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International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

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

Project: **Business Combinations II**

Subject: **Replacement Awards (Agenda Paper 2E)**

INTRODUCTION

1. Paragraphs A102-A109 of the BC ED contain application guidance on the accounting for acquirer share-based payment awards exchanged for awards held by the employees of the acquiree (replacement awards). Paragraphs A102 and A103 state:

> In a business combination, an acquirer may exchange its share-based payment awards (replacement awards) for awards held by employees of the acquiree. If the acquirer is obligated to replace the acquiree's awards, all or a portion of the acquirer's replacement awards shall be included in the measurement of the consideration transferred by the acquirer in the business combination, as explained in the following paragraph.
>
> For the purposes of determining the portion of a replacement award that is part of the consideration exchanged for the acquiree, the share-based payment awards made by the acquirer and acquiree shall be measured using the fair value based measurement method of IFRS 2 *Share-based Payment*. The portion of the replacement award that is part of the consideration transferred in exchange for the acquiree shall be determined as follows:
>
> a) On the acquisition date, the acquirer recognises an expense in post-combination profit or loss 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.

b) The remaining fair value-based measure of the acquirer's replacement award is the amount that remains after deducting the excess, if any, recognised in post-combination profit or loss under a). Of this amount, the portion attributable to past services is regarded as part of the consideration transferred in exchange for the acquiree. The portion, if any, attributable to future services is not part of the consideration transferred and is an expense to be recognised in post-combination profit or loss. The guidance in c) and d) shall be followed to determine the portion of the remaining fair value-based measure of the replacement award attribution to past and future services. Depending on the circumstances, the acquirer recognises the replacement award as a liability or an equity instrument, as required in accordance with IFRS 2.

c) Of the remaining fair value-based measure of the replacement award, the portion attributable to past services is equal to the remaining fair value-based measure of the replacement award (or settlement) multiplied by the ratio of the portion of the vesting period completed to the total vesting period. (The amount, if any, to be recognised in post-combination profit or loss is the remaining fair value based measure of the replacement award (or settlement) multiplied by the ratio of the future vesting period to the total vesting period.)

d) The vesting period is the period during which all the specified vesting conditions are to be satisfied. Vesting conditions are defined in IFRS 2.

2. The Boards received only one comment letter on the proposed guidance. However, the FASB decided to review the proposal on a more comprehensive basis because it discussed the accounting for replacement awards in the BC ED before Statement 123(R), *Share-Based Payment*, had been finalised.

3. The FASB deliberated 12 issues related to replacement awards at its 13 February, 2007 Board meeting. The FASB Memorandum is attached as appendix to this agenda paper. The purpose of this agenda paper is to give an overview of the issues discussed by the FASB and to identify those issues that should also be considered by the IASB.

ISSUES DELIBERATED BY THE FASB

Issue 1 – How should any excess fair value in the acquirer's replacement award over the acquiree's award be accounted for (paragraphs 8-14 of the appendix)?

4. The FASB decided to modify the guidance in the BC ED for the purpose of being consistent with Statement 123(R) and to require that any excess fair value in the

acquirer's replacement award over the acquiree's award be recognised over the post-combination requisite service period of the acquirer's replacement award along with any portion of the award attributable to future services.

5. The staff refers to paragraphs 8-14 of the appendix. Paragraph 5 of IFRS 2 excludes transactions in which the entity acquires goods as part of the net assets acquired in a business combination to which IFRS 3 applies. Hence, equity instruments issued as consideration transferred in a business combination are outside of the scope of IFRS 2. However, equity instruments granted to employees of the acquiree in their capacity as employees are within the scope of IFRS 2.

6. The staff believes that the treatment of an excess of the fair value based measure of the acquirer's replacement award over the fair value based measure of the replaced acquiree awards in the BC ED is inconsistent with the principles underpinning IFRS 2. According to those principles an entity recognises compensation expenses when services are received. We recommend that the IASB modify the guidance in the BC ED to be consistent with the priniciples undperinning IFRS 2 and require that excess fair value in the acquirer's replacement award over the acquiree's award be recognised over the post-combination requisite service period of the acquirer's replacement award along with any portion of the award attributable to future services. The staff notes that this would also align the accounting for the excess fair value in the acquirer's replacement award over the acquiree's award with its treatment under US GAAP.

7. *Does the Board agree?*

Issue 2 – How should the acquirer allocate the remaining fair value of the acquirer award between consideration transferred in the business combination and compensation cost (paragraphs 15-20 of the appendix)?

8. The FASB decided to modify the guidance in the BC ED related to the allocation of the remaining fair value (that is, after considering any excess fair value) of the replacement award between consideration transferred in the business combination and post-combination compensation cost by revising the description of the calculation amounts attributable to past services. The revision would result in the portion of the award attributable to future services being equal to the total fair value of the replacement award less the portion attributable to past services.

9. The staff refers to paragraphs 15-20 of the appendix. We agree that the present wording in the BC ED might have unintended consequences for situations in which the acquirer modifies the required service period or the vesting of share-based payment awards. We recommend therefore that the wording in A103(c) be modified as follows:

> Of the remaining fair value based measure of the replacement award the portion attributable to past services is equal to the remaining fair-value-based measure of the replacement award (or settlement) multiplied by the ratio of the portion of the vesting period completed to <u>the greater of</u> the total vesting period <u>or the original vesting period of the acquiree award</u>.

10. The staff believes that the proposed wording is similar to the US GAAP requirement. Differences in wording arise only from the non-converged terminology applied by Statement No. 123(R) and IFRS 2.

11. *Does the Board agree?*

Issue 3 – How should the Statement define the "total service period" to be used in allocating the fair value of an acquirer replacement award classified as an equity instrument between consideration transferred in the business combination and compensation cost (paragraphs 21-25 of the appendix)?

12. The FASB decided to modify the guidance in the Exposure Draft by aligning the definition of total service period with the IASB's definition of the total vesting period. Specifically, the total service period should include only periods of employee service that are required to vest in the award. No further deliberation by the IASB is needed on this matter.

Issue 4 – How should an acquirer replacement award classified as a liability be allocated between consideration transferred in the business combination and compensation cost (paragraphs 26-29 of the appendix)?

13. The FASB decided to require that an acquirer replacement award classified as a liability be allocated between consideration transferred in the business combination and compensation cost in the same manner that awards classified as equity instruments would be.

14. The staff refers to paragraphs 26-29 of the appendix. We believe that the amounts in the acquiree's pre-combination balance sheet are irrelevant to the acquirer's accounting for the acquisition and that the acquirer should account for the terms of the awards that it issues. The staff recommends therefore that the IASB also require that an acquirer's replacement award be allocated between consideration transferred and post-combination expense in the same manner that awards classified as equity instruments would be.

15. *Does the Board agree?*

Issue 5 – How should an acquirer consider replacement awards with a graded vesting schedule with respect to measurement and allocation between past and future services (paragraphs 30-36 of the appendix)?

16. The FASB decided to require that the measurement and attribution of acquirer replacement awards with graded vesting follow the acquirer's accounting policy elections under Statement 123(R) for such awards.

17. The staff notes that IFRS 2 does not contain specific guidance on share-based payment awards with graded vesting schedules. We believe that the final business combinations standard should not contain more detailed guidance on share-based payment awards than IFRS 2. We recommend therefore that the IASB does not address the accounting for share-based payment awards with graded vesting schedules as part of the business combinations phase II project.

18. *Does the Board agree?*

Issue 6 – Should the portion of the replacement award attributable to past services (that is, the portion recognized as consideration transferred in the business combination) include a forfeiture assumption for awards for which the requisite service has not yet been provided (paragraphs 37-44 of the appendix)?

19. The FASB decided to require that a forfeiture estimate be included in the fair value of unvested awards included in the purchase price. That is, the fair value of the portion of unvested awards attributed to past services should be recorded net with the forfeiture estimate based on the acquirer's estimate of pre-vesting forfeitures.

20. Paragraph 19 of IFRS 2 states that vesting conditions, other than market conditions shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, the measurement of equity instruments in accordance with IFRS 2 would exclude a forfeiture estimateBC178 of IFRS 2 states:

> [Respondents] raised a variety of concerns about the inclusion of vesting conditions in the grant date valuation. Some respondents were concerned about the practicality and subjectivity of including non-market performance conditions in the share option valuation. Some were also concerned about the practicality of including service conditions in the grant date valuation, particularly in conjunction with the units of service method proposed in ED 2.

21. The staff refers to paragraphs 38-44 of the appendix. We agree with the FASB's decision that the fair value of unvested awards included in the consideration transferred should include a forfeiture estimate. The total amount of compensation costs recognised under IFRS 2 is based on the number of instruments for which the vesting conditions are met. Because all the service conditions have not yet been rendered for these awards, the amount of consideration transferred in the business combination should also reflect an estimate of the awards for which the remaining service conditions will not be met.

22. The staff believes that at least some of the concerns described in BC 178 are mitigated in a business combination because:

    a. the consideration transferred in exchange for the acquiree is likely to reflect the acqurirer's and sellers estimates on the forfeitures of the acquiree's share based payment awards;

    b. the acquiree has been able to collect historical data on forfeitures from the date the share based payment award has been initially granted; and

    c. the BC ED includes a measurement period of one year to adjust provisional amounts recognised at the acquisition date.

23. We recommend therefore that the IASB requires that a forfeiture estimate be included in the fair value of unvested replacement awards deemed to be consideration transferred in a business combination.

24. *Does the Board agree?*

Issue 7 – How should an acquirer account for post-combination forfeitures of awards considered to be consideration transferred in the business combination or for changes in forfeiture estimates in the post-combination period (paragraphs 45-49 of the appendix)?

25. The FASB decided to affirm the guidance in the BC ED that post-combination forfeitures of awards considered to be consideration transferred in the business combination do not affect the purchase price.

26. The staff refers to paragraphs 45 – 49 of the appendix. We believe that the forfeiture after the acquisition date of a share-based payment award that is deemed to be consideration transferred in a business combination represents a post-combination event; thus should not affect the amounts recognised in the business combination. We recommend therefore that the IASB affirm the guidance in the BC ED that post-combination forfeitures of awards considered to be consideration transferred in the business combination do not affect the purchase price.

27. *Does the Board agree?*

Issue 8 – How should an acquirer account for the post-combination effects of replacement share based payment awards classified as liabilities that were issued in a business combination and included in the consideration transferred in the business combination (paragraphs 50-56 of the appendix)?

28. The FASB decided to affirm the guidance in the BC ED requiring an acquirer to account for the post-combination effects of replacement awards classified as liabilities that were issued in a business combination and included in the consideration transferred in the business combination through adjustments to compensation cost and income tax expense in the period in which they arise.

29. The staff refers to paragraphs 50-55 of the appendix. We believe that the remeasurement of replacement awards classified as a liability represents a post-

combination event; thus should not affect the amounts recognised in the business combination. We recommend therefore that the IASB affirm the guidance in the BC ED requiring an acquirer to account for the post-combination effects of replacement share-based payment awards classified as liabilities through adjustments to compensation cost and income tax expense in the period in which they arise.

30. *Does the Board agree?*

Issue 9 – How should an acquirer account for the income tax effects from awards classified as equity that were issued in a non-taxable business combination and included in the consideration for the business combination and that ordinarily would result in a future tax deduction under existing tax law (paragraphs 57-64 of the appendix)?

Issue 10 – How should an acquirer account for the income tax effects from awards classified as equity that were issued in a non-taxable business combination and included in the consideration for the business combination and that ordinarily would NOT result in a future tax deduction under existing tax law (paragraphs 65-67 of the appendix)?

Issue 11 – How should an acquirer account for the income tax effects from awards classified as equity that were issued in a business combination and considered post-combination compensation cost (paragraphs 68 and 69 of the appendix)?

Issue 12 – How should the pool of excess tax benefits be determined for replacement share based payment awards (paragraphs 70-74 of the appendix)?

31. Statement No. 123(R) does not provide explicit guidance on the accounting for income tax effects of replacement awards that were issued by an acquirer in a business combination. The FASB staff believes that, therefore, U.S. constituents analogise the guidance given in Issues 29(a) and 29(b) of the nullified EITF Issue 00-23, *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44*, to the accounting for replacement awards according to Statement No. 123(R) and Statement No. 141. Thus, the FASB decided to address the accounting for income tax effects of replacement awards as part of its business combinations project.

32. The FASB decided with respect to issues 9-12, to:

a. require that an acquirer account for the income tax effects that ordinarily would result in future tax deductions under current tax law from awards classified as equity that were issued in a non-taxable business combination and included in the consideration for the business combination on (a) day 1 and on (b) day 2 as follows:

   i. record deferred taxes in the business combination based on the fair value of equity-classified share-based payment awards issued in a business combination and included as consideration for the business combination with respect to day 1 accounting.

   ii. account for the difference in the deferred taxes recorded in the business combination and the ultimate deduction received by the acquirer as an adjustment to additional paid-in capital, that is, an adjustment to equity as a transaction with a shareholder. Such an adjustment would have no effect on the additional paid-in capital pool.

b. require that an acquirer account for the income tax effects that ordinarily would not result in future tax deductions under current tax law from awards classified as equity that were issued in a non-taxable business combination and included in the consideration for the business combination on (a) day 1 and on (b) day 2 as follows:

   i. do not record deferred taxes. That is, the tax benefits should only be recognized when they occur. The FASB believes that this approach is consistent with Statement 123(R).

   ii. recognize the income tax effects of these awards as an adjustment to equity as a transaction with a shareholder. Such an adjustment would have no effect on the additional paid-in capital pool.

c. to require an acquirer account for the income tax effects from awards classified as equity that were issued in a business combination and considered post-combination cost in a manner consistent with Statement 123(R) as if they were granted absent a business combination.

d. to require the income tax effects of awards issued in a business combination be evaluated against a pool of excess tax benefits from awards granted by any entities that are consolidated within the reporting entity's consolidated financial statements. The income tax effect must be evaluated in comparison to the pool at exercise, vesting, or settlement of the award.

33. The FASB believes that this approach would be consistent with the objectives of Statement 123(R) with respect to accounting for the tax effects of share-based payment awards.

34. Paragraphs 66-68 of IAS 12 *Income Taxes* address the accounting for deferred tax arising from a business combination. Paragraphs 68A-68C of IAS 12 provide guidance on the accounting for current and deferred tax arising from share-based payment transactions. However, neither IAS 12 nor the related interpretative guidance contain explicit principles on the accounting for the income tax effects associated with replacement awards. Hence, some staff believe that further research should be conducted on the income tax effects of replacement awards under IFRSs.

35. However, IASB constituents did not request guidance on this matter and the staff is not aware of diversity in practice that has arisen from the lack of guidance on the accounting for income taxes effects of replacement awards. Thus, other staff believe that the IASB should not address Issues 9-12 as part of phase II of the business combinations project.

36. *Does the Board believe that Issues 9-12 should be investigated further as part of phase II of the business combinations project?*