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 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:	**15 April 2008, London**
Project:	**Annual Improvements Process**
Subject:	**IAS 39 *Financial Instruments: Recognition and Measurement* Scope of IAS 39 paragraph 2(g) (Agenda paper 2)**

THE ISSUE

1. Paragraph 2(g) of IAS 39 exempts from the scope of IAS 39 'contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date'.

2. The IFRIC was asked whether the scope exception in paragraph 2(g) of IAS 39 applies only to binding contracts (forwards) to acquire shares that constitute a controlling interest in another entity or if it applies more widely (option contracts).

3. The submission to the IFRIC also asked for guidance on whether the scope exception could be applied to other similar transactions, such as those to acquire an interest in an associate.

4. At the November 2007 meeting, the IFRIC issued a tentative agenda decision noting that, for the scope exception to apply, an acquirer or vendor must conclude that a business combination exists or will occur which includes the contract in question.

5. The IFRIC also noted that scope exceptions cannot be applied by analogy to other transactions.

6. The IFRIC did not expect significant diversity in practice in the application of the above requirements and therefore decided not to add the issue to its agenda.

7. The IFRIC reconsidered the issue at the January 2008 meeting, following comments received from constituents on the tentative agenda decision.

8. At that meeting the IFRIC acknowledged that the wording in paragraph 2(g) of IAS 39 is ambiguous and could lead to diversity in practice.

9. The IFRIC therefore decided to ask the Board to clarify the standard, addressing in particular:

    (a) whether the scope exception in paragraph 2(g) applies to all contracts (including options) between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date; and

    (b) whether the scope exception provided in paragraph 2(g) could be applied to other similar transactions, such as those to acquire an interest in an associate.

PURPOSE OF THE PAPER

10. This paper analyses the issues raised in IFRIC's request to the Board and provides a recommendation as to how the standard could be clarified.

STAFF RECOMMENDATION

11. The staff recommends that the Board clarifies the standard to state that the exemption in paragraph 2(g) applies only to binding (forward) contracts between the acquirer and a vendor in a business combination to buy or sell an acquiree at a future date.

12. The staff also recommends that the Board clarify that paragraph 2(g) does not apply to investments in associates and other similar transactions.

13. The staff's recommended wording for paragraph 2(g) and a draft basis for conclusions are attached as appendices 1 and 2 respectively.

14. The staff also recommends that the proposed amendment be included in the Annual Improvement Process because it is a minor and non-urgent issue.

STAFF ANALYSIS

15. IAS 32 *Financial Instruments: Presentation*, defines a financial instrument as 'any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity'.

16. IAS 39 applies to all financial instruments except those excluded from the scope of the standard by paragraph 2 or other provisions of the standard.

17. Many of the contracts in which the acquirer and the vendor agree to transfer the shares of the acquiree to the acquirer in exchange for another financial instrument meet the definition of a derivative in IAS 39.

18. Without the exception in paragraph 2(g), a contract in which the acquirer and the vendor agree to transfer the shares of the acquiree to the acquirer in exchange for another financial instrument would be within the scope of IAS 39.

Background to the scope exception

19. The scope exception was added to IAS 39 as a consequential amendment arising from IFRS 3 *Business Combinations* (issued in 2004) but no Basis for Conclusions was provided in either standard for the amendment.

20. The November 2003 IASB Update stated the following:

Forward Contracts Arising from Business Combination Agreements

> The Board agreed 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), any resulting forward contract should be excluded from the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. [Emphasis added]

21. However, the Update did not provide a basis for the Board's decision to exempt such forward contracts from the scope of IAS 39.

Whether the scope exception in paragraph 2(g) applies to all contracts (including options) between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date

22. Paragraph 2(g), as currently drafted, could be construed to apply to the following types of financial instrument contracts –:

- binding contracts (eg forwards) to acquire shares that constitute a controlling interest in a subsidiary within the period necessary to complete a business combination.
- currently exercisable option contracts to acquire shares in another entity, the exercise of which would result in a transaction to which IFRS 3 applies.
- non-currently exercisable option contracts to acquire shares in another entity.

Forward Contracts

23. It is clear from the November 2003 Observer Notes, that the staff's recommendation to the Board intended excluding from the scope of IAS 39 only business combination purchase and sale agreements that are forward contracts.

24. But more importantly (based on the November 2003 IASB Update), the staff believes that the Board intended to exclude only forward contracts between an acquirer and a vendor in a business combination to buy an acquiree at a future date from the scope of IAS 39 (see paragraph 20 of this paper).

25. Hence the exemption in paragraph 2(g) applies to forward contracts between an acquirer and a vendor in a business combination to buy an acquiree at a future date.

Currently Exercisable Option Contracts

26. Paragraph 2(a) of IAS 39 excludes from the scope of IAS 39 interests in subsidiaries, associates and jointly controlled entities that are consolidated, accounted for using the equity method or proportionately consolidated in accordance with IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates*, and IAS 31 *Interests in Joint Ventures* respectively.

27. IAS 27 applies only to investments in subsidiaries and the standard defines a subsidiary as 'an entity … that is controlled by another entity (known as the parent)'.

28. IAS 27 paragraph 4 also defines control as 'the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities'.

29. IAS 27 states that an entity has control when it currently has the ability to exercise that power, regardless of whether control is actively demonstrated or is passive in nature.

30. Potential voting rights such as share call options and convertible debt are capable of giving an entity control over a majority of the voting power of another entity. Hence potential voting rights held by an entity that are currently exercisable or convertible provide this ability.

31. The existence of control is therefore determined only after assessing all the factors described in paragraph 13 of IAS 27 and considering the existence and effect of potential voting rights.

32. When consideration of instruments containing potential voting rights leads to the conclusion that the holder controls the entity, the investments are accounted for in accordance with IAS 27.

33. Consequently, the staff concludes that the exemption in paragraph 2(g) cannot be applied to currently exercisable option contracts that on exercise will yield control over an entity, as they are excluded from the scope of IAS 39 by paragraph 2(a).

Non-Currently Exercisable Option Contracts

34. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event

35. Potential voting rights that are not currently exercisable are not considered in determining control in accordance with IAS 27 as they, in substance, do not provide the ability to exercise power. Accordingly, the scope exception in paragraph 2(a) does not apply to potential voting rights (option contracts) that are currently not exercisable.

36. Paragraph 2(g) refers specifically to contracts between an acquirer and a vendor <u>in a business combination</u> to buy or sell an acquiree at a future date.

37. Appendix A (Defined terms) of IFRS 3 defines a business combination 'as a transaction or other event in which an acquirer obtains control of one or more businesses'.

38. As non-currently exercisable potential voting rights are not considered in determining control, non-currently exercisable option contracts would not meet the definition of a business combination under IFRS 3.

39. Hence, the exemption in paragraph 2(g) would not apply to such transactions. As illustrated in IG7 of IAS 27, instruments containing potential voting rights which in substance do not currently give access to the economic benefits associated with an ownership interest are accounted for as derivatives under IAS 39.

Whether the scope exemption in paragraph 2(g) can be applied by analogy to other 'similar' transactions

40. The staff believes that the primary justification for the scope exemption in paragraph 2(g) is that two transactions that are economically similar should not be accounted for differently.

41. The exemption in paragraph 2(g) avoids having business combination contracts that meet the definition of financial instruments accounted for differently from those that do not.

42. Business combination transactions can be structured either as an acquisition of the net assets of an entity or as a purchase of controlling equity interests in the acquiree, as illustrated below:

- An acquirer promises to transfer its equity instruments in exchange for net assets that constitute a business, and the vendor in turn promises to transfer control of the net assets to the acquirer in exchange for the equity instruments to be issued by the acquirer.

- An acquirer promises to transfer a financial instrument in exchange for a controlling equity interest in an acquiree, and the vendor in turn promises to transfer that controlling equity interest to the acquirer in exchange for the financial instrument.

43. Without the scope exemption, one entity might apply other IFRSs to account for a business combination transaction structured as an acquisition of the constituent assets of the entity, whereas another entity might apply IAS 39 to a similar transaction effected as a purchase or sale of a controlling equity interest.

44. Hence in the absence of the exemption, both the representational faithfulness and the comparability of those financial statements might be impaired.

45. The effect of the scope exemption in paragraph 2(g) is that however an acquisition is structured (whether through acquisition of shares or transfer of the constituent assets) does not affect the determination as to the application of IAS 39 to the transaction.

46. The issue of consistency of application of accounting standards (and substance over form) does not arise in the case of investments in associates because an

investment in an associate does not represent an acquisition of the constituent assets of the investee.

QUESTIONS FOR THE BOARD

47. Does the Board agree with the staff analysis and recommendation?

48. If so, does the Board agree that paragraph 2(g) should be amended as drafted in appendix 1?

49. Does the Board agree that this issue should be included as part of the Annual Improvements process? If not, how would the Board like to proceed?

Appendix 1

DRAFT AMENDMENTS

2 This standard shall be applied by all entities to all types of financial instruments except:

……….

(g) any forward contract that results from an agreement entered into before the acquisition date (ie before the date the acquirer obtains control of the acquiree) by ~~between~~ an acquirer and a vendor, in a business combination, to buy or sell an acquiree at a future date and at a specified cost (or on a specified cost basis).

………..

<u>Appendix 2</u>

Draft Basis for Conclusions for
Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

---

1. The Board was advised that there was diversity in practice regarding the application the exemption in paragraph 2(g) of IAS 39.

2. Paragraph 2(g) is intended to exempt entities that have committed to a business combination from accounting for the contract as a derivative while necessary regulatory and legal processes are being completed.

3. Business combination transactions can be structured either as an acquisition of the net assets of an entity or as a purchase of controlling equity interests in the acquiree.

4. Without the scope exemption, one entity might apply other IFRSs to account for a business combination transaction structured as an acquisition of the constituent assets of the entity, whereas another will apply IAS 39 to a similar transaction effected as a purchase or sale of a controlling equity interest.

5. Hence, in the absence of the exemption, both the representational faithfulness and the comparability of those financial statements might be impaired.

6. In adding the scope exemption, the Board was mindful of the disadvantages of having more than one method of accounting for similar business combination agreements.

7. The effect of the scope exemption in paragraph 2(g) is that however an acquisition is structured (whether through acquisition of shares or transfer of the constituent assets) does not affect the determination as to the application of IAS 39 to the transaction.

8. The issue of consistency of application of accounting standards (and substance over form) does not arise in the case of investments in associates because an investment in an associate does not represent an acquisition of the constituent assets of the investee.

9. Hence the Board concluded that the exemption in paragraph 2(g) should be restricted to binding (forward) business combination contracts and should not be applied by analogy to investments in associates and other similar transactions.

10. The exemption in paragraph 2(g) also does not apply to currently exercisable option contracts that on exercise will yield control over an entity, as they are excluded from the scope of IAS 39 by paragraph 2(a).

11. IAS 27states that non-currently exercisable potential voting rights are not considered in determining control. As such non-currently exercisable option contracts would not meet the definition of business combination under IFRS 3. Hence, the exemption in paragraph 2(g) does not apply to such transactions.

12. Consequently, the Board amended the standard to state that the exemption in paragraph 2(g) applies only to forward (binding) contracts between an acquirer and a vendor in a business combination to buy an acquiree at a future date.