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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **22 February 2007, London**

Project: **Business Combinations II**

Subject: **Reassessments (Agenda Paper 2B)**

This agenda paper has been prepared for the IASB.
It has been given to the FASB for information purposes only.

Introduction

1. Several respondents to the BC ED commented that the proposed standard does not provide guidance on whether, and in what circumstances, a business combination triggers a reassessment of the acquiree's classification or designation of assets, liabilities, equity and relationships acquired in a business combination. The types of reassessment issue includes:

   a. the classification of leases as operating or finance leases;

   b. the classification of contracts as insurance contracts;

   c. the classification of assets as held for sale;

   d. whether embedded derivatives should be separated from the host;

   e. the continuation or de-designation of hedge relationships; or

f. the classification of financial instruments (eg as held-to-maturity, available-for-sale or at fair value through profit or loss)?

2. The staff followed up these concerns with the major accountancy firms. It is clear that there is divergence in thinking among the firms, and it is likely that there is divergence in practice.

3. Identification of the difficulties associated with deciding if, or when, to reassess items in a business combination did not originate with the BC ED. Several respondents to the exposure draft preceding IFRIC 9 *Reassessment of Embedded Derivatives* asked the IFRIC to address the acquisition of contracts with embedded derivatives in a business combination. The IFRIC did not do so. The IFRIC has recently been asked to consider, at a more general level, the matter of reassessments in a business combination.

4. Because the matter was raised in comment letters on the BC ED the staff thinks that it is appropriate for the Board to consider this matter as part of its redeliberations. Consideration of this issue is also justified because there is also a risk that the guidance that does exist in IFRSs and US GAAP could result in some aspects of a business combination being accounting for differently even if the business combinations standard is, in all other respects, converged.

5. This paper discusses some situations in which the question of reassessment might arise and summarises relevant current requirements. The staff thinks that the proposals in the BC ED are unlikely to introduce any additional difficulties with reassessments. The staff also thinks that more guidance on reassessments would be helpful, but any such guidance need not be developed as part of the current phase of the business combinations project.

Examples and related current requirements

6. This section describes several examples in which the question of reassessment of classifications in a business combination might arise. IFRSs and US GAAP provide guidance on re-assessing classifications for some transactions and activities. These are discussed in the following paragraphs.

Classification of leases

7. IAS 17 *Leases* and FASB Statement No. 13, *Accounting for Leases*, require a lease to be classified as either a finance/capital lease or an operating lease based on its characteristics at inception.

8. IAS 17 and Statement 13 describe the circumstances in which the classification of a lease should be re-assessed. IAS 17.13 states (see also Statement 13.9):

> Lease classification ide at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7-12 if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term. However, changes in estimate (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

9. FASB Interpretation No. 21, *Accounting for Leases in a Business Combination,* clarifies the classification of leases acquired in a business combination:

> The classification of a lease in accordance with the criteria of *FASB Statement No. 13* shall not be changed as a result of a business combination unless the provisions of the lease are modified… (paragraph 12)
>
> If in connection with a business combination, the provisions of a lease are modified in a way that would require the revised agreement to be considered a new agreement under paragraph 9 of *FASB Statement No. 13,* the new lease shall be classified by the combined enterprise according to the criteria set forth in Statement No. 13, based on conditions as of the date of the modification of the lease. (paragraph 13)
>
> ….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)

10. Similar guidance was proposed in paragraph 38 of the Business Combinations Exposure Draft (BC ED):

> In accordance with [IAS 17 *Leases/*FASB Statement No. 13, *Accounting for Leases,* as interpreted by FASB Interpretation No. 21, *Accounting for Leases in a Business Combination,* as amended by paragraph D2 of this

> Statement], a lease of the acquiree (regardless of whether the acquiree is the lessee or lessor) retains the lease classification determined by the acquiree at the lease inception, unless the provisions of a lease are modified as a result of the business combination in a way that would require the acquirer to consider the revised agreement a new lease agreement in accordance with [paragraph 13 of IAS 17/paragraph 9 of Statement 13]. In that circumstance, the acquirer would classify the new lease according to the criteria set out in [IAS 17/Statement 13] on the basis of the conditions of the modified lease.

11. The guidance in IFRSs and US GAAP is consistent, but US GAAP provides additional clarification that changing the names on a lease as a result of a business combination is not a substantial modification of the lease terms. The proposal is consistent with FAS 13, which does not permit or require redesignation when a lessor purchases an existing lessor's position outside of a business combination.

Classification of contracts as insurance contracts

12. IFRS 4 *Insurance Contracts* defines an insurance contract as:

> A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

13. Paragraph B30 of IFRS 4 states, '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 a contract as an insurance contract should be re-assessed in a business combination.

Classification of assets as held for sale

14. In accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (see also FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets)*, an entity classifies a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. To be classified as held for sale:

a. an asset must be available for immediate sale in its present condition subject only to terms that are usual and customary for sale of such assets and its sale must be highly probable;

b. the appropriate level of management must be committed to a plan to sell the asset and an active programme to locate a buyer and complete the plan must have been initiated;

c. the asset must be actively marketed for sale at a price that is reasonable in relation to its current fair value;

d. the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification; and

e. actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

15. In addition, paragraph 11 of IFRS 5 (see also paragraph 32 of Statement 144) states:

> When an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal, it shall classify the non-current asset (or disposal group) as held for sale at the acquisition date only if the one-year requirement…is met…and it is highly probable that any other criteria…that are not met at that date will be met within a short period following the acquisition (usually within three months).

16. The BC ED proposed an exception to the fair value measurement principle for assets held for sale (it proposed that those assets be measured at fair value less cost to sell). In May 2006 (IASB Agenda Paper 2B/FASB Memo 18), the Boards tentatively decided instead that those assets should be measured at fair value and decided to amend IFRS 5 and Statement 144 to replace "fair value less cost to sell" with "fair value." The Boards also 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. In addition, at that meeting:

a. the FASB decided to amend Statement 144 to eliminate the special guidance for determining whether an acquired asset meets the held-for-sale criteria (that guidance, contained in paragraph 32 of Statement 144, allowed 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 of 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.

b. the IASB asked the staff to make it clear in the final business combinations standard that it is the acquirer, and not the acquiree, that must meet the criteria in IFRS 5 at the acquisition date.

17. The staff seeks clarification on whether the Board intended that the acquirer must meet all of the recognition criteria on its own at the acquisition date or whether the acquirer might be able to use the actions an acquiree has initiated in putting into place an active programme to locate a buyer and complete a plan to sell to meet the recognition criteria.

Question for the Board

18. ***Does the Board intend that an acquirer must satisfy all of the recognition criteria in IFRS 5 on its own before it may classify an asset as held for sale at the acquisition date or may an acquirer use the actions an acquiree has initiated in putting into place an active programme to locate a buyer and complete a plan to sell to meet the recognition criteria?***

Reassessment of embedded derivatives for separation

19. In accordance with paragraph 11 of IAS 39 *Financial Instruments: Recognition and Measurement* (see also paragraph 12 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities),* an embedded derivative is generally required to be separated from a host contract if:

a. the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contracts;

b. a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

c. the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

20. Paragraph 13 of Statement 133 states:

> …Because the existence of those 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 in this paragraph at different points in time. (emphasis added)

21. Paragraph 7 of IFRIC 9 states:

> An entity shall assess 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.

22. IFRIC 9.BC 10 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 on the basis of conditions at that date'. However, IFRIC 9 specifically excludes from its scope the acquisition of contracts with embedded derivatives in a business combination.

23. Neither IFRSs nor US GAAP are clear on whether a business combination should trigger reassessment.

    a. Some might view a business combination as analogous to the separate purchase of a contract containing an embedded derivative that the acquirer first becomes party to at the acquisition date. Therefore embedded derivatives would have to be re-assessed for separation at the acquisition date.

    b. Others might view a business combination as being different than the separate purchase of a contract containing an embedded derivative (eg because part of the group—the acquiree—remains a party to the contract) and therefore believe that reassessment should not be required 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.

Continuation or de-designation of hedge relationships

24. Paragraph 88 of IAS 39 (see also paragraphs 20, 21, 28, 29, and 36-42 of Statement 133) permits entities to apply hedge accounting to designated hedge relationships if all of the following conditions are met:

    a. At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

    b. The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

    c. For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

    d. The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

    e. The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

25. The question arises as to whether an acquirer should:

    a. be permitted to continue to apply the hedge accounting model to hedge relationships designated previously by the acquiree, assuming it is consistent with the acquirer's strategies and policies; or

    b. be required to re-designate hedge relationships at the acquisition date.

26. If an acquirer is required to re-designate hedge relationships at the acquisition date, it is possible that a hedge relationship that would continue to be effective for the acquiree had the business combination not occurred will 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.

27. Furthermore, if an acquirer is required to re-designate a hedge relationship, the fact that the hedging instrument has a fair value other than zero will likely introduce ineffectiveness in a hedge that may have been nearly 100% effective prior to the acquisition. This may cause the acquirer to choose to either:

   a. re-designate and accept ineffectiveness, or

   b. sell off the hedging instruments so they can be replaced with more effective hedging instruments subsequent to the combination.

28. In a business combination, the acquirer recognises the assets acquired and liabilities assumed. Therefore, hedging reserves in equity disappear. Therefore, even if an acquirer is permitted to continue the acquiree's designation of a hedged relationship, recycling will be limited to post-acquisition gains or losses.

29. IFRSs are silent on re-designation in a business combination. FASB DIG Issue No. E15, *Hedging—General: Continuing the Shortcut Method after a Purchase Business Combination*, requires an acquirer to re-assess whether a hedging relationship qualifies for the shortcut method of accounting in accordance with Statement 133. That guidance states:

> 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.'

Classification of financial instruments

30. In accordance with IAS 39.9 (see also FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities)*, an entity classifies financial instruments based on its strategies and intentions:

> A *financial asset or financial liability at fair value through profit or loss* is a financial asset or financial liability that meets either of the following conditions.
>
> a. It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:
>
>   i. acquired or incurred principally for the purpose of selling or repurchasing it in the near term;…
>
> b. Upon initial recognition it is designated by the entity as at fair value through profit or loss…
>
> *Held-to-maturity investments* are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity…
>
> *Loans and receivables* are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:
>
> a. those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;
>
> b. those that the entity upon initial recognition designates as available for sale; or
>
> c. those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.
>
> *Available-for-sale financial assets* are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.

31. IAS 39 provides some guidance on reclassifying financial instruments:

> 50 An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.
>
> 51 If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it shall be reclassified as

available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).

52 Whenever sales or reclassification of more than an insignificant amount of held-to-maturity investments do not meet any of the conditions in paragraph 9, any remaining held-to-maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).

32. Paragraph 6 of Statement 115 states:

> At acquisition, an enterprise shall classify 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 shall be reassessed.

33. Paragraph 10(a) of the 27 January 2007 Ballot Draft of FASB Statement No. 15X, *The Fair Value Option for Financial Assets and Financial Liabilities,* states that a business combination creates an election date for the fair value option.

Staff Analysis

34. In the preceding paragraphs we have documented existing guidance on reassessments in, and outside of, a business combination. The staff thinks that it would be helpful to develop a general principle to guide the reassessment question.

35. There are clearly two candidates for such a principle. One view is that the classification by the acquirer should be the same as it would have been had the particular assets and liabilities been acquired outside a business combination. Another view is that a business combination is different from other acquisitions and in many cases it is the continuation of an existing business by a new owner. The first view would be more likely to result in many of the items discussed in this paper being reassessed (such as hedges) whereas the second view is more likely to result in items such as hedges remaining intact from a group perspective.

36. An initial assessment by the staff suggests that there is tension between each of the views and current practice. For example, if all items should be reassessed does this suggest that leases should also be reclassified?

37. The staff is not asking the Board to make any decisions about which of these views might be the best starting point for a more comprehensive analysis of reassessments. The staff is seeking Board input on how the matter of reassessments might best be addressed. As is noted in the introduction, the BC ED does not appear to contain any proposals that add any new difficulties with reassessments. Although the staff thinks that guidance would be helpful it need not be completed before the proposed business combinations standard is finalised.

Question for the Board

38. ***Does the Board agree that guidance on whether, and in what circumstances, a business combination triggers a reassessment of the acquiree's classification or designation of assets, liabilities, equity and relationships acquired in a business combination would be helpful? If so, how would they like the staff to proceed with this?***