Project **Amendments to IFRS 3 and IAS 27**

Topic **Un-replaced and Voluntarily Replaced Share-based Payment Awards**

Introduction

1. IFRS 3 contains requirements for the measurement of some share-based payment awards. However, IFRS 3 does not contain explicit requirements for:

   (a) the measurement of share-based payment awards of the acquiree that the acquirer does not replace in the business combination; and

   (b) the allocation of the value of share-based payment awards of the acquiree that the acquirer voluntarily replaces in the business combination.

2. *Issue: Constituents have asked the IFRIC to clarify how those share-based payment awards should be accounted for.*

Background

3. Paragraph 30 of IFRS 3 requires an acquirer to measure a liability or an equity instrument related to the replacement of an acquiree's share-based payment awards with share-based payment awards of the acquirer in accordance with IFRS 2.

4. In addition, paragraphs B56 to B61 require an acquirer that is obliged to replace a share-based payment award of the acquiree to account for the exchange as a modification of a share-based payment award in accordance with IFRS 2 *Share-based Payment* and to measure the replacement awards at their acquisition date market-based measure.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

5. IFRS 3.B56 states that if the acquirer is obliged to replace awards, either all or a portion of the market-based measure of the acquirer's replacement award is included in measuring the consideration transferred in the business combination. Paragraph B56 also states that in some situations, acquiree awards may expire as a consequence of a business combination. If the acquirer replaces those awards even though it is not obliged to do so, all of the market-based measure of the replacement awards shall be recognised as remuneration cost in the post-combination financial statements.

6. IFRS 3 does not contain explicit requirements for:

   (a) the measurement of share-based payment awards of the acquiree that the acquirer does not replace in the business combination (unreplaced awards); and

   (b) the allocation of share-based payment awards of the acquiree that the acquirer voluntarily replaces in the business combination, with the exception of acquiree awards that would expire as a result of the business combination (other voluntarily replaced awards).

7. With respect to the unreplaced awards in Note 6(a) above, constituents ask:

   (a) Are unreplaced awards part of the consideration transferred for the acquiree or part of the non-controlling interest (NCI)?

   (b) Should unreplaced awards be remeasured at the acquisition date?

   (c) What is the measurement basis?

   (d) Should an entity allocate some or all of the value of the unreplaced awards to post-combination expense?

8. With respect to the other voluntarily replaced awards in Note 6(b) above, constituents ask how an entity should allocate the value of replacement awards between consideration transferred and post-combination expense. This occurs, for example, when the acquiree awards are unaffected by a business combination or when vesting accelerates as a consequence of a business combination if the award is not replaced.

Staff Analysis

Share-based payment awards of the acquiree that are not replaced by the acquirer

Classification as non-controlling interest

9. The staff considers that the unreplaced awards of the acquiree meet the definition of non-controlling interest. Equity-settled share-based payment awards are part of the equity of the acquiree. As they are not controlled by the owners of the acquirer after the acquisition, they meet the definition of NCI. Paragraph 4 of IAS 27 defines NCI as the equity in a subsidiary not attributable, directly or indirectly, to a parent.

Measurement date and basis

10. If the IFRIC agrees with the Staff that the unreplaced awards are part of non-controlling interest, the staff considers that unreplaced awards should be measured at their market-based measure at the acquisition date. This is supported by the Board's conclusion in paragraph BC209 that "…in principle, an acquirer should measure all components of a business combination, including any non-controlling interest in an acquiree, at their acquisition-date fair values."

11. IFRS 3 allows entities the choice to measure NCI at its proportionate share of the acquiree's identifiable net assets. As explained in Paper 3C– Measurement of NCI, the staff believes that when the Board issued IFRS 3 (as issued in 2008) it intended the measurement choice to apply only to those components of NCI that are equivalent to minority interests as defined in IFRS 3 (as issued in 2004) (MI).

12. Therefore, the staff believes that NCI components other than MI should be measured at fair value or other measurement basis as required by the IFRS. That means the unreplaced awards that are stock options should be measured in accordance with the method in IFRS 2 *Share-based Payment.*

13. The staff is concerned that some constituents argue that, because there is no explicit guidance in IFRS 3, the business combination should not affect the measurement of unreplaced awards and therefore the grant-date measurement of those awards should be carried over. Some constituents refer to IFRS 2 which

states that if a modification of a share-based payment award does not result in incremental value, the original grant date fair value accounting is preserved. The staff disagrees with the reference to IFRS 2 because the requirements in IFRS 2 address a change in the terms of a share-based payment award. In contrast, in a business combination the parties to the award change when the acquirer, which has never been a party to the arrangement, assumes the obligation from the perspective of the acquirer.

14. The staff believes that the proposal would create a consistent treatment of cash-settled share-based payment awards that are classified as liabilities and would be measured at their acquisition date fair value and equity-settled share-based payment awards that according to the proposal would be measured at their acquisition-date market-based measure. Both of these are consistent with the accounting requirements of IFRS 2.

Apportionment to consideration transferred and post-combination expenses

15. If the unreplaced awards are remeasured at their market-based measure at the acquisition date, a further question arises about whether and how an entity should allocate some or all of the value to post-combination expense. The staff has learned that constituents currently hold different views:

View 1 Proponents of this view note that the application guidance in paragraph B56 applies only when an entity is obliged to replace the share-based payment awards of the acquiree. In this case, either all or a portion of the replacement awards are included in the consideration transferred in the business combination. Proponents of View 1 argue that, because the scope of the application guidance is limited to share-based payment awards that the entity is obliged to replace, an entity should account for other replacement awards in full as post-combination compensation expenses.

They point out that the general principle of IFRS 3 is to reappraise contracts at the acquisition date as if that were the inception date of those contracts. The reappraisal of unreplaced awards as a new arrangement would imply that they should be recognised as post-combination compensation expenses over the remaining vesting period.

View 2 Proponents of this view note that, when the acquirer does not replace the share-based payment awards of the acquiree, it is obliged to honour the terms of the existing awards. Accordingly, they argue that it would not be appropriate to apportion all of the value of the unreplaced awards to post-combination compensation. Rather, they would apply the allocation guidance in paragraph B56 to unreplaced awards by analogy and allocate some or all of the market-based measure of those rewards to NCI.

View 3 Proponents of this view believe that the standard is not clear. Therefore an entity has a policy choice between View 1 and 2.

16. The staff agrees with View 2 and that the acquirer is bound by the terms of unreplaced awards. If the employees have provided services for unreplaced awards they are accounted for as NCI. Therefore, a portion of the market-based measure should be allocated to NCI. The staff believes that an entity should include in post-combination expense only that portion of the market-based measure that relates to undelivered employee services. An entity would achieve this accounting outcome if it applied the application guidance in paragraphs B57 to 61 of IFRS 3.

Question to the IFRIC (1)	
(a)	Does the IFRIC agree that unreplaced awards are non-controlling interest and are measured at a market-based measure in accordance with IFRS 2 on the date of acquisition?
(b)	Does the IFRIC agree that the application guidance in paragraphs B57 to 61 of IFRS 3 should be adopted for the apportionment of the market-based measure of the unreplaced awards to the consideration transferred and post-combination expenses?

Share-based payment awards of the acquiree that the acquirer chooses to replace

17. The staff has learned that constituents also apply Views 1 to 3 in paragraph 17 of this agenda paper to other voluntarily replaced awards.

18. The staff notes that the wording in IFRS 3 is not intended to limit the allocation of the market-based measure of share-based payment awards between consideration transferred and post-combination expense to those awards that are mentioned in paragraph B56. The staff considers that for share-based payment awards that are not explicitly addressed in the application guidance, judgement is required to determine whether some or all of the market-based measure should be allocated to consideration transferred.

19. The staff believes that when an acquirer issues share-based payment awards to replace unexpired share-based payment awards of the acquiree at the time of the business combination, the replacement awards represent consideration transferred, regardless of whether the acquirer must or chooses to replace those awards. Paragraph 37 of IFRS 3 states that consideration transferred includes the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the aquiree and equity interests issued by the acquirer. The issue of replacement award represents consideration transferred because it is an issue of equity instruments of the acquirer in exchange for unexpired awards of the acquiree.

20. The staff also considers that when issuing replacement awards voluntarily the acquirer honours its obligation to the terms of the existing share-based payment awards. This is no different from honouring a change of control provision in the existing terms of the awards, i.e. “obliged to replace” as prescribed in IFRS 3.

21. Accordingly, an acquirer should apply the same requirements, regardless of whether it is “obliged to replace” the share-based payment awards or chooses to replace those awards.

Question to the IFRIC (2)	
(a)	Does the IFRIC agree with the staff analysis that other voluntarily replaced awards shall be accounted for similarly as “obliged to replace” awards in paragraph B56 of IFRS 3?

Staff recommendation

22. The staff believes that agenda paper 3C – Measurement of Non-controlling Interests addresses the issues on the classification, measurement date and basis of unreplaced awards.

23. If the IFRIC agrees with the staff's analysis in questions 1 and 2 above, the staff believes that there are two alternatives to approach the apportionment issue of unreplaced and other voluntarily replaced awards:

    (a) the IFRIC could add a project to its agenda to clarify the accounting for unreplaced awards and other voluntarily replaced awards; or

    (b) the staff could present the issues to the Board for their consideration for potential inclusion in the exposure draft of proposed Improvements to IFRSs

24. The staff recommends alternative (b). The staff is concerned that the current wording of IFRS 3 might not be sufficiently clear for constituents to reach the staff conclusion and therefore an amendment to the standard might be needed. The staff, in this case, propose amending paragraph B56 of IFRS 3 Appendix B and adding a new paragraph B62A to clarify that the requirement applies to unreplaced awards, and all replacement awards, including voluntarily replaced awards. A draft of the proposed amendment is included in Appendix A.

Question to the IFRIC (3)	
(a)	Does the IFRIC agree that the issues should not be added to its agenda?
(b)	If the IFRIC agrees with the staff on question (a), does it believe it is necessary to amend IFRS 3 and agree to propose such an amendment to the Board?
(d)	Does the IFRIC have any comments on the proposed wording of the drafting in Appendix A?

IFRIC Agenda Criteria

25. The staff has analysed the issue against the IFRIC's agenda criteria:

    (a) Can the issue be resolved efficiently within the confines of existing IFRSs?
    We do not believe IFRSs provide sufficient guidance to resolve the issue.

    (b) Do the issues indicate significantly divergent interpretations (either emerging or already existing in practice)?
    Although the standard is only effective on 1 July 2009, we understand there are emerging divergent interpretations.

    (c) Would financial reporting be improved through elimination of the diverse reporting methods?
    Yes, because of the emerging divergent interpretations.

[Appendix A has been omitted from this observer note]