subject: **Identifying the Components of a Business Combination (Agenda Paper 2A)**

INTRODUCTION

1. The Business Combinations Exposure Draft (BC ED) proposes:

> 69 The acquirer shall assess whether any portion of the transaction price (payments or other arrangements) and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree shall be included in the business combination accounting. Any portion of the transaction price or any assets acquired or liabilities assumed or incurred that are not part of the exchange for the acquiree shall be accounted for separately from the business combination. [Emphasis omitted.]

2. The staff believes that there are two ways to view transactions or events that occur in relation to a business combination. The BC ED defines a business combination as 'a transaction or other event in which an acquirer obtains control of one or more businesses' (the acquiree). One view is that the definition of a business combination is broader than 'the exchange for the acquiree'. That is, a business

combination includes all transactions or events that occur in relation to the business combination because it is the sum of all of those transactions and events that results in the acquirer obtaining control of the acquiree. The second view is that the definition of a business combination is narrower. That is, a business combination is only the acquisition of assets and assumption of liabilities that comprise the acquiree. Other related transactions are separate from the business combination transaction.

3. The staff believes that the objective of the guidance proposed in this paper is the same under both views. The analysis in this paper is based on the first view. That is, the analysis assumes that all transactions or events that occur in relation to a business combination transaction are part of the business combination. If Board members prefer to take a narrow view of the definition of a business combination, the staff will draft the principles and related guidance to reflect that view. However, the staff does not believe that should affect the discussion of the fundamental ideas behind the principles and related guidance proposed in this paper.

4. A business combination might be comprised of several substantively separate, but related, transactions and events. For convenience, in this paper the staff refers to the related transactions and events that comprise a business combination as ‘components’ of a business combination. For example, in exchange for the total consideration transferred as part of the business combination, an acquirer is likely to have received services to assist with the completion of the acquisition (eg legal or valuation services) in addition to acquiring the assets and assuming the liabilities that comprise the acquiree. In addition, as part of the business combination the acquirer might have:

   a. paid employees for future services; or
   b. received other assets or assumed other liabilities that are not part of the acquiree.

5. It is important to identify each of the components of a business combination so that each component is accounted for in accordance with its economic substance. The component of the business combination that involves acquiring the assets and

assuming the liabilities that comprise the acquiree should be accounted for as an acquisition (ie using the acquisition method). A component of the business combination that represents the payment of employees for future services should be accounted for in accordance with its economic substance in the financial statements of the acquirer (eg as remuneration or compensation expense).

6. The focus of the BC ED seems to be on assessing whether the assets acquired and liabilities assumed in a business combination are part of the exchange for the acquiree. The staff believes that the focus should be on providing guidance so accounting reflects the economic substance of the components of a business combination. Therefore, the focus of this paper is developing guidance for identifying the components of a business combination so that those components can be accounted for in accordance with their economic substance.

7. This paper:

    a. describes the objective for providing guidance on identifying the components of a business combination;

    b. summarises the proposed guidance and analyses comments received on that guidance;

    c. recommends that the following principles be included in the final standard:

        > The acquirer shall assess whether a business combination includes any transactions that are substantively separate from the acquisition of assets and assumption of liabilities that comprise the acquiree. Only the consideration transferred and the assets acquired or liabilities assumed that comprise the acquiree shall be accounted for using the acquisition method. Other transactions should be accounted for separately based on their economic substance in accordance with other IFRSs/U.S. GAAP.
        >
        > A transaction or event arranged by or on behalf of the acquirer and/or initiated primarily for the economic benefit of the acquirer or the combined entity (rather than for the benefit of the acquiree or its former owners **prior to** the business combination) is a substantively separate transaction.

d. applies the proposed principles to a variety of transactions; and

e. analyses comments received and outlines the staff's plans on the proposed guidance for the accounting for effective settlement of pre-existing relationships between the acquirer and acquiree, arrangements to pay for employee services and acquirer share-based payment awards exchanged for awards held by the employees of the acquiree.

OBJECTIVE

8. The objective of the proposed guidance on identifying the components of a business combination is to ensure that each of the components is accounted for in accordance with its economic substance. This will provide users with relevant information about the financial effects of transactions and events entered into by the acquirer.

9. The acquirer's financial statements should reflect the financial effects of all transactions and events for which the acquirer is responsible. That is, the acquirer should recognise and report any expenses incurred for acquisition-related services or for post-combination transactions or events, in addition to reflecting the assets acquired and liabilities assumed that comprise the acquiree.

10. The component of a business combination that involves acquiring the assets and assuming the liabilities that comprise the acquiree and transferring consideration for those assets and liabilities is accounted for using the acquisition method. The other components of a business combination are accounted for in accordance with other IFRSs or U.S. GAAP. It is important that all components of a business combination be identified and the accounting requirements be aligned with the economic substance of those components. Otherwise, consideration transferred in exchange for the acquiree might be overstated, which might result in goodwill being overstated or expenses for which the acquirer is responsible not being reflected in the acquirer's financial statements.

11. Guidance is needed on identifying the components of a business combination because:

a. in some circumstances it might be difficult to determine which parts of a business combination transaction are substantively separate yet concurrent transactions. For example, if an acquirer exchanges its share-based payment awards (replacement awards) for awards held by employees of the acquiree, it might be difficult to assess the portion of the acquirer's replacement awards is part of the consideration transferred for the assets and liabilities that comprise the acquiree and the portion, if any, that represents payment for future services.

b. parties involved directly in the negotiations of an impending business combination could take on the characteristics of related parties. As a result, they might be willing to enter into other agreements or include conditions as part of the business combination agreement that are designed primarily to achieve favourable post-combination reporting outcomes (eg shifting post-combination expenses of the acquirer into the accounting for the assets acquired and liabilities assumed that comprise the acquiree).

Application of the Objective to Acquisition-Related Costs

12. This section illustrates the objective by applying it to acquisition-related costs. Acquirers often incur costs in connection with a business combination (eg legal, accounting, valuation or other professional or consulting fees). The acquirer initiates the transactions that result in the acquisition-related costs and is the primary beneficiary of the services received. Those transactions are a separate component of the business combination.

13. In this case, the objective of the proposed guidance on identifying the components of a business combination is to ensure that the acquirer accounts for the acquisition-related costs in accordance with their economic substance. The acquirer is responsible for the acquisition-related costs and thus the transaction(s) giving rise to the costs should be reflected in the acquirer's financial statements. If, based on the economic substance of the transaction(s), the appropriate accounting is to expense the acquisition-related costs, then that expense should be reflected in the acquirer's income statement.

14. To avoid recognising acquisition-related costs as an expense, an acquirer might ask a seller to make payments to the service providers on its behalf (see Example B in Appendix C). To facilitate the negotiations the seller might agree to make those payments if the agreed acquisition price includes an amount sufficient to reimburse the seller for payments it made on the buyer's behalf. Prior to the acquisition, the acquiree might have paid the acquisition-related costs or it might have a liability for the costs. In either case, the acquiree will have recognised an expense for the costs. If the disguised reimbursements were treated as part of the consideration transferred for the assets and liabilities that comprise the acquiree, those expenses might not be recognised by the acquirer. As a result, the amount recognised for goodwill could be overstated because the consideration transferred includes consideration for the assets acquired and liabilities assumed, as well as for reimbursement of the acquisition-related costs.

15. Thus, the guidance on identifying the components of a business combination should result in the transaction for the acquisition-related services being reflected in accordance with its economic substance in the financial statements of the acquirer, even if the acquiree pays for the services on the buyer's behalf.

BC ED GUIDANCE

16. The BC ED proposes:

> 69 The acquirer shall assess whether any portion of the transaction price (payments or other arrangements) and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree shall be included in the business combination accounting. Any portion of the transaction price or any assets acquired or liabilities assumed or incurred that are not part of the exchange for the acquiree shall be accounted for separately from the business combination. [Emphasis omitted.]
>
> 70 Examples of payments or other arrangements that are not part of the exchange for the acquiree include:
>
> (a) payments that effectively settle pre-existing relationships between the acquirer and acquiree (see paragraphs A91-A97).
>
> (b) payments to compensate employees or former owners of the acquiree for future services (see paragraphs A98-A101).

(c) payments to reimburse the acquiree or its former owners for paying the acquirer's costs incurred in connection with the business combination.

17. The BC ED acknowledges that judgement is required in determining what is part of the exchange for the acquiree and provides application/implementation guidance to assist constituents:

> A88 …A transaction or event arranged primarily for the economic benefit of the acquirer or the combined entity is not part of the exchange for the acquiree and is accounted for separately from the business combination. One arranged primarily for the benefit of the acquiree or its former owners generally is part of the exchange and is included in the business combination accounting. The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a transaction or event is arranged primarily for the economic benefit of the acquirer or combined entity, rather than for the acquiree or its former owners.
>
> (a) *The reasons for the transaction or event…*
>
> (b) *Who initiated the transaction or event…*
>
> (c) *The timing of the transaction or event…*

18. The BC ED also includes additional application/implementation guidance and related examples for the following situations:

    a. effective settlement of pre-existing relationships between the acquirer and acquiree (paragraphs A91-A97).

    b. arrangements to pay for employee services (paragraphs A98-A101).

    c. acquirer share-based payment awards exchanged for awards held by the employees of the acquiree (paragraphs A102-A109).

PREVIOUS BOARD DISCUSSIONS

19. The Boards discussed the approach for identifying the components of a business combination several times in a variety of contexts. Appendix B of this paper summarises the Boards' initial discussions.

SUMMARY OF COMMENT LETTERS

20. The BC ED asked respondents whether the proposed guidance would be sufficient for assessing whether any portion of the transaction price or any assets acquired and liabilities assumed or incurred are not part of the exchange for the acquiree.

21. Respondents generally agreed that acquirers should assess whether any portion of the transaction price and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. They also generally agreed that only the consideration transferred and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree should be included in the accounting for the exchange for the acquiree and everything else should be accounted for separately.

22. At the July meeting, the staff plans to focus on the overall principles and guidance for identifying the components of a business combination. In this section, the staff analyses respondents' comments on the principles and the amount of detailed application guidance provided in the BC ED.

23. The majority of respondents' comments were related to the specific guidance proposed for pre-existing relationships, payments to employees, and exchanges of share-based payment awards. Those comments and the staff's plans for addressing the comments are outlined in Appendix A. The staff does not plan to discuss those topics in detail at the July Board meetings, but it will address any comments Board members have on its plans for these issues. In summary, the staff plans to analyse further the following issues raised by respondents:

    a. issues related to the accounting for pre-existing relationships and reacquired rights, including (1) distinguishing between pre-existing relationships and reacquired rights, (2) concerns that recognising a reacquired right as a separately identifiable intangible asset is analogous to recognising an internally generated intangible asset and (3) whether a renewable reacquired right should be valued assuming renewal rights or not;

b. whether a gain or loss for the effective settlement of pre-existing relationships between the acquirer and acquiree should be recognised; and

c. the differences between contingent payments that are based on multiples of earnings and those that are based on percentages of earnings (when we consider contingent consideration more broadly).

Level of Detail and Need for Principles-Based Guidance

24. Several respondents stated that identifying the components of a business combination will require judgement and must be based on the individual facts and circumstances of the business combination. However, respondents' views on the implications of that observation differed.

    a. Some respondents stated that the BC ED guidance is appropriate, useful and sufficient for identifying the components of a business combination.

    b. Other respondents stated that the guidance in the BC ED is not sufficient, and that the Boards should provide additional examples from a variety of industries illustrating the application of the principle.

    c. Other respondents stated that the BC ED guidance is too detailed and complex and should be more principles-based.

25. Respondents' views on the principles proposed in the BC ED varied. Some respondents stated that the principle outlined in paragraphs 69, 70 and A88 is sufficient. Other respondents stated that the proposed guidance appears to lack a clear principle. Those respondents expressed concern that without a clear principle, the detailed guidance will be difficult to apply or might be viewed as a 'checklist' for preparers to follow.

Drafting Suggestions Proposed by Respondents

26. Paragraph A88 of the BC ED states:

> A transaction or event arranged primarily for the economic benefit of the acquirer or the combined entity is not part of the exchange for the acquiree and is accounted for separately from the business combination. One arranged primarily for the benefit of the acquiree or its former owners generally is part of the exchange and is included in the business combination accounting.

27. Several respondents suggested that the Boards clarify this guidance because a transaction or event that benefits the acquiree also will benefit the combined entity because the acquiree is part of the combined entity.

28. Grant Thornton (CL #20) also noted a similar issue with paragraph A98, which states:

> To assist in that determination [of whether arrangements to pay for employee services are part of the exchange for the acquiree], it is important to understand whether the transaction includes payments or other arrangements for the economic benefit of the acquirer or combined entity *with little or no benefit received by the acquiree or its former owners*.

Grant Thornton stated that the guidance is not useful because 'arrangements that effectively provide compensation in exchange for continued employment benefit *both* the combined entity and the former owners/employees'.

29. The staff plans to clarify the guidance in drafting. The staff believes that the intention behind the guidance is appropriate and useful. That is, in assessing whether a transaction or event is a separate component of a business combination, the acquirer should consider whether the transaction or event is arranged *primarily* for the economic benefit of the acquirer or combined entity or whether the transaction or event is arranged *primarily* for the benefit of the acquiree or its former owners **before** the business combination.

STAFF ANALYSIS

30. In reaching its recommendation, the staff considered carefully constituents' comments. The staff agrees with respondents that identifying the components of a business combination will require judgement and depend on the facts and circumstances of the business combination. The staff also agrees that it is

important for the final business combinations standard to articulate clearly a principle for identifying the components of a business combination.

31. The BC ED guidance on assessing what is part of the exchange for the acquiree focused on determining whether assets and liabilities and the consideration transferred for those assets and liabilities were part of the exchange for the acquiree. However, the staff believes that focusing on whether assets or liabilities are part of the exchange for the acquiree might not result in all transactions being accounted for in accordance with their economic substance. For example, if an acquirer asks the acquiree to pay for the acquisition-related costs on its behalf and the acquiree has paid those costs before the acquisition date, the acquiree will not have a liability in its books for the costs. Therefore, some might believe that the principle in the BC ED does not apply to the transactions giving rise to the acquisition-related costs. As a result, the acquirer might not recognise those transactions separately in its financial statements in accordance with their economic substance.

32. Therefore, the staff believes that the focus of the principle should be identifying whether a business combination consists of substantively separate transactions that should be accounted for separately in accordance with their economic substance. This will provide users with relevant information about the financial effects of transactions and events entered into by the acquirer. The acquirer's financial statements will reflect the financial effects of all transactions and events for which the acquirer is responsible in accordance with the economic substance of those transactions and events.

33. The staff believes that the principle is needed to ensure that transactions are accounted for in accordance with their economic substance. Without the principle, substantively separate components of a business combination might not be accounted for separately in accordance with their economic substance. This might result in consideration transferred in exchange for the assets and liabilities comprising the acquiree being overstated, which might result in goodwill being overstated or expenses for which the acquirer is responsible not being reflected in the acquirer's financial statements.

34. The staff also considered whether a statement should be included in the final standard that explains explicitly the abuses that the principle on assessing whether a business combination consists of substantively separate transactions is trying to prevent. For example, a statement could be added saying something like the following:

> This guidance is provided to prevent an acquirer from circumventing the accounting for separate exchange transactions by incorporating them into a business combination—for example, circumventing the requirement to recognise acquisition-related costs in the financial statements of the acquirer in accordance with other IFRSs/U.S. GAAP . . .

35. The staff believes that the principle should stand alone and be clear enough to prevent acquirers from circumventing the accounting for separate exchange transactions without having to state explicitly that it is the intention of the guidance. In addition, the staff does not believe that the guidance is only applicable to circumstances in which an acquirer is trying to circumvent the accounting guidelines. For example, the guidance might also be used in some circumstances in which it is difficult to determine which parts of a business combination transaction are substantively separate yet concurrent transactions (eg exchanges of share-based payment awards). Therefore, the staff does not believe that such an explicit statement should be included in the final standard.

36. Comments varied on the level of detail provided in the BC ED. The staff believes that a balance is appropriate. The assessment of what is part of the exchange for the acquiree will depend on the facts and circumstances of individual situations. As a result, it is not possible to provide examples addressing every possible situation in every industry. However, the staff does believe that it would be useful to provide one or two examples illustrating the application of the principles.

STAFF RECOMMENDATION

37. The staff recommends that the following principles be included in the final business combinations standard:

> The acquirer shall assess whether a business combination includes any transactions that are substantively separate from the acquisition of assets and assumption of liabilities that comprise the acquiree. Only the consideration transferred and the assets acquired or liabilities assumed that comprise the acquiree shall be accounted for using the acquisition method. Other transactions should be accounted for separately based on their economic substance in accordance with other IFRSs/U.S. GAAP.
>
> A transaction or event arranged by or on behalf of the acquirer and/or initiated primarily for the economic benefit of the acquirer or the combined entity (rather than for the benefit of the acquiree or its former owners **prior to** the business combination) is a substantively separate transaction.[1]

38. In addition, the staff recommends that the following guidance proposed in the BC ED be included in the application/implementation guidance to assist constituents in assessing whether a transaction is substantively separate from the acquisition of assets and assumption of liabilities that comprise the acquiree:

> The acquirer should consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a transaction or event is initiated primarily for the economic benefit of the acquirer or combined entity, rather than for the acquiree or its former owners prior to the business combination.
>
> (a) *The reasons for the transaction or event*
>
> (b) *Who initiated the transaction or event*
>
> (c) *The timing of the transaction or event.*

39. The staff believes the proposed principles and application guidance will achieve the objective outlined at the beginning of this paper. That is, the proposed principles will result in acquirers accounting for each of the substantively separate transactions that comprise a business combination in accordance with its economic substance. This will provide users with relevant information about the financial effects of transactions and events entered into by the acquirer.

40. The staff tested the robustness of the principles and related guidance for identifying the components of a business combination by applying them to a variety of examples (see below and Appendix C). The staff believes that the

[1] The second principle is based on guidance that was included in the application/implementation guidance of the BC ED. It has been revised to address respondents' observations that a transaction for the benefit of the acquiree also will benefit the combined entity and to reflect the focus on identifying the components of a business combination.

principles and related guidance result in consistent answers when applied to the examples and that the outcomes satisfy the objective of accounting for substantively separate transactions in accordance with their economic substance.

EXAMPLES

41. An analysis of the application of the principles and related guidance to acquisition-related costs, restructuring costs and 'golden parachutes' is provided below. Additional examples and staff analysis are included in Appendix C.

Acquisition-Related Costs

42. In April the Boards tentatively affirmed the proposal in the BC ED that acquisition-related costs represent payments made for services received and consumed that an acquirer should recognise separately in accordance with other IFRSs/U.S. GAAP.

43. This is consistent with the outcome that would result by applying the principles proposed by the staff. As noted previously, the transactions that generated acquisition-related costs are initiated by the acquirer and the acquirer is the primary beneficiary of the services received. Therefore, the transactions that generated the acquisition-related costs are substantively separate transactions that should be accounted for separately in accordance with other IFRSs/US GAAP (see Examples A and B in Appendix C).

Restructuring Costs

44. Agenda Paper 2B/Memo #22 addresses the proposed accounting for restructuring costs. At the July meeting, the staff will ask the Boards to affirm that an acquirer recognise restructuring costs only if those costs meet the recognition criteria in SFAS 146 or IAS 37 at the acquisition date. If the recognition criteria are met at the acquisition date, the acquirer should assess whether that transaction was arranged by or on behalf of the acquirer and/or initiated primarily for the economic benefit of the acquirer or the combined entity to determine the substance of the transaction. Unless the restructuring costs transaction was initiated by and primarily on behalf of the acquiree, that transaction should be

accounted for separately in accordance with IAS 37/SFAS146 (see Examples C and D in Appendix C).

Golden Parachutes

45. This section analyses three different fact patterns in which Target Co. (the acquiree) enters into an agreement with its CEO that requires Target Co. to pay the CEO CU1 million if Target Co. is acquired before the CEO's employment contract expires (a golden parachute agreement). In all three cases, the CEO remained an employee of Target Co. through the acquisition date and, thus, will receive the additional payment under the golden parachute agreement.

Case 1: Target Co. seeks to hire a new CEO (Candidate). The highly-desired and sought Candidate agrees to accept a position with Target Co. provided that Target Co. enters into the golden parachute agreement. Acquirer Co. acquires Target Co. eight years later (also Example G in Appendix C).

Case 2: Acquirer Co. is negotiating to acquire Target Co. Acquirer Co. plans to terminate the CEO's employment contract as part of its restructuring of Target Co. after the business combination. However, Acquirer Co. would like to avoid recognition of a post-combination expense for the restructuring. So prior to the closing date, Acquirer Co. makes a 'quiet' arrangement with the key directors of Target Co. to set up a golden parachute agreement that effectively provides termination benefits to the CEO. As part of that arrangement, Acquirer agrees that any increase in the liabilities of Target as a result of the golden parachute agreement will not be included in potential downward adjustments to the previously negotiated and agreed upon purchase price. Target Co. agrees to initiate the golden parachute agreement in order to facilitate negotiations (also Example H in Appendix C).

Case 3: Target Co. is the target of a much-publicised hostile takeover bid by Acquirer Co. The CEO is concerned that the management of Acquirer Co. intends to replace the executives at Target Co. with its own senior staff. Consequently, the CEO begins to seek employment elsewhere. Worried about its CEO's departure during a critical moment, Target Co.'s directors enter into the golden parachute agreement with the CEO, which would provide reasonable compensation for the CEO's services in the event of an acquisition. A few weeks later, Acquirer Co. raises its tender offer and Target Co. is acquired anyway (also Example I in Appendix C).

46. In each case, the acquiree has a liability for the golden parachute agreement at the time of the acquisition. Some believe the obligating event occurred when the agreement between Target Co. and the CEO was entered into. Others believe the obligation is conditional until the combination occurs. In either event, there is a liability at the acquisition date.

47. The question is whether the transaction or event giving rise to the golden parachute agreement is a substantively separate transaction from the acquisition of the assets and assumption of the liabilities comprising the acquiree. That is, is the golden parachute agreement a separate transaction that was arranged by or on behalf of the acquirer and/or initiated primarily for the economic benefit of the acquirer or the combined entity (rather than for the benefit of the acquiree or its former owners **prior to** the business combination)? If so, the golden parachute agreement should be accounted for separately by the acquirer in accordance with its economic substance (eg as remuneration or compensation expense).

48. These cases illustrate that the appropriate accounting for business combinations often depends on the facts and circumstances of the individual transactions.

49. In Case 1, the golden parachute agreement was clearly arranged for the benefit of Target Co. before the acquisition date (the contract date precedes the business combination by eight years). The employment agreement (including the golden parachute agreement) was entered into by Target Co. to secure the employment of the CEO and by the CEO to secure payment and security. The employment agreement was entered into before the negotiations of the combination began and relates to the benefits that Target Co. received over the employment period of the CEO. Thus, there is no reason to believe that the agreement was arranged primarily to achieve economic benefits for Acquirer Co. As a result, the golden parachute agreement is not a substantively separate transaction that should be accounted for separately.

50. In Case 2, the golden parachute agreement was initiated on behalf of and primarily for the economic benefit of the acquirer or the combined entity. The golden parachute agreement was initiated by the Acquirer Co. to provide severance pay to the CEO. The agreement between Acquirer Co. and Target Co.'s directors was

initiated by the Acquirer Co. to avoid recognising post-combination restructuring costs. The restructuring of Target Co. is primarily for the benefit of the combined entity. Thus, the golden parachute agreement is a substantively separate transaction from the acquisition of the assets and assumption of the liabilities that comprise the acquiree. The golden parachute agreement should be accounted for separately in the financial statements of the acquiree based on the substance of the transaction in accordance with other IFRSs/U.S. GAAP. In this case, the acquirer should recognise an expense for the severance pay in its financial statements.

51. If the golden parachute agreement was not accounted for as a separate transaction, the expense for the severance pay would not be recognised in the acquirer's financial statements, even though the transaction was initiated by the acquirer. In addition, goodwill would be overstated because the acquirer did not adjust the purchase price downward to reflect the additional liability on the books of the acquiree.

52. In Case 3, judgement must be applied in determining whether the golden parachute agreement was arranged on behalf of or primarily for the economic benefit of the acquirer or the combined entity. The following factors should be considered (as proposed by the staff to be included in the application/implementation guidance):

   (a) *The reasons for the transaction or event*
   (b) *Who initiated the transaction or event*
   (c) *The timing of the transaction or event.*

53. The golden parachute agreement was entered in the midst of a hostile takeover bid. The facts tell us that the contract was entered into by the Target Co.'s directors to retain the employment of the CEO during a critical time prior to the combination, but sceptics may find that 'fact' questionable, especially if there are other factors to suggest that the hostile environment turned friendly. It is unclear who the intended beneficiary of the arrangement is. Some assert that the Target Co. and its owners are the intended beneficiaries of retaining the CEO's services prior to the combination and that Acquirer Co. would be uninterested in the continued employment of Target Co.'s CEO. Others believe that the arrangement was

initiated by the Acquirer Co. in contemplation of the business combination to receive benefits from the continuity of leadership provided by the CEO during and beyond the takeover period. In addition, there is not enough information given in the case to determine whether the CU1 million is 'reasonable' compensation for the CEO.

54. The acquirer (and its auditors) will be aware of all of the details of the golden parachute agreement and will have to exercise judgement in determining whether it is a substantively separate transaction.

55. The staff also notes that if the acquirer is able to influence the acquiree to enter into golden parachute agreements with employees, the acquirer should consider whether it has obtained control of the acquiree.

56. The staff believes that the outcomes resulting from the application of the principles and related guidance to these cases meet the objective outlined at the beginning of this paper by appropriately reflecting the economic substance of the golden parachute agreement in the financial statements of the acquirer.

QUESTIONS FOR THE BOARDS

57. ***Do the Boards agree with the principles and additional application/implementation guidance proposed by the staff?***

58. ***Do the Boards agree with the staff's analysis of the application of the principles to the examples above and in Appendix C?***

59. ***Do the Boards agree that the final standard should not include a statement that explains explicitly the abuses that the principles are trying to prevent?***

APPENDIX A

PROPOSED GUIDANCE FOR PRE-EXISTING RELATIONSHIPS, ARRANGEMENTS TO PAY FOR EMPLOYEE SERVICES AND EXCHANGES OF SHARE-BASED PAYMENT AWARDS

60. As noted in the paper, the BC ED provides application/implementation guidance for the following situations:

    a. the effective settlement of pre-existing relationships between the acquirer and acquiree.

    b. arrangements to pay for employee services.

    c. acquirer share-based payment awards exchanged for awards held by the employees of the acquiree.

61. This appendix summarises the comments received on each topic and outlines the staff's plans for addressing those comments. The staff does not plan to discuss these topics at the July 2006 Board meetings, but it will address any comments Board members have on its plans for these issues.

Pre-Existing Relationships between the Acquirer and Acquiree

62. The BC ED codifies the guidance that currently exists in EITF Issue No. 04-1, "Accounting for Preexisting Relationships between the Parties to a Business Combination." As a result, consistent with the guidance in Issue 04-1, the BC ED proposes:

    a. ***Reacquired rights***: If as part of the business combination an acquirer reacquires a right that it had granted to the acquiree to use the acquirer's intangible assets, that right is an identifiable intangible asset that would be recognised separately from goodwill. Examples of such rights are a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. If the pricing terms in the contract giving rise to the reacquired right are favourable or unfavourable when compared with pricing terms for current market transactions for the same or similar items, the acquirer would recognise a settlement gain or loss. [Paragraph 41, paraphrased.]

b. ***Preexisting relationships:*** If the acquirer and acquiree have a contractual or noncontractual preexisting relationship that existed before the business combination, the acquirer would recognise a settlement gain or loss if the business combination results in the effective settlement of that relationship. As a result, the effective settlement of that preexisting relationship would be accounted for the same way regardless of whether it was settled as part of the business combination or separately. [Paragraphs A91 and A92, paraphrased.]

63. The Boards did not solicit input on this issue in the Notice/Invitation; however, a few respondents did raise this issue in their comment letters. Those who responded generally disagreed that the acquirer should recognise a reacquired right as a separately identifiable intangible asset. They believe that the proposal would lead to the acquirer recognising an internally generated intangible asset as part of the business combination.

64. Several respondents also disagreed with recognising a gain or loss for the effective settlement of pre-existing relationships between the acquirer and acquiree or expressed concern about the practicalities of measuring the settlement gain or loss.

65. In addition, the staff has become aware that the provisions of Issue 04-1 have resulted in a number of practice problems. Specifically, distinguishing a reacquired right from a pre-existing relationship is sometimes difficult because these terms are not defined.

66. The staff also has received questions about the subsequent accounting for reacquired rights. The Boards added a provision in the BC ED that is not in Issue 04-1. That provision is "…after initial recognition, reacquired rights shall be amortised over the remaining contractual period of the precombination contract that granted those rights." Some have questioned the purpose of that provision and whether or not a renewable reacquired right should be valued assuming renewal rights.

67. The staff plans to analyse further these comments and bring the issues back to the Boards at a future meeting.

Arrangements to Pay for Employee Services

68. The BC ED codifies the guidance in EITF Issue No. 95-8, "Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination." That guidance is intended to help assess whether an arrangement to pay for employee services should be accounted for as a separate transaction for the payment for future services.

69. The staff believes that the proposed guidance should be included in the final business combinations standard. The staff believes that the guidance is consistent with the principles and additional guidance recommended by the staff above and useful for assisting constituents in determining what portion of arrangements to pay for employee services is a substantively separate transaction that should be accounted for separately in accordance with other IFRSs/U.S. GAAP.

Relationship with Issue 95-8

70. The guidance in the BC ED was paraphrased and not all of Issue 95-8 was incorporated. Two respondents noted that Issue 95-8 states that vesting requirements are a strong indicator that an arrangement is compensation for post-combination services, but that the proposed guidance does not distinguish vesting requirements as being more persuasive than other factors. The respondents believe that this will make the guidance more difficult to apply in practice.

71. The staff notes that it was not their intention to modify the application of the guidance in Issue 95-8, but only to incorporate the existing guidance into the business combinations standard. As a result, unless Board members object, the staff plans to state in the application guidance of the final standard that vesting requirements are a strong indicator that arrangements are compensation for post-combination services.

Multiple of Earnings vs. Percentage of Earnings

72. Paragraph A99 of the BC ED provides indicators for acquirers to consider if it is not clear whether an arrangement to pay for employee services is a substantively separate transaction. One of those indicators is the formula used for determining consideration. The guidance states:

> Contingent payments that are based on multiples of future earnings, future cash flows, or other similar performance measures may indicate that the formula is intended to verify the fair value of the acquiree and, therefore, should be accounted for as part of the business combination. In contrast, contingent payments based on percentages of earnings may indicate a profit-sharing arrangement that should be accounted for separately from the business combination.

73. Several respondents suggested that the Board clarify the differences between contingent payments that are based on multiples of earnings and those that are based on percentages of earnings and explain why those payments should be treated differently. Respondents suggested that contingent payments based on (a) performance measures might be a post-combination performance bonus, rather than a fair value adjustment and (b) percentages of earnings might be used to verify the fair value of the acquiree. Respondents also suggested that the final standard include principles on the subsequent accounting for contingent consideration (ie whether changes in the fair value of contingent consideration should be treated as adjustments to acquisition accounting or recognised through income).

74. The staff believes that this issue should be addressed when it analyses contingent consideration more broadly. The staff will bring that analysis to the Boards at a future meeting.

Exchanges of share-based payment awards

75. In a business combination, an acquirer might exchange its share-based payment awards (replacement awards) for awards held by employees of the acquiree. The BC ED provides guidance on determining which portion of the acquirer's replacement awards is part of the consideration transferred in exchange for the

assets and liabilities that comprise the acquiree and which portion is payment for future services.

76. The Boards received comments on this topic from only one respondent. That respondent requested clarification on the intent of the requirement in paragraph A103(a) of the BC ED which states:

> On the acquisition date, the acquirer recognises an expense in post-combination profit or loss [income] for any excess of (1) the fair value-based measure of the acquirer's replacement award over (2) the fair value-based measure of the replaced acquiree awards.

The respondent also requested clarification on whether the expense should be recognised immediately or over the remaining service period.

77. The staff plans to have its share-based payments experts review the guidance in the BC ED to verify that it is consistent with the principles proposed by the staff in this paper. If any inconsistency is noted, the staff will bring an analysis to the Boards at a future meeting.

APPENDIX B

OVERVIEW OF DECISIONS REACHED DURING INITIAL DELIBERATIONS

78. At several meetings during initial deliberations, the Boards discussed whether particular items should be included as part of the accounting for the exchange for the acquiree or treated as a separate transaction.[2] Initially the staff compared project decisions reached by the IASB and the FASB to help the Boards resolve specific issues[3] and ensure that their joint decisions on those issues and other issues were internally consistent. From that analysis, the staff observed that the Boards' divergent decisions seemed to result from two distinct views about which assets and liabilities should be included as part of the exchange for the acquiree. As deliberations progressed and the Boards modified their views, the Boards applied their decisions to several examples prepared by the staff. Many of those examples are included in Appendix C. Following is a staff compilation of the FASB Action Alerts and IASB Decision Summaries for the meetings discussed.

79. At the FASB's 22 April 2003 meeting, the staff provided a comparative analysis of the project decisions reached by the IASB and the FASB related to determining whether a specific item (asset or liability) is part of the business combination transaction. The purpose of that analysis was to determine if there was an underlying principle for those decisions and, if so, to assess whether the Boards' decisions were consistent with that principle. From that analysis, the staff identified that the IASB's decisions seemed to rely on one view and the FASB's decisions seemed to rely on a separate view as follows:

<u>View A (Emphasised in IASB decisions)</u>

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[2] The Boards discussed this topic at the following meetings:

a. The FASB's 22 April 2003, 8 October 2003, 14 April 2004, and 27 July 2004 Board meetings.
b. The IASB's April 2003, September 2003, and April 2004 Board meetings.
c. The 23 October 2003 and 22 April 2004 joint FASB-IASB meetings.

[3] The specific issues related to previous decisions for the accounting for amendments to postemployment benefit plans that are a condition of the business combination and particular constructive obligations incident to the business combination.

The business combination includes only the assets and liabilities of the acquired business at the acquisition date.

View B (Emphasised in FASB decisions)

In addition to the assets and liabilities included under the IASB's view, the business combination would include other assets or liabilities exchanged among the parties to the combination as a condition of the agreement that are directly related to and essential to the business combination.

80. As a result of the 22 April 2003 meeting, the FASB continued to support View B, with clarifications that would (1) emphasise that to recognise an item in the business combination it must meet the definition of an asset or liability at the acquisition date and (2) distinguish conditions of a combination agreement that are essential to the business combination from those that are gratuitous. The FASB affirmed those clarifications at its 8 October 2003 meeting. The IASB discussed this issue at its April 2003 meeting and indicated its continued support for View A at its September 2003 meeting.

81. At their joint 23 October 2003 meeting, the FASB and the IASB discussed their differences in views about which assets and liabilities should be included as part of the business combination accounting. The Boards decided that the following assets and liabilities, other than goodwill, should be included as part of the business combination accounting:

    a. All identifiable assets and liabilities of the acquired business that meet the definition of an *asset* or a *liability* immediately before the combination and that would have been assets or liabilities absent the prospects of a business combination.

    b. Those identifiable assets acquired and liabilities assumed by the combined entity that arise from the combination as a result of actions and requirements of external parties—parties not within the control of either the acquirer or the acquired business. For example, actions of a regulator to induce a combination, requirements of laws that impose obligations as a result of a combination, and so forth.

    The Boards discussed how the criteria agreed to in (a) and (b) would be applied to several examples prepared by the staff. The Boards discussed concerns about the timing of events and the potential for abuse.

82. At the FASB's 25 February 2004 Board meeting, some Board members and staff suggested that the Boards form a collaborative group of joint staff and Board members to reconcile differing interpretations about the application of the Boards' joint decision made at the 23 October 2003 meeting. The staff discussed the group's findings and analysis at their separate April 2004 meetings and reported at the joint 22 April 2004 meeting that the Boards had reached converged decisions. A summary of the agreed-upon approach for determining which assets acquired and liabilities assumed should be included as part of the business combination accounting is as follows:

a. An acquirer should recognise *as part of the combination* the assets acquired and liabilities assumed at their fair values at the acquisition date.
b. Transactions entered into by the parties to the combination (that is, by the acquirer, the acquiree, or its owners) and past events affecting those parties should be assessed to determine whether the transactions or events result in elements that should be part of the business combination accounting. The objective of that assessment is to determine whether a transaction or event was arranged primarily to achieve economic benefits or effects, including accounting effects, favorable to the acquirer or combined entity.

    (1) Assets or liabilities arising from such transactions or events should be recognised as part of the business combination accounting to the extent that the benefits derived from the transactions or events are to be received by the acquiree.
    (2) To the extent that a transaction or event relates to benefits to be received by the acquirer or the combined entity, it is postcombination in nature and, therefore, should not be recognised as part of the business combination accounting.

c. The following factors (which are neither mutually exclusive nor individually conclusive) should be considered in assessing whether a transaction or event relates to benefits to be received by the acquirer (combined enterprise):

    (1) The timing of the obligating event or transaction
    (2) The reason for the contract or transaction
    (3) Who initiated the contract or transaction.

83. At their April 2004 meetings, the Boards requested that the staff solicit feedback from preparers and auditors of the business combination project's resource group about the application of the agreed-upon April 2004 approach. The staff reported at the FASB's 27 July 2004 meeting that the resource group members generally

supported both the approach and the proposed guidance for applying that approach.

APPENDIX C

EXAMPLES ILLUSTRATING THE APPLICATION OF THE PRINCIPLES

The following table includes several examples that the staff used to test the robustness of the principles and related guidance proposed for identifying the components of a business combination. [Staff analysis omitted from observer notes]

A	***Acquisition-Related Costs I*** Acquirer Co. acquires 100% of Sub Co. and incurs CU1 million of costs related to legal fees and due diligence associated with the deal.
B	***Acquisition-Related Costs II*** Acquirer Co. seeks to acquire Target Co., a subsidiary of Seller Co. Acquirer Co. would like to avoid recognising CU1 million expense for its costs incurred related to legal fees and due diligence associated with the deal. Prior to the closing date, Acquirer Co. makes a deal with Seller Co. to pay CU1 million additional "consideration for Target Co." if Seller Co. will assume the liabilities for Acquirer Co.'s acquisition-related costs.
C	***Restructuring Costs I*** Acquirer Co. purchases 100% of Sub Co. Acquirer Co. plans to sell one of Sub Co.'s divisions (Division A).
D	***Restructuring Costs II*** Acquirer Co. purchases 100% of Sub Co. Sub Co. planned to sell its Division A and met the criteria under existing guidance to recognise a liability *for certain exit costs* associated with the planned sale (IAS 37 or SFAS 146). The sale of Division A to another buyer is pending. Acquirer Co. agrees to assume Sub Co.'s liability for the exit costs relating to the sale of Division A.
E	***Restructuring Costs III*** Acquirer Co. purchases 100% of Sub Co. from Trade Co. Sub Co. owns a fleet of trucks that are branded with Trade Co.'s name. Because Trade Co. will continue to operate other similar truck fleets, it insists that its brand name be removed from Sub Co.'s trucks as a condition of the combination.
F	***Restructuring Costs IV*** Acquirer Co. purchases Sub Co. from Trade Co. Sub Co. owns a fleet of trucks branded with its name. Acquirer Co. plans to brand the trucks using its name. Trade Co. does not insist that the Sub Co. brand name on the trucks be removed.
G	***Golden Parachute I*** Target Co. seeks to hire a new CEO (Candidate). The highly-desired and sought Candidate agrees to accept a position with Target provided that Target enters into a golden parachute agreement that requires Target Co. to pay the CEO CU1 million if Target Co. is acquired before the CEO's employment contract expires. Acquirer Co. acquires Target Co. eight years later.

H	***Golden Parachute II*** Acquirer Co. is negotiating to acquire Target Co. Acquirer plans to terminate the CEO's employment contract as part of its restructuring of Target Co. after the business combination. However, Acquirer would like to avoid recognition of a post-combination expense for the restructuring. So prior to the closing date, Acquirer makes a "quiet" arrangement with the key directors of Target to set up a 'golden parachute' agreement that effectively provides termination benefits to the CEO. The 'golden parachute agreement' requires Target Co. to pay the CEO CU1 million if Target Co. is acquired before the CEO's employment contract expires. As part of that arrangement, Acquirer agrees that any increase in the liabilities of Target as a result of the golden parachute agreement will not be included in potential downward adjustments to the previously negotiated and agreed upon purchase price. Target agrees to enter into the golden parachute agreement in order to facilitate negotiations.
I	***Golden Parachute III*** Target Co. is the target of a much-publicised hostile takeover bid by Acquirer Co. The CEO is concerned that the management of Acquirer Co. intends to replace the executives at Target with its own senior staff. Consequently, the CEO begins to seek employment elsewhere. Worried about its CEO's departure during a critical moment, Target's directors enter into a golden parachute agreement with the CEO, which would provide reasonable compensation for the CEO's services in the event of an acquisition. The golden parachute agreement requires Target Co. to pay the CEO CU1 million if Target Co. is acquired before the CEO's employment contract expires. A few weeks later, Acquirer raises its tender offer and Target is acquired anyway.
J	***Employee Benefits I*** Acquirer Co. acquires 100% of Sub Co. Sub Co. has a pre-existing contractual agreement that requires Sub Co. to make payments to its employees in the event that Sub Co. is acquired.
K	***Employee Benefits II*** Acquirer Co. acquires 100% of Sub Co. It is asserted that Sub Co.'s owners require that as a condition of the business combination, Acquirer Co. improve the post-employment benefit plan for Sub Co.'s employees.
L	***Employee Benefits III*** Acquirer Co. acquires 100% of Sub Co. Acquirer Co. expects to change the terms of the acquiree's post-employment benefit plan. Those changes are not made before the acquisition date.
M	***Constructive Obligations*** As a result of a business combination, Acquirer Co. has a liability of CU16,000 that meets the definition of a constructive obligation. The constructive obligation arises because Acquirer Co. has a widely published policy that is historically honoured. Under the policy, Acquirer Co. rectifies faults in its products and faults of acquired companies' products even if these faults become apparent after the warranty period has expired. Sub Co. did not have a similar constructive obligation relating to product faults.