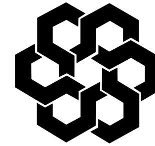

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International Accounting Standards Board

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: **January 2008, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement* – Scope of IAS 39 paragraph 2(g) (Agenda Paper 4E)**

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1. At the November meeting the IFRIC discussed the scope of IAS 39 paragraph 2(g).

2. 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'.

3. The IFRIC noted 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.

4. The IFRIC also noted that this conclusion is appropriate in two situations:

    - The contract commits the acquirer and vendor to a future business combination and any conditions in the contract cannot be within the control of the entities.

- In accordance with both IFRS 3 Business Combinations and the revised version of IFRS 3 Business Combinations to be issued in 2008, a business combination exists when the acquirer obtains control of the acquiree. Consequently, the IFRIC noted that a contract included in the determination that the acquirer has obtained control in accordance with IAS 27 would be part of the business combination

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

Purpose of the paper

6. This paper provides a summary of the comments received from constituents on IFRIC's tentative agenda decision on the above issue and the staff's analysis and conclusions.

Comment 1: Whether the paragraph 2(g) exemption can be applied by analogy to similar transactions

7. Respondents question the general statement that scope exceptions cannot be applied by analogy to other transactions. Respondents cite as an example that although there is no specific scope exemption in IAS 28 or IAS 31 for transfers between entities under common control of investments in associates and/or interests in joint ventures, such an exemption is inferred in practice.

8. Also a scope exemption is applied by analogy in the context of IFRS 2 Share-based Payment. Share-based consideration paid for net assets acquired in a business combination is outside the scope of IFRS 2. This exemption is in practice applied beyond business combination transactions within the scope of IFRS 3 to common control transactions, acquisition of minority interests after control is obtained, acquisition of significant influence, and the formation of joint ventures.

Staff Analysis:

9. Although the staff agrees that in principle a scope exception should not be applied by analogy to other transactions; there may be circumstances where such an extension might be appropriate. This will depend on the Board's

reasons for permitting the exception and the degree of similarity between the transactions that the exception is to be applied and the transactions that the exception is being applied to by analogy.

10. The minutes of the November 2003 Board meeting do not provide a basis for the Board's decision to exempt such contracts from the scope of IAS 39. However, the staff paper recommending the exemption to the Board provided two key reasons for providing the exemption.

11. Paragraph 12 of the staff paper stated -

> "In the staff's view forward contracts arising from a business combination agreement should be excluded from the scope of IAS 39 for the following reasons:
>
> - The period of time between the agreement date and the acquisition date in a business combination could be viewed as "the time frame established generally by regulation or convention in the marketplace concerned" and, therefore, the business combination agreement could be viewed as a regular way purchase or sale under IAS 39. Under paragraph AG12 of 'improved' IAS 39 "a regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment, it is not recognised as a derivative financial instrument." The parties to a business combination normally are desirous of proceeding quickly with the transaction and, therefore, business combination agreements normally do not allow for unnecessary delays on the part of the parties to the transaction. Delays normally result from delays in the regulatory approval process or other events not within the control of the parties to the transaction. Given that every business combination is unique, it would be difficult to identify what is a customary timeframe for completing a business combination. On the other hand, both parties to a business combination are aiming to complete it within "the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents" (extracted form IGC Interpretation16-1 "Regular way" contracts: no established market).

Therefore, it could be argued that forward contracts arising from a business combination agreement should not be recognised as derivative financial instruments for the same reasons that derivatives are not recognised in a regular way purchase or sale.

- It could also be argued that a business combination meets the "normal purchase" requirements for exclusion from IAS 39. Paragraph 5 of 'Improved' IAS 39 provides that "This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or in another financial instrument as if they were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements". If a business is viewed broadly as a non-financial item, a business combination agreement should be viewed as a contract entered for the purpose of receipt or delivery of a non-financial item in accordance "with the entity's expected purchase, sale, or usage", regardless of the way the business combination is structured (ie, irrespective of whether control is obtained via acquiring equity instruments of the acquiree or via the purchase of the underlying net assets)."

12. Paragraph 13 of the same paper also states the following –

> "Some might suggest that an explicit scope exclusion for forward contracts arising from business combination agreements is not necessary, given the arguments in paragraph 12 above. However, to avoid any confusion, the staff recommends that forward contracts arising from a business combination agreement be explicitly excluded from the scope of IAS 39 as a consequential amendment when the IFRS on business combinations is issued."

13. Based on the reasons for which the exemption was provided, the staff believes the exemption should not be applied to acquisition of an interest in an associate and other similar transactions.

14. The regular way purchase or sale exemption applies to terms that require delivery of an asset within the time frame established generally by regulation or

convention in the market place concerned. It is important to note that shareholder approval is not one of such factors.

15. The parties to a business combination normally are desirous of proceeding quickly with the transaction. Delays normally result from delays in the regulatory approval process, in particular competition or antitrust clearance. Parties to a business combination aim to complete it within "the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

16. Almost all jurisdictions around the world have regulatory and competition (antitrust) approval processes for business combination transactions. These requirements are pervasive and are on the increase. Hence many of such transactions are executed subject to regulatory and competition authorities approval. Investments in associates and like transactions, generally do not face such hurdles. As such it would not be appropriate to apply the exemption by analogy to such transactions.

17. Hence the staff concludes that the exemption in paragraph 2(g) should not be applied by analogy to investments in associates and similar transactions.

Comment 2: Whether shareholder approval is within the control of the entity

18. Another respondent questions the IFRIC's basis for the tentative decision; that a contract will meet the scope exemption if 'any conditions in the contract cannot be within the control of the entities' -

    "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 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….. 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."

Staff Analysis:

19. A critical feature in differentiating a financial liability from an equity instrument is the existence of a **contractual obligation** of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.

20. Although the holder of an equity instrument may be entitled to receive or vote to be paid any dividends or other distributions of equity, until the dividends are declared (ie the dividends are appropriately authorised and no longer at the discretion of the entity) it is unlikely that the issuer has a contractual (present) obligation to deliver cash or economic resource to the holder.

21. Paragraph BC4 of IAS 10 Events after the Balance Sheet Date also states -

"For this limited clarification of IAS 10 the main change made is in paragraphs 12 and 13 (paragraphs 11 and 12 of the previous version of IAS 10). As revised, those paragraphs state that if dividends are declared after the balance sheet date, an entity shall not recognise those dividends as a liability at the balance sheet date. ***This is because undeclared dividends do not meet the criteria of a present obligation in IAS 37 Provisions, Contingent Liabilities and Contingent Assets***. The Board discussed whether or not an entity's past

practice of paying dividends could be considered a constructive obligation. The Board concluded that such practices do not give rise to a liability to pay dividends." [Emphasis added]

22. Consequently, the staff does not believe that the wording of IFRIC's tentative decision impacts the analysis of whether an instrument is equity or liability.

23. But more significantly, as analysed under comment 1 (see above), shareholder approval is not one of the factors cited to justify the provision of the business combination exemption. One of the factors mentioned in the original staff paper recommending the exemption specified regulatory and market convention that normally could delay closure of a transaction (hence meeting the regular way purchase and sale criteria).

24. Hence, the staff believes shareholder approval (that is, whether it is within the control of the entity or not) should not be taken into account in analysing or applying the exemption.

Comment 3: Whether the business combination contract is a financial asset/liability

Respondents commented as follows:

"We are 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 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 different.

Staff Analysis:

25. The staff notes that however a business combination is effected (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.

26. The following examples illustrate the staff view and conclusion:

    (a) An 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 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."

27. IAS 32 paragraph 11 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".

28. In example (a), the contract does not qualify as a financial instrument as a contract to buy or sell a non-financial item does not meet the definition of a financial instrument. The contractual right of the acquirer to receive a non-financial asset (a business) and the corresponding obligation of the acquiree to transfer a business do not establish a present obligation or obligation of either party to receive, deliver or exchange a financial asset.

29. However, as the contract is to be settled in equity (a financial instrument) and it is presumably not entered into in accordance with the entity's expected purchase, sale or usage requirements, it may meet the net settlement criteria and hence be accounted for under IAS 39. If the transaction were to fail the net settlement criteria, the contract would be out of scope of IAS 39.

30. In example (b), the acquirer's promise to transfer cash in exchange for a controlling equity interest in the acquiree and the promise of the owners of the acquiree to transfer the controlling equity interest in exchange for cash is, meets

the definition of a financial instrument. Hence the contract should be accounted for under IAS 39 save for the paragraph 2(g) exemption.

31. The assertion that the IASB originally considered that contracts to purchase a business might meet the definition of a financial instrument, because some of the underlying assets and liabilities of the business to be acquired might consist of financial assets and financial liabilities is not supportable in the staff's view.

Comment 4: Suggested amendment to the wording of the tentative agenda decision

32. One of the respondents suggested the following amendment to the wording of the tentative agenda decision:

> "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'"
>
> "…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 would not 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**'"

Staff Analysis

33. The staff agrees that the suggested amendments to the wording of the tentative agenda decision will enhance understanding of IFRIC's conclusions and recommends that IFRIC consider adopting them.

Question for the IFRIC

34. Does the IFRIC agree with the staff analysis, comments and conclusions? If not, why not?.