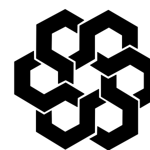

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **November 2007, London**

Project: **IAS 39 and Business Combinations (Agenda Paper 7E)**

INTRODUCTION

1. In September 2007 the IFRIC received a request for it to provide guidance on the appropriate interpretation of IAS 39 paragraph 2(g). This paragraph exempts from the scope of IAS 39 "contracts between the acquirer and a vendor in a business combination to buy or sell an acquiree at a future date". The submitter requested guidance on the following questions:

   - Does this scope exception apply only to binding contracts to acquire shares that constitute a controlling interest in another entity, or does it apply more widely to options that, if exercised, would result in the acquisition of such a controlling interest?
   - If the exception applies only to binding contracts to acquire shares that constitute a controlling interest in another entity, does it apply to any binding contract, or only to contracts that cover the period necessary to complete a business combination once its principal terms have been agreed?

2. The submitter also requested guidance on an ancillary question:

   - Would the exception also apply to other transactions to which IFRS 3 *Business Combinations* is applied either directly or by analogy? These might

include, for example, contracts to acquire a non-controlling interest and, by analogy, contracts to acquire interests in associates and joint ventures.

DIFFERING VIEWS

3. The submission noted that divergent practices have emerged and that at least two different approaches to the interpretation of IAS 39.2(g) are applied in practice:

View 1 – narrow interpretation

Under this view, IAS 39.2(g) applies only to binding contracts to buy or sell shares that constitute a controlling interest in a subsidiary within the period necessary to complete a business combination. Any other contract to buy or sell shares in another entity is within the scope of IAS 39.

Support for View 1

4. Supporters of this view note that IAS 39.2(g) was a consequential amendment to IAS 39 made by IFRS 3. The typical contracts the Board considered when discussing IFRS 3 were agreements between an acquirer and a vendor that are settled as soon as necessary legal processes are completed or regulatory approvals are obtained. The purpose of IAS 39.2(g) is to avoid entities that have committed to a business combination having to account for a derivative while necessary regulatory and legal processes are completed. IAS 39.2(g) also avoids having business combination contracts that meet the definition of financial instruments accounted for differently from those that do not.

5. Therefore supporters of View 1 believe that IAS 39.2(g) should be applied narrowly. Otherwise, derivatives may not be accounted for in accordance with IAS 39 in the absence of a business combination. In particular, under View 1 the following arrangements would not be covered by IAS 39.2(g) and so would be within the scope of IAS 39:

   - a contract with a settlement period longer than that required to complete the legal or regulatory processes necessary to effect a business combination; and

   - an option to acquire shares in another entity, because until the option is exercised no business combination exists.

View 2 – wide interpretation

6. Under this view, IAS 39.2(g) applies to any financial instrument acquired or issued that, when settled or if exercised, would result in a transaction to which IFRS 3 is applied. Any such contract is therefore outside the scope of IAS 39.

   Support for View 2

7. Supporters of this view note that IAS 39.2(g) applies without limitation to "contracts between the acquirer and a vendor in a business combination to buy or sell an acquiree at a future date". None of the interpretative material that accompanies IAS 39 limits the application of this exception, and the specific contracts considered by the Board in drafting IAS 39.2(g) are not relevant to the interpretation of the standard as drafted.

8. Therefore IAS 39.2(g) should be applied widely. The key test in assessing whether an entity is entitled to apply the exception to a given financial instrument is whether the settlement of the contract (in the case of an option, if exercised) would result in a business combination transaction to which IFRS 3 is applied. In particular, the following arrangements would be covered by IAS 39.2(g) and so would be outside the scope of IAS 39:

- a binding contract with a long settlement period, e.g. ten years, provided that settlement would result in a transaction to which IFRS 3 applies; and
- an option to acquire shares in another entity, provided only that the exercise of the option would result in a transaction to which IFRS 3 applies.

Consequences of differing views

9. The submitter also noted that the issue arises commonly in practice, and the amounts involved often can be very significant. Accounting at fair value through profit or loss, or hedge accounting, for a derivative contract during the option/commitment period produces results that are significantly different from accounting for an executory contract if the scope exception is applied.

   - If the acquirer has accounted for the contract as a derivative, on settlement or exercise the consideration given by the acquirer will be allocated partly to extinguish the derivative asset or liability. The cost of the business combination under IFRS 3 is then likely to approximate the fair value of the shares at the date of settlement.
   - If the contract is not accounted for as a derivative, the cost of the business combination is likely to approximate the fair value of the shares at the inception of the contract, not their fair value at the date at which control is transferred. The effect can therefore extend beyond the term of the contract itself because it can affect the cost of a business combination and the amount at which goodwill is measured.

STAFF ANALYSIS

Introduction

10. The following discussion considers the issues raised in the submission in relation to business combination transactions first. The question related to applying the scope exception by analogy to other transactions is considered later. In addition, the staff considered the issues raised by the submission in relation to both existing IFRS 3 and the revised version of IFRS 3 to be issued in 2007 (IFRS 3R). This is because the staff believes that some of the effects of the differing treatments outlined in paragraph 9 may be eliminated by the requirements of IFRS 3R.

11. A contract in which one party agrees to exchange a financial asset or assume a financial liability in return for a financial asset meets the definition of a financial instrument in IAS 39. Consequently, without the exception in paragraph 2(g), a contract in which the acquirer and the acquiree's owners (the vendor) agree to transfer the shares of the acquiree to the acquirer in exchange for the shares of the acquirer or other financial instruments would be within the scope of IAS 39. In addition, because the value of the contract will change in response to the value of the shares to be acquired, it requires no or a relatively small initial net investment

and it will be settled at a future date, that contract meets the definition of a derivative.

IAS 39

12. The staff's first observation is that this issue does not arise when one or both sides of the contract is not a financial instrument— that is, a business combination is the result of the acquisition of activities that meet the definition of a business in IFRS 3 rather than shares of an entity, or when the consideration provided by the acquirer is not the transfer of a financial asset, the assumption of a financial liability or the issue of the acquirer's equity instruments. In such cases, the agreement is accounted for in accordance with IFRS 3 or other standards.

13. The scope exception was added to IAS 39 as a consequential amendment arising from IFRS 3. There is no discussion in the Basis for Conclusions in either document of the reason for the amendment. It was not included in ED 3, the exposure draft that preceded the standard.

14. Adding the scope exception to IAS 39 was discussed and agreed to by the Board at its meeting in November 2003. The relevant portion of the Observer Notes for that meeting are included as Appendix A. From the Observer Notes it is clear that the staff's recommendation and the Board's discussion considered only excluding from the scope of IAS 39 business combination purchase and sale agreements that technically are forward contracts. The concern was that all contracts for the purchase or sale of a business be accounted for in the same way, whether they met the definition of a financial instrument or not.

15. In some respects, this scope exception can be considered similar to the exception in IAS 39.5 for 'normal' purchase or sale contracts for non-financial items that would otherwise be in the scope of IAS 39. These purchase or sale contracts also technically meet the requirements to be accounted for as derivatives in accordance with IAS 39 because they can be settled net in cash. However, when their purpose is for the receipt or delivery of the item in accordance with the entity's expected purchase, sale or usage requirements, the Board concluded that they should be accounted for in the same way as other executory contracts.

16. If the requirements of the 'normal' purchase or sale exception are applied by analogy to contracts for business combinations, a written option to buy or sell a business would not qualify for the scope exclusion. IAS 39.7 states that 'Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item' because the entity cannot control whether it will be exercised.

IFRS 3 and IFRS 3R

17. In IFRS 3, a business combination is defined as 'the bringing together of separate entities or businesses into one reporting entity'. The cost of a business combination is 'the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the

acquirer, in exchange for control of the acquiree'. The acquisition date is date on which the acquirer effectively obtains control of the acquiree. The date of exchange and the acquisition date are different if the business combination is achieved in stages, e.g., through successive share purchases.

18. In the staff's view, for the exception to apply there must be a business combination of which the contract in question is a part. That is, it cannot be a contract for a future business combination. It must be clear that the acquirer has or will shortly acquire control over the acquiree. The application of IAS 39.2(g) to a contract is assessed when the holder enters into it. Binding contracts to buy or sell businesses at fixed prices, such as forward contracts, are certain to result in business combinations. If the settlement period of the contract simply accommodates the length of time necessary to complete legal processes or to obtain regulatory approvals, it is clear that the scope exception would apply. The cost of the derivative is included in the cost of the business combination.

19. Control is assessed in the context of IAS 27, which requires consideration of the existence and effect of 'instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another entity's voting power over the financial and operating policies of another entity (potential voting rights).' (IAS 27.14). IAS 27.15 requires an entity to examine all facts and circumstances that affect potential voting rights that are currently exercisable or convertible, including their terms of exercise and any other contractual arrangements, in assessing whether they contribute to control. Because the assessment of control in accordance with IAS 27 is not restricted to consideration of instruments that are binding contracts to buy and sell, the staff concludes that the scope exception in IAS 39.2(g) cannot be restricted to such contracts.

20. However, in the staff's view, the applicability of the scope exception to contracts other than the binding contracts described in paragraph 18 is linked to whether they contribute to an assessment that the acquirer has obtained control of the acquiree, that is, that a business combination has occurred. This view is reflected in some of the published guidance the staff reviewed.

21. Thus, in the staff's view, the existence of control, and therefore the date of acquisition, should be assessed for binding contracts to buy and sell at fixed prices with long settlement periods as well as for options. Such an assessment may indicate that control exists at the inception of the contract and that only the settlement of the cost of the business combination is deferred. In this case, the accounting for the deferred settlement is specified by IFRS 3.26. Similarly, if the existence of an option leads to the conclusion that the holder controls the acquiree, the acquisition date has already occurred and the scope exception is applicable to that option.

22. In IFRS 3R, a business combination is defined as 'a transaction or other event in which an acquirer obtains control of one or more businesses'. The consideration transferred to obtain control of the acquiree is measured at its acquisition-date fair

value. The acquisition date is the date on which the acquirer obtains control of the acquiree.

23. Consequently, under IFRS 3R, whether the scope exception applies to a business combination contract has no effect on the amounts recognised as consideration for the business combination. The value of the consideration is always determined on the acquisition date—when control is obtained. So once again for business combination accounting, the critical issue is the effect that contract has on the assessment of when the acquirer obtains control. Obviously, whether the scope exception applies always affects the accounting for contract from its inception to the acquisition date.

Applying the exception by analogy

24. Paragraph 20 of IAS 28 *Investments in Associates* notes 'Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures described in IAS 27. Furthermore, the concepts underlying the procedures used in accounting for he acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.' Consequently, it might seem appropriate to apply the scope exception in IAS 39.2(g) to contracts to acquire investments that will be accounted for using the equity method.

25. However, in the staff's view it is not possible to apply an exception to the scope of a standard to any other transaction by analogy.

SHOULD THE ISSUE BE TAKEN ONTO THE IFRIC AGENDA?

26. The staff has considered whether the issue should be taken onto the IFRIC agenda with reference to the agenda criteria set out in the IFRIC Due Process Handbook.

Widespread and practical relevance

27. Business combination transactions are common in many jurisdictions. They often involve a preliminary agreement of purchase and sale (sometimes called a 'heads of' agreement) while the final legal agreements are prepared and any necessary regulatory approvals are sought.

28. Therefore the staff believes that the practical question of the application of IAS 39.2(g) will apply broadly.

Divergent interpretations

29. The submission states that divergent interpretations exist. A staff review of published accounting guidance found differing views on the application of the scope exception.

30. Different conclusions on whether or not the scope exception applies can have a significant effect on reported results from the inception of the contract until the acquisition date. After IFRS 3R is effective, it will not have an effect on the accounting for the business combination.

Improvement to financial reporting

31. Consistent application of the scope exception to contracts for transactions that are likely to be significant would improve the usefulness of financial statements for users.

Sufficiently narrow in scope?

32. The issue relates only to the application of one scope exception paragraph in IAS 39. However, as demonstrated by the analysis above, resolution of the question is likely to involve consideration of other standards, in particular IAS 27 and IFRS 3.

33. On the other hand, it can be argued that any guidance that could be provided would be in the nature of application guidance. Also, in this case it is clear from public documents the contracts the Board intended the exception to apply to.

Ability to reach a consensus

34. The scope is sufficiently narrow that the staff believes that the IFRIC should be able to reach a consensus in a reasonable period of time.

Relationship with an IASB project

35. There is currently no active agenda project that will address this issue. IFRS 3R includes a consequential amendment to IAS 39 to delete paragraph 2(f) but no change is made to paragraph 2(g).

CONCLUSIONS

36. Although this issue satisfies almost all of the criteria to be taken onto the IFRIC's agenda, the staff is concerned that its narrow scope indicates that any guidance provided would be application guidance rather than an interpretation. Consequently, the staff recommends that the IFRIC not add this item to its agenda.

37. If the IFRIC believes that the issue requires clarification, the staff recommends that the IFRIC refer it and the application of IAS 39.2(g) to analogous transactions to the Board. In the staff's view, this would be a much more effective way of clarifying the standard.

38. Draft rejection wording is included in Appendix B.

QUESTIONS FOR THE IFRIC

39. Does the IFRIC agree with the staff's recommendation?

40. Does the IFRIC have any comments on the wording of the tentative agenda decision?

Appendix A — Extract from Observer Notes for the IASB Meeting November 2003

TREATMENT OF FORWARD CONTRACTS IN A BUSINESS COMBINATION

33. During the pre-ballot process for IAS 39, one Board member suggested that when an acquirer and vendor in a business combination agree the cost of the combination before the acquisition date (ie, before the date the acquirer obtains control of the acquiree), a forward contract arises that, in theory, should be accounted for under IAS 39 *Financial Instruments: Recognition and Measurement*. Board members considered this issue and agreed that: (1) it should not be dealt with as part of the Financial Instruments project; and (2) the issue should be considered by the Board in finalising Phase I of the Business Combinations project.

34. ED 3 defines 'agreement date' as "the date that a substantive agreement between the combining parties is reached and, in the case of publicly listed entities, announced to the public. …" At the agreement date, the parties to the business combination often are committed to the transaction such that they cannot unilaterally terminate the transaction without some negative consequences (such as the payment of a 'break' fee if one is specified in the agreement, or the high likelihood of litigation).

35. A business combination agreement under which the acquirer commits to transferring consideration in exchange for obtaining control of the acquiree at some date in the future might, in certain circumstances, have the characteristics of a forward contract. Some examples of circumstances in which forward contracts arise on the agreement date are when:

    a. the acquirer promises to issue 5,000 of its shares in exchange for net assets that constitute a business, and the owners of those net assets promise to transfer control of the net assets to the acquirer in exchange for the 5,000 shares.

    b. The acquirer promises to transfer fixed-rate government bonds with a face value of 1,000,000 in exchange for net assets that constitute a business, and the owners of those net assets promise to transfer control of the net assets to the acquirer in exchange for the fixed-rate government bonds.

    c. The acquirer promises to transfer cash of 5,000,000 in exchange for a controlling equity interest in an acquiree, and the owners of the acquiree promise to transfer that controlling equity interest to the acquirer in exchange for the 5,000,000 cash.

36. In example (a), the acquirer's commitment to issue a specified number of equity instruments in exchange for the acquiree is, from the acquirer's perspective, a forward contract to sell equity. A commitment of the owners of the acquiree to transfer control of the acquiree's net assets in exchange for a specified number of equity instruments is, from the perspective of the owners of the acquiree, a forward contract to purchase equity. To the extent the financial assets and financial liabilities arising from these forward contracts are within the scope of IAS 39, they are required to be recognised on the commitment date (ie, the agreement date in this example), at their fair values at that date, and subsequently measured at fair value with changes reflected in profit or loss (absent a hedge of a firm commitment).

37. In example (b), the acquirer's promise to deliver fixed-rate government bonds with a face value of 1,000,000 in exchange for the acquiree is, from the acquirer's perspective, a forward contract that gives rise to a financial liability. Similarly, a promise of the owners of the acquiree to transfer control of the net assets of the acquiree in exchange for the fixed-rate government bonds is, from the perspective of the owners of the acquiree, a forward contract that gives rise to a financial asset.

38. The acquirer's promise in example (c) to transfer cash in exchange for a controlling equity interest in the acquiree is, from the acquirer's perspective, also a forward contract that on the agreement date gives rise to a financial liability. The promise of the owners of the acquiree to transfer the controlling equity interest in exchange for cash is, from the perspective of the owners of the acquirer, a forward contract that gives rise to a financial asset.

39. Furthermore, the promise of the owners of the acquiree in examples (a) and (b) to transfer net assets that constitute a business on a certain date in the future may also be viewed by the acquirer as forward contracts that gives rise to assets. If the business being transferred were viewed as a single non-financial item, the forward contract would not be within the scope of IAS 39. However, if the business being transferred were viewed as a number of individual assets and liabilities, some of which might be financial assets and liabilities, the agreement to transfer the financial assets and liabilities in the future would be a forward contract within the scope of IAS 39.

40. The issue the Board will consider is whether forward contracts arising at the agreement date that meet the definition of a derivative in IAS 39, and are therefore within the scope of IAS 39, *should* in fact be within the scope of IAS 39 and subject to the recognition and measurement requirements in that Standard.

Staff Recommendation

41. The staff will recommend that forward contracts arising from business combination agreements be explicitly excluded from the scope of IAS 39, and that the following consequential amendment be made to IAS 39 when the IFRS on business combinations is issued:

> ***"2. This Standard shall be applied by all entities to all types of financial instruments except:***
>
> **…**
>
> ***(g) contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date"***

[Appendix B omitted from observer note]