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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **19 April 2007, London**

Project: **Business Combinations II**

Subject: **Classification and Designation of Assets, Liabilities and Equity Instruments Acquired or Assumed in a Business Combination (Agenda Paper 2B)**

Introduction

1. At its February meeting, the IASB discussed the classification and designation of assets, liabilities and equity instruments acquired or assumed in a business combination (see IASB Agenda Paper 2B/FASB Memorandum #42). The IASB members decided it is important to try to develop a principle for determining whether, and in what circumstances, a business combination triggers a reassessment of the acquiree's classification or designation. The IASB asked the staff to develop such a principle as part of phase II of the Business Combinations project, if possible, because IASB constituents asked the IASB or IFRIC for guidance.

Staff Analysis

2. Constituents first raised this issue in terms of whether an acquirer should carry over the acquiree's classifications and designations or whether the acquirer should reassess

those classifications and designations at the acquisition date. The February agenda paper also articulated the issue in that manner.

3. However, since the February meeting, the staff has concluded that describing the issue in terms of a 'reassessment' of the acquiree's classifications is not helpful. The staff believes that it is important to clarify that:

   a. the acquiree's classifications and designations are irrelevant for the acquirer. The acquirer's classification or designation of items in the consolidated financial statements should be based on its policies, intent, assessments, and designations, rather than those of the acquiree; and

   b. classification and designation do not affect the measurement basis at the acquisition date. All items acquired in a business combination should be measured at fair value at the acquisition date unless the Boards have decided to make an exception to fair value measurement for a particular item.

4. As a result, this paper shifts the focus away from discussing whether or not the acquiree's classification should be carried over. Instead, the staff recommends that the standard emphasise that a business combination results in the initial recognition in the consolidated financial statements of the assets, liabilities and equity instruments acquired or assumed as part of the business combination. Therefore, the acquirer should classify and designate all items acquired in a business combination at the acquisition date. For example, some accounting designations are based on management intent. Management of the acquirer cannot make their designation or exercise their intent until control has been obtained. As such, classifications and designations should be made at the time of initial recognition, considering the terms and economic conditions that exist on the acquisition date. Therefore, the staff recommends including the following principle in the business combinations standard:

   An acquirer shall classify or designate the assets, liabilities and equity instruments acquired or assumed at the acquisition date based on the conditions that exist at the acquisition date (for example, the contract terms, the economic conditions and the acquirer's intent and accounting policies).

5. The staff believes that this is consistent with the underlying principles in the business combinations standard:

   a. Recognition Principle: In a business combination, the acquirer recognises all of the assets acquired and all of the liabilities and equity instruments assumed.

   b. Measurement Principle: In a business combination, the acquirer measures each recognised asset acquired and each liability and equity instrument assumed at its acquisition date fair value.

6. The staff notes that this is also consistent with the recently issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities,* which views a business combination as an initial recognition event that is an election date for the fair value option.

7. The principle also is consistent with the guidance in FASB DIG Issue No. E15, *Hedging—General: Continuing the Shortcut Method after a Purchase Business Combination,* which requires an acquirer to assess whether a hedging relationship qualifies for the shortcut method of accounting in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* at the acquisition date. The basis for that guidance is as follows:

> Company A is acquiring the individual assets and liabilities of Company B at the date of the business combination and accordingly any pre-existing hedging relationships of old Company B must be designated anew by the combined entity at the date of the business combination in accordance with the relevant requirements of Statement 133. **The concept of purchase accounting follows the accounting for acquisitions of individual assets and liabilities. That is, the combined entity should account for the assets and liabilities acquired in the business combination consistent with how it would be required to account for those assets and liabilities if they were acquired individually in separate transactions.** The purchase method is based on the premise that in a purchase acquisition the acquired entity (Company B) ceases to exist and only the acquiring entity (Company A) survives. Thus, the post-acquisition hedging relationship designated by Company A is a new relationship that has a new inception date. Even in the unlikely circumstance that the new hedging relationship qualifies for the shortcut method, there would be no "continuation" of the shortcut method of accounting that had been applied by the acquired entity. [DIG E15; emphasis added.]

8. The application of this principle seems intuitive in most cases. For example, when a standard requires the classification or designation of items based on management's intent (eg assets held for sale, hedge relationships and classification of financial instruments as held-to-maturity, available-for-sale, etc.), it seems clear that the classification should be based on the acquirer's policies and intent, rather than on the acquiree's policies and intent.

9. However, the staff believes that in some situations the assets, liabilities and equity instruments that are acquired or assumed in a business combination are determined based on the classification of a contract at its inception. In some situations, IFRSs and US GAAP determine the classification of a contract at its inception (which in turn defines which assets, liabilities and equity instruments are recognised) and this classification is not changed unless the terms of the contract are substantively modified (eg leases, embedded derivatives, insurance contracts). In some instances, the acquirer is stepping into existing contracts and agreements that were negotiated by management of the acquiree. Often the acquirer 'steps into the shoes' of the acquiree without substantively modifying the terms of the underlying contracts. In such cases, the application of the above principle might not be intuitive.

10. For example, our respective leasing standards (IAS 17 *Leases* and FASB Statement No. 13*, Accounting for Leases*) both require the classification of a lease contract as either an operating lease or a capital/finance lease based on the terms and conditions that exist at its inception. US GAAP already provides guidance for leases acquired in a business combination. FASB Interpretation No. 21, *Accounting for Leases in a Business Combination,* states that the classification of a lease should not be changed as a result of a business combination unless the provisions of the lease are modified in a way that would require the revised agreement to be considered a new agreement under Statement 13. If the provisions of the lease are modified, the new lease should be classified by the acquirer based on the conditions at the acquisition date. The basis for that guidance is as follows:

> ….Statement [No. 13] does not permit an enterprise that purchases property from a lessor while the property is leased to a third party lessee to classify the acquired lease as a new lease at the acquisition date. The lessee is not a party to the transaction and the original lessor ceases to be a party to the lease; thus, there has

> been no new agreement between a lessee and a lessor and the purchase date is not the inception of a new lease requiring classification at that date. **The Board views the substance of a business combination that is accounted for under the purchase method to be the purchase of the lessor's or lessee's interest in an existing lease.** The original lessor or lessee does not become a party to a new agreement; accordingly, there is no new agreement to be classified, and Statement No. 13 does not permit reclassification of the existing lease unless the provisions of the lease are modified. The Board is aware that the identity of a party to a lease may change in a business combination and that the lease may be modified to reflect that change. If the provisions of the lease are not changed…, the modification does not represent a new agreement between the lessee and lessor in substance, and the lease should not be reclassified. [Paragraph 8 of Interpretation 21; emphasis added.]

11. The staff believes that the basis of Interpretation 21 provides useful guidance that clarifies 'what' the acquirer is acquiring at the acquisition date. A business combination would not normally establish a new lease agreement. It is clearly not the transaction that put the lease into place. Therefore, in most cases, the acquirer is acquiring an interest in an existing, partly completed lease rather than establishing a new lease at the acquisition date. In the event that a business combination triggers a change in the lease terms that is equivalent to initiating a new agreement, the acquirer should assess the nature of the lease based on those new terms.

12. The staff believes that the guidance in Interpretation 21 should be extended to other situations in which the acquirer 'steps into the shoes' of the acquiree in an existing contract (without modification). Therefore, the staff recommends that the business combinations standard include the following clarifying guidance to supplement the principle:

> In some cases, IFRSs/US GAAP require an entity to classify or designate a contract only at its inception and that classification is not changed unless the terms of the contract are substantively modified.* An acquirer shall classify such a contract based on the original terms and conditions at its **inception** (or at the date of the last substantive modification) unless the contract is substantively modified as a result of the business combination. In that case, the acquirer shall classify the contract at the acquisition date based on its modified terms. Regardless of whether the terms of the contract are substantively modified, the assets, liabilities and equity instruments that arise from the contract shall be measured as of the acquisition date.

*The identity of a party to a contract might change in a business combination and the contract might be modified to reflect that change. However, if the other provisions of the contract are not changed, that modification does not represent a substantive modification.

13. Application of this principle and clarifying guidance would require that the acquirer classify or designate all of the assets, liabilities and equity instruments acquired or assumed at the acquisition date. However, in situations in which IFRSs/US GAAP require an entity to classify or designate a contract only at its inception and that classification is not changed unless the terms of the contract are substantively modified, the classification or designation will be based on the original terms and conditions at the inception of the contract.

14. The February agenda paper described six examples for which questions about classification or designation have arisen. The following table describes the current accounting for those examples under US GAAP and IFRS and the effect of the above principle and clarifying guidance on existing practice.

<table>
<tr><th>#</th><th>Issue</th><th>Current US GAAP</th><th>Current IFRS</th><th>Effect of the Principle</th></tr>
<tr><td rowspan="2">1</td><td rowspan="2">Classification of leases</td><td>Statement 13.9 requires a lease to be classified as capital or operating based on its characteristics at inception. Statement 13 does not require reassessment of that classification unless the terms of the lease are modified in a manner that would have resulted in a different classification of the lease, in which case the revised agreement is regarded as a new agreement over its term. Interpretation 21.12 precludes an acquirer from changing the acquiree's classification unless the provisions of the lease are modified in a way that would result in the lease being considered a new agreement.</td><td>IAS 17.13 requires a lease to be classified as finance or operating based on its characteristics at inception. IAS 17 does not require reassessment of that classification unless the lease is modified in a way that would result in the lease having a different classification, in which case the classification of the lease would be changed. IAS 17 is silent about whether the classification of a lease acquired in a business combination should be based on the terms and conditions that exist at the inception of the lease or at the acquisition date, but it is the staff's understanding that the classification is typically based on the terms and conditions at inception.</td><td rowspan="2">A lease is classified at its inception and that classification is not changed unless the terms of the contract are substantively modified. Therefore, an acquirer would classify a lease based on the terms and conditions that existed at its inception unless the terms of the lease are substantively modified as part of the business combination (ie modified in such a way that Statement 13 or IAS 17 would require reclassification).
The principle would result in the same accounting that is currently required by Interpretation 21 and is implied by IAS 17. It would also be consistent with the proposal in the BC ED and with the staff's understanding of current practice.</td></tr>
<tr><td colspan="2">In addition, paragraph 38 of the Business Combinations Exposure Draft (BC ED) proposed to codify the guidance in Interpretation 21.</td></tr>
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#	Issue	Current US GAAP	Current IFRS	Effect of the Principle
2	Classification of contracts as insurance contracts	EITF Topic No. D-34, Q&A #14 states that for reinsurance contracts "the status of a contract should be determinable at inception and, absent amendment, subsequent changes should be very rare. . . Nevertheless, FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* does not preclude reclassification if the initial assessment is later deemed incorrect. However, careful consideration would need to be given to whether the reclassification represents the correction of an error." There is no similar guidance in US GAAP for insurance contracts. In addition, US GAAP is silent about whether the classification of an insurance contract acquired in a business combination should be based on the terms and conditions that exist at the inception of the contract or at the acquisition date, but it is the staff's understanding that the classification is typically based on the terms and conditions at inception.	Paragraph B30 of IFRS 4 *Insurance Contracts* states that "a contract that qualifies as an insurance contract remains an insurance contract until all rights and obligations are extinguished or expire." Therefore, the classification of a contract as an insurance contract is not changed until all of the rights and obligations are extinguished or expire. IFRS 4 is silent about whether the classification of an insurance contract acquired in a business combination should be based on the terms and conditions that exist at the inception of the contract or at the acquisition date, but it is the staff's understanding that the classification is typically based on the terms and conditions at inception.	A contract is classified as an insurance contract at its inception and entities are not required to periodically or continually reassess that classification. Therefore, an acquirer would classify an insurance contract based on the terms and conditions that existed at its **inception** unless the terms of the insurance contract are substantively modified as part of the business combination (ie modified in such a way that US GAAP or IFRS 4 would require reclassification). **The principle would result in consistency with current practice, which seems consistent with EITF Topic D-34 and IFRS 4.**

#	Issue	Current US GAAP	Current IFRS	Effect of the Principle
3	Classification of assets as held for sale	The classification of assets as held for sale under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* is based on management's documented intent. As part of redeliberations, the FASB noted that the classification of assets acquired in a business combination as held for sale should be based on the acquirer's intentions, as opposed to the acquiree's classification.	The classification of assets as held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* is based on management's documented intent. As part of redeliberations, the IASB noted that the classification of assets acquired in a business combination as held for sale should be based on the acquirer's intentions, as opposed to the acquiree's classification.	The classification of assets as held for sale is based on intent rather than on the terms of a contract at its inception. Therefore, the acquirer would have to assess whether it meets the requirements for classification as held for sale as of the **acquisition date.** **The principle would result in the same accounting that the Boards agreed to in redeliberations.**
		In redeliberations, the FASB also decided to eliminate the guidance in paragraph 32 of Statement 144 that allows the acquirer to classify a long-lived asset as held for sale if it was *probable* that the acquirer could meet the recognition criteria within three months from the acquisition date. Thus, the FASB decided that an acquirer would have to meet *all* of the recognition criteria *at the acquisition date* to classify a long-lived asset as held for sale at that date. The staff is not clear on whether the IASB intended to eliminate the similar guidance in paragraph 11 of IFRS 5.		**This issue is addressed in the sweep issues memo for the joint meeting (see Agenda Paper 2I/FASB Memorandum #57).**

#	Issue	Current US GAAP	Current IFRS	Effect of the Principle
4	Separation of embedded derivatives from the host	Statement 133 requires an embedded derivative to be separated from the host contract if certain conditions are met. Statement 133.13 states that because the existence of the conditions used in assessing whether the embedded derivative is clearly and closely related to the host contract is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions at different points in time. It is the staff's understanding that current US practice is to evaluate embedded derivatives for separation from the host contract based on the terms and conditions at the acquisition date.	Paragraph 7 of IFRIC 9 *Reassessment of Embedded Derivatives* states that an entity assesses whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. IFRIC 9.BC 10 also states that if an entity purchases a contract that contains an embedded derivative, it assesses whether the embedded derivative needs to be separated and accounted for as a derivative based on the conditions at that date. However, IFRIC 9 specifically scopes out the acquisition of contracts with embedded derivatives in a business combination. It is the staff's understanding that current IFRS practice is to permit entities to choose whether to evaluate embedded derivatives for separation from the host contract based on the terms and conditions either at the acquisition date or at the inception of the contract.	Embedded derivatives are evaluated for separation from the host contract at the inception of the contract and entities are not required to re-evaluate that decision unless the terms of the contract are substantively modified. Therefore, an acquirer would assess whether an embedded derivative should be separated from the host based on the characteristics of the contract that existed at its **inception** unless the terms of the contract have been substantively modified as part of the business combination (ie modified in such a way that Statement 133 or IFRIC 9 would require reassessment). **It is the staff's understanding that the principle likely would result in a change to current US practice and likely would result in a change for some entities applying IFRS.** The staff believes that this result is appropriate. Unless the business combination causes a change to the derivative instrument or host contract that is equivalent to creating a new contract, the staff believes that the acquisition date should not be treated as a new inception date. Therefore, the assessment of whether a derivative instrument should be separated from the host contract should be made by the acquirer based on the original terms of the contract. The staff notes that IFRIC 9 requires an entity to assess a derivative instrument for separation from the host contract when an entity first becomes a party to the contract. Unless the contract is substantively modified, the staff does not view a business combination as resulting in a new agreement. Therefore, the staff believes that the parties to the contract have not changed, in substance, and reassessment should not be required under IFRIC 9. The staff believes that this point should be clarified either in the business combinations standard or as a consequential amendment to IFRIC 9.

#	Issue	Current US GAAP	Current IFRS	Effect of the Principle
5	Continuation of the designation of an hedge instrument	Statement 133 permits entities to apply hedge accounting to designated hedge relationships if certain conditions are met. Statement 133 also states that a hedge is assessed on an ongoing basis to determine whether it was highly effective throughout the financial reporting periods for which the hedge was designated. US GAAP is silent about whether a hedge relationship acquired in a business combination must meet the criteria in Statement 133 at the inception of the hedge or at the acquisition date. However, DIG E15 requires an acquirer to assess whether a hedging relationship qualifies for the shortcut method of accounting in accordance with Statement 133 at the acquisition date.	IAS 39 *Financial Instruments: Recognition and Measurement* permits entities to apply hedge accounting to designated hedge relationships if certain conditions are met. IAS 39 also states that a hedge is assessed on an ongoing basis to determine whether it was highly effective throughout the financial reporting periods for which the hedge was designated. IFRSs are silent about whether a hedge relationship acquired in a business combination must meet the criteria in IAS 39 at the inception of the hedge or at the acquisition date.	The designation of a hedging relationship (1) is based on a documented designation by the management of the entity and (2) is required to be continually assessed by IFRSs/GAAP. Also, the designation of a hedging relationship is based on intent rather than on the terms of a contract at its inception. Therefore, the acquirer would have to assess whether it meets the requirements for hedge accounting designation as of the **acquisition date.** **It is not clear whether that would be a change to practice since US GAAP and IFRSs are silent (although the principle is consistent with DIG E15).** The effects of the principle would be: (1) If an acquirer designates a hedge relationship based on the conditions that existed at the acquisition date, a hedge relationship that would have been effective for the acquiree had the business combination not occurred might fail to qualify for hedge accounting in the consolidated financial statements. This might occur if the hedging instrument has a significant fair value at the acquisition date that might cause the hedge to fail the prospective effectiveness test. (2) If an acquirer is required to designate a new hedge relationship at the acquisition date, the fact that the hedging instrument has a fair value other than zero might introduce ineffectiveness in a hedge that might have been nearly 100% effective before the acquisition. (3) In a business combination, hedging reserves in equity/OCI disappear. Therefore, even if the acquirer designates the hedging relationship at the acquisition date, recycling will be limited to post-acquisition gains or losses.

#	Issue	Current US GAAP	Current IFRS	Effect of the Principle
6	Classification of financial instruments (eg as held-to-maturity, available-for-sale or trading/fair value through profit or loss)	FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* allows an entity to classify financial instruments (trading/available-for-sale/held-to-maturity) based on its strategies and intentions. Statement 115.6 also states that at acquisition, an entity classifies debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification should be reassessed. Statement 159 permits entities to elect the fair value option at the acquisition date for eligible items acquired in a business combination.	IAS 39 allows an entity to classify financial instruments (financial asset or liability at fair value through profit or loss/available-for-sale/held-to-maturity) based on its strategies and intentions. IAS 39 requires an entity to continually assess the classifications and to change the classifications, if appropriate.	The classification of financial instruments (1) is required to be continually reassessed by IFRSs/GAAP and (2) is based on intent. Therefore, the acquirer would classify acquired financial instruments based on the conditions at the **acquisition date.** **The principle would result in the same accounting that is currently required by Statement 115 and implied from IAS 39.**

Staff Recommendation and Question for the Boards

15. The staff proposes that the following principle and clarifying guidance be included in the business combinations standard:

> **An acquirer shall classify or designate the assets, liabilities and equity instruments acquired or assumed at the acquisition date based on the conditions that exist at the acquisition date (for example, the contract terms, the economic conditions and the acquirer's intent and accounting policies).**
>
> In some cases, IFRSs/US GAAP require an entity to classify or designate a contract only at its inception and that classification is not changed unless the terms of the contract are substantively modified.* An acquirer shall classify such a contract based on the original terms and conditions at its **inception** (or at the date of the last substantive modification) unless the contract is substantively modified as a result of the business combination. In that case, the acquirer shall classify the contract at the acquisition date based on its modified terms. Regardless of whether the terms of the contract are substantively modified, the assets, liabilities and equity instruments that arise from the contract shall be measured as of the acquisition date.
>
> *The identity of a party to a contract might change in a business combination and the contract might be modified to reflect that change. However, if the other provisions of the contract are not changed, that modification does not represent a substantive modification.

16. ***Do the Boards agree with the principle proposed by the staff and the clarifying guidance provided? If not, how should the staff approach this issue?***