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Dear Tricia O'Malley

Tentative Agenda Decision IAS 39 *Financial Instruments: Recognition and Measurement*– Scope of IAS 39 paragraph 2(g)

We do not agree with the tentative agenda decision in respect of the above issue as set out in the November 2007 *IFRIC Update*, without clarifying two important elements of the basis of its rejection. Further, due to the complexity created by these related issues we believe the issue will not be resolved adequately if the IFRIC simply issues rejection wording. For the reasons set out below, we believe the IFRIC should take the issue onto its agenda to allow normal due process to be completed.

The IFRIC's tentative agenda decision indicates that a contract will meet the scope exemption if 'any conditions in the contract cannot be within the control of the entities'. We can understand the reason for including such a requirement, however in practice we believe this criterion will be difficult to apply. Often, business combination agreements will include conditions that require the vendor to transfer assets or transfer employees. We believe it is difficult to determine in which situations the entity has control over these conditions. Therefore, there is likely to be differing views regarding when something is within the control of the entity, which could result in the rejection wording creating greater diversity in practice.

Following on from this, we note it is common in practice for conditions of a contract for a business combination to include a requirement for shareholders of the acquirer and/or the vendor to vote and approve the business combination transaction. During the November 2007 IFRIC meeting, some IFRIC members noted that they considered shareholders to be unrelated to the company and therefore votes cast by shareholders at a general meeting are not considered within the control of the entity. Although we agree that individual shareholders are not part of the entity and therefore not within the control of the entity, we believe that the general meeting of shareholders in many jurisdictions is a decision making body of the entity. Further, where the shareholders in a general meeting can appoint and remove directors, drawing a distinction between the general meeting and the board of directors does not seem to be a useful dichotomy. In other words, we do not consider decisions of the general meeting to be events that are beyond the control of the entity, more they are decisions of the entity.

If shareholders in a general meeting are considered unrelated to the entity, there could be significant knock on effects, specifically in the determination of whether an instrument such as a share is classified as either a financial liability or as equity. For example, in some jurisdictions, ordinary shareholders have a right to vote in a general meeting whether the entity will pay a dividend. If the shareholders' right to demand payment of the company's distributable reserves at a general meeting is not considered to be within the control of the entity, the shares to which the distribution relates will be considered to be (or contain) a financial liability because of the potential contractual obligation to deliver cash or another financial asset.

IAS 32 *Financial Instruments: Presentation* paragraph 25 states that a financial instrument is considered to be a financial liability if the entity may be required to deliver cash or another financial asset in the event of the occurrence or non-occurrence of uncertain future events that are beyond the control of both the issuer and the holder. We believe that the IFRIC's conclusion regarding whether the entity controls the shareholders at a general meeting will create complications for preference shares that are redeemable in the event of an initial public offering which must be voted on and approved by the shareholders at a general meeting. In this situation, if the decision to go for an IPO is within the control of the shareholders but is not considered to be in the control of the entity, such preference shares would be considered a liability because the company does not have discretion over whether the preference shares are repaid or not.

We are aware of a view that there is no present obligation in situations where ordinary shareholders have a right to demand payment of the company's distributable reserves because the demand has not been made by the shareholders, and as such there is no liability. However, if a present obligation exists only once the demand for payment has been made and not from the right to demand payment, we would argue that demand deposits cannot be a liability of a bank until the holder demands payment. This situation does not seem reasonable.

Because of our concerns about determining the situations in which an entity controls conditions in the contract, and the possible knock-on effects for the classification of instruments as debt or equity, we believe the IFRIC should add a project to its agenda to discuss and debate the issues fully. We believe that as part of this project, the IFRIC should make it clear whether it considers shareholder decisions made in general meeting to be within the control of an entity.

We are also concerned that the IFRIC may be creating confusion as to why contracts that do not meet the scope exemption are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement.* The Observer Notes to the November 2003 IASB meeting indicate that the IASB originally considered that contracts to purchase a business might meet the definition of a financial instrument, at least in part, because some of the underlying assets and liabilities of the business to be acquired might consist of financial assets and financial liabilities. Essentially it appears that the IASB considered one should 'look through' the corporate wrapper of the business being acquired to the underlying assets and liabilities as would be done when preparing the consolidated financial statements of the acquirer. However, the discussion at the IFRIC in November 2007 seemed to imply that such contracts meet the definition of a financial liability because in a business combination an entity is typically purchasing shares of the acquiree, which are financial assets. Clearly the accounting consequences of applying IAS 39 using one or other of these perspectives could be very different.

Whilst we accept that there is merit to both of these perspectives, we believe the latter analysis could give rise to a number of unintended consequences for contracts to purchase or sell assets within a 'corporate wrapper' (for example commercial properties which are commonly held within corporate wrappers). On this basis, such contracts will be within the scope of IAS 39, when in substance they are the purchase of the underlying properties, not shares. Thus we believe the IFRIC should make it clear which of these two perspectives it believes is appropriate before finalising the tentative agenda decision.

Finally, if the IFRIC decide to continue to issue the rejection notice, we believe the wording should be amended to clarify the IFRIC's meaning for the following reasons:

- The tentative agenda decision currently states 'the contract commits the acquirer and vendor to a future business combination; any conditions in the contract cannot be within the control of the entities'. We believe that the wording should be made clearer by including the following words in bold 'the contract commits **both** the acquirer and vendor to a future business combination; any conditions in the contract cannot be within the control of **either of** the entities'.

- We are concerned with the wording that states that 'an acquirer or vendor must conclude that a business combination *exists or will occur'*. In our view, if the business combination exists then it will not meet the scope exemption in IAS 39 because it is not a 'future business combination'. Clarifying that the scope exemption applies in situations that won't actually meet the scope exemption seems pointless. We believe the wording should state 'an acquirer or vendor must conclude that a business combination ~~exists or~~ will occur **unless external contingencies prevent it from occurring**'.

We would be pleased to discuss our views with the Committee. Please do not hesitate to contact Leo van der Tas at 020 7951 3152.

Yours faithfully

Ernst & Young