



**International  
Accounting Standards  
Board**

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*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 June 2007, London  
**Project:** Business Combinations II  
**Subject:** Appendix to Agenda Paper 2B - Replacement Awards

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### **PURPOSE AND BOARD MEETING OBJECTIVE**

#### ***Accounting for the Replacement of Acquiree Share-Based Payment Awards in a Business Combination***

1. At the April 7 and June 9, 2004 meetings the Board discussed several issues relating to the fair value of outstanding share-based payment (SBP) awards granted by the acquiree, such as employee stock options, that are replaced by the acquirer as part of the business combination.
2. At the January 31, 2007 meeting, the Board discussed several issues related to reconciling the clarifying previous decisions related to replacement SBP awards, addressing inconsistencies with Statement 123(R), and proposing additional guidance with respect to practice issues related to SBP awards.
4. The purpose of this meeting is to address comments that the staff has received in the external review of the preballot draft.

## OUTLINE OF ISSUES

Issue 1 – How should income tax effects of replacement awards classified as equity be accounting for?

Issue 2 – Should the accounting for replacement awards in Statement 141(R) be limited to situations in which the acquirer was "obligated" to issue replacement awards?

## DISCUSSION OF ISSUES AND ALTERNATIVES

**Issue 1 – How should income tax effects of replacement awards classified as equity be accounting for?**

4. Based on the Board's decision at the January 31 meeting (Issues 9-12 in Memorandum 39), the pre-ballot draft of Statement 141(R) contained the following guidance with respect to income tax effects of replacement SBP awards classified as equity:

A80. For a replacement award classified as equity that ordinarily **would** result in future tax deductions under current tax law, an acquirer shall recognize deferred taxes on the deductible temporary differences attributable to the portion of the fair value-based measure attributed to past service and thus included in consideration transferred in the business combination. In accordance with paragraph 36(c) of Statement 109, the tax effect of replacement share-based payment awards is credited directly to shareholders' equity. The acquirer shall recognize any difference between the deferred taxes recognized at the acquisition date and the tax deduction the acquirer ultimately receives related to the portion of the replacement award that is included in consideration transferred as an adjustment to equity resulting from a transaction with shareholders. That amount is not remaining additional paid-in capital from excess tax benefits from previous share-based payment awards as discussed in Statement 123(R), paragraph 63. In other words, that amount cannot be used to offset deficiencies of amounts deductible on the employer's tax return and cumulative compensation cost recognized for financial reporting purposes. Paragraph A94, footnote 82, of Statement 123(R) addresses the recognition of excess tax deductions. [Emphasis added.]

5. Several reviewers of the pre-ballot draft questioned the approach in paragraph A80 with respect to the resulting tax benefits or deficiencies. That is, they disagreed with the Board's conclusion that these items should not be considered in the "APIC pool."

6. *View A:* Replacement SBP awards should be treated similarly to any other SBP awards under Statement 123(R) with respect to income tax effects.

7. Some proponents of View A did not think that this decision was consistent with the underlying concept behind the APIC pool. Others had concerns regarding the operational difficulties. Others noted that the APIC pool has no conceptual basis and is just a convention, and questioned why the convention should be made more difficult to implement.

8. The operational issues noted by proponents of View A relate to separately tracking awards issued "in the normal course of business" and replacement awards in a business combination (including awards that may have only been partially vested, so only a portion of the award's excess tax benefit would be excluded from the APIC pool). They believed that the decision created a distinction without a substantive difference for SBP awards that are or are not issued in conjunction with a business combination. This decision only adds complexity without a corresponding improvement in financial reporting.

9. Proponents of View A also note that creating a separate "class" of SBP transactions will result in additional implementation questions. Since Statement 123(R) was issued in December 2005, several issues that unforeseen have arisen related to accounting for income tax effects of SBP awards. The participants in the financial reporting process have largely addressed these issues, but proponents of View A are concerned that developing a different model could raise further implementation issues that will only result in increased complexity.

10. Some proponents of View A note that this and other issues related to the tax effects of SBP awards in general highlight the complexity of Statement 123(R)'s approach in this area. They would like to see the Board add a project to its agenda to revisit the accounting for the income tax effects of SBP awards.

11. *View B:* Replacement SBP awards should be accounted for based on the decisions at the January 31 Board meeting.

12. Proponents of View B recognize that preparers may have some additional tracking of SBP awards to properly account for those that were issued in conjunction with a business combination and those that were not. However, they do not believe that this additional effort is sufficient to justify an answer that is inconsistent with the concepts underlying the APIC pool. They believe that the APIC pool properly accounts for the compensation and equity transactions associated with SBP transactions. Replacement SBP awards that are part of the consideration issued in a business combination do not represent a compensation transaction for the acquirer, so none of the excess tax benefit should be included in the APIC pool.

***Discussion Question No. 1: How should income tax effects of replacement awards classified as equity be accounting for?***

13. *Staff Recommendation:* The staff's view is mixed.

**Issue 2 – Should the accounting for replacement awards in Statement 141(R) be limited to situations in which the acquirer was "obligated" to issue replacement awards?**

17. At the Board's April 7, 2004 meeting, the Board concluded the following with respect to share-based payment awards exchanged in conjunction with a business combination:

To be considered part of the consideration paid in a business combination, an acquirer must have an obligation as part of the business combination to replace outstanding equity-based awards issued by the acquiree. If there is no obligation, then the replacement awards issued by the acquirer would be treated as a separate compensation arrangement of the acquirer. (Minutes to April 7, 2004 Board Meeting)

18. The concept that the acquirer must have an obligation to replace the acquiree's SBP awards in order for the exchange to be included in the accounting for the business combination was included in the Exposure Draft (paragraph A102) and in the preballot draft (paragraphs 60 and A75).

19. In conjunction with the external review of the preballot draft, the staff received a suggestion to revise the notion of an acquirer being obligated to replace the awards to the exchange of SBP awards being "in connection with a business combination."

20. *View A:* The guidance in the preballot draft with respect to an obligation to exchange SBP awards should be retained.

21. Proponents of View A believe that the Board has thoroughly evaluated this matter since the initial Board discussion in April 2004. The notion of the acquirer being obligated to replace the awards was re-affirmed by the Board at the February 13, 2007 meeting and is consistent with other aspects of the Business Combinations project. This concept was also included in the Exposure Draft that was available for public comment, and the Board did not receive any comments on this aspect of the document. Proponents of this view believe that any exchange of SBP awards in which the acquirer was not obligated as a result of the business combination represent compensation transactions on the part of the acquirer.

22. Opponents to View A note that the preballot draft is the first document to contain a "definition" of obligated in this context, which, after revisions in the initial drafting is as follows:

The acquirer is obligated to replace the acquiree awards if the acquiree or its employees have the ability to enforce replacement. For example, the acquirer is obligated to replace the acquiree's awards if replacement is required by:

- a. The terms of the acquisition agreement
- b. The terms of the acquiree's awards
- c. Applicable legal regulations.

If the acquirer replaces the acquiree's share-based payment awards although it is not obligated to do so, the acquirer shall account for the awards as compensation cost in accordance with [Statement 123(R) / IFRS 2].

23. Proponents of View A believe that these instances are consistent with the Board's view of the circumstances in which an acquirer would be obligated to issue replacement SBP awards in a business combination throughout the Board's deliberations on the issue. As a result, the fact that these notions were not articulated in the standard prior to the preballot draft should not bear on the conclusion on this issue.

24. *View B:* Revise the guidance in Statement 141(R) to indicate that exchanges of SBP awards should be accounted for in accordance with Statement 141(R) if the exchange is "in connection with a business combination."

25. Proponents of View B believe that accounting for exchanges of share-based payment awards when the acquirer has an obligation to exchange is consistent with several aspects of business combination accounting relating to assumed and incurred liabilities. However, the wording in paragraph 60 may potentially exclude some share-based payment exchanges from being accounted for in connection with a business combination transaction when, in fact, they are a part of the business combination transaction. If such an exchange were accounted for outside of the business combination, it could have the effect of reducing the purchase price and increasing compensation cost recognized in the acquirer's postcombination financial statements. They also note that if an exchange outside of the business combination is at fair value, there may be no compensation cost recognized in the acquirer's postcombination financial statements.

26. Opponents to View B recognize that structuring an exchange of SBP awards is possible, and that such structuring could result in different accounting for substantively similar arrangements. However, opponents believe that the exchange of SBP awards would be a substantive, bargained-for provision of business combinations between parties with significant SBP compensation arrangements. They believe that parties' economic incentives would serve as an effective counterweight to incentives to structure the transaction for an accounting result in this respect.

27. In addition, opponents to View B question whether a fair value exchange would be possible outside of the business combination. If the acquiree awards were not going to be exchanged in the transaction, opponents to View B would question whether the acquiree awards would have significant value. If not, then the arrangement would generate significant incremental compensation cost that would be recognized in the acquirer's postcombination financial statements.

***Discussion Question No. 2: Should the accounting for replacement awards in Statement 141(R) be limited to situations in which the acquirer was "obligated" to issue replacement awards?***

*Staff recommendation* – The staff recommends View A.