30 Cannon Street, London EC4M 6XH, United Kingdom

Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **March 2009, London**

Project: **Annual Improvements Project – Comment Letter Analysis**

Subject: **IAS 39 *Financial Instruments: Recognition and Measurement* Scope exemption for business combination contracts (IAS 39.2(g)) (Agenda Paper 10C)**

SUMMARY OVERVIEW

1. Included in the exposure draft of proposed *Improvements to IFRSs* issued in August 2008 was a proposed amendment of the scope exemption for business combination contracts within IAS 39 *Financial Instruments: Recognition and Measurement*. The objective of this paper is to obtain a final Board decision to allow this issue to be included in the final *Improvements to IFRSs* planned to be issued in April 2009. This agenda paper:

a. provides **background** information on the issue,

b. **analyses the comments received** as part of the exposure draft process,

c. **recommends changes** to the proposed amendment, and

d. **requests the Board to confirm** whether they agree with the staff's recommendations.

2. The staff recommendation is to approve the amendment with the revisions the staff suggests to the exposure draft. Appendix A shows the proposed amendment with revisions from the currently effective standard. Appendix B shows the revisions from the exposure draft proposal.

BACKGROUND

3. 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'.

4. In 2007, IFRIC was asked whether this scope exception applies only to binding contracts (forwards) to acquire shares that constitute a controlling interest in another entity or if it applies more widely (for example to option contracts). Additionally, the submission to the IFRIC 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.

5. After its November 2007 meeting, the IFRIC published a tentative agenda decision not to add the issue to its agenda 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. The IFRIC also noted that scope exceptions cannot be applied by analogy to other transactions. The IFRIC did not expect significant diversity in practice in the application of these requirements.

6. The IFRIC received several comments from constituents on the tentative agenda decision and reconsidered the issue at the January 2008 meeting. 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 and the IFRIC 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.

7. At the April 2008 meeting, the Board deliberated the questions identified by the IFRIC. At that meeting, the Board approved the following conclusions to be included in the exposure draft of proposed *Improvements to IFRSs* issued in August 2008, to clarify that the exemption in paragraph 2(g) of IAS 39:

   a. 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, and

   b. does not apply to interests in associates and other similar transactions.

COMMENT LETTER ANALYSIS

8. The Board received 60 comment letters on the entire ED. Most comment letters included a specific comment directly related to this issue.

9. Several of the respondents want the scope exemption to include **option contracts** in addition to forward contracts. One respondent states, "In our view, the amendment to paragraph 2(g) may result in an option arrangement, that is not currently exercisable, to purchase shares in an entity that holds a property (or group of properties) to be accounted for as a derivative. In contrast, the very same arrangement, except that the option is currently exercisable, would be excluded

from the scope of IAS 39 based on paragraph 2(a). Further, a contract to purchase a property directly (rather than through shares in an entity) would not be accounted for as a derivative as it would generally be a contract to purchase a non-financial item that cannot be net settled in cash in accordance with IAS 39, paragraph 5. Consequently, transactions that are economically identical would be accounted for differently and result in a situation where form over substance of an arrangement impacts the accounting treatment."

10. The staff does not agree with this analysis. In our view the conclusion depends first on the assumption that a single property (or group of properties) meets the definition of a business in IFRS 3. It also depends on the assumption that the currently exercisable option results in a conclusion that the option holder controls the property entity and should therefore consolidate it. If both assumptions are true, we agree that the option would be excluded from IAS 39 under paragraph 2(a). However, we also believe that if the property entity is not considered to be a business, the non-exercisable option would be a contract to purchase items, many of which are non-financial. If the contract cannot be settled net in cash, it would be within the scope of IAS 39 paragraph 5 in precisely the same way as a contract to acquire a property directly described by the respondent. Therefore we disagree with the assertion that the amendment would result in accounting based on form rather than on substance.

11. The staff does not believe any option contracts should be included in the scope exemption. Based on the principles of IAS 39, purchase and sale contracts meet the definition of a derivative; however, IAS 39 includes various exemptions for practical reasons. The intent of paragraph 2(g) is to provide an exemption from the provisions of IAS 39 for contracts that will result in business combinations, that is, for transactions that are firmly committed to be completed. Once consummated, the business combination will follow the provisions of IFRS 3. The scope exemption should be allowed only when completion of the business combination is not dependent on further actions of either party (and only the passage of time is required). An option contract allows one party to control the

occurrence or non-occurrence of future events depending on whether the option is exercised.

12. The staff agrees with the guidance issued by one accounting firm which states, "In our view, an option to acquire a business is a derivative that falls within the scope of IAS 39; the scope exemption [in paragraph 2(g) of IAS 39] does not extend to options because with an option an acquisition is conditional upon the option being exercised. Therefore the option will be measured at fair value through profit or loss, and the cost of acquisition should include the fair value of the derivative at the date of acquisition."

13. Several respondents noted the proposed amendment should be altered to include **"in substance" or "synthetic" forward contracts** stating that these types of contractual agreements are "substantially identical with forward contracts, i.e. the economic results are the same as with 'real' forward contracts. Examples of these types of contracts include the combination of a written put and purchased call where the strike prices, exercise dates and notional amounts are equal.

14. Guidance issued by an accounting firm explicitly includes in substance forward contracts within the scope exclusion of paragraph 2(g) of IAS 39 noting that "the combination of the put and the call is economically equivalent to a forward contract that will result in a business combination that is certain to occur. Equally, an option that is very deeply in the money at inception because the strike price is very low compared with the value of the shares to be delivered under it, which is analogous to a forward contract, is also outside the scope of IAS 39."

15. The staff notes the range of views accepted in practice; however, the staff does not agree with the notion that synthetic forward contracts are substantially identical to forward contracts. Synthetic forward contracts provide optionality to both parties; forward contracts have no optionality, but rather commit both parties. The staff agrees that in normal financial instrument transactions, the economics of a synthetic forward will be favourable to one of the parties to the contract and should therefore result in its exercise. However, we do not believe that a similar assumption necessarily holds in business combination transactions –

one of the parties may choose not to exercise the option due to other factors. Therefore, the staff does not believe synthetic forwards should be included in this scope exemption.

16. Similar to the staff's analysis earlier in paragraph 10, we believe that a deep in the money option would be considered in determining whether the holder of the option had control in accordance with IAS 27. If so, that option would be covered by the exemption in paragraph 2(a) of IAS 39.

17. A few of the respondents noted that the scope exemption should apply only to contracts that are settled within a **normal time frame**. One respondent states, "In our view, only forward contracts that transfer control within the normal time frame for a business combination are outside the scope of IAS 39; normal time frame being limited to situations in which the acquisition will occur subject only to the passage of time to allow administrative-type tasks to be completed and any approval from a third party to be obtained."

18. The staff agrees that the scope exemption should be limited to contracts that are settled within a normal time frame. The draft wording proposed in Appendix A has been revised to include this notion.

19. Several respondents questioned why the scope exemption from IAS 39 does not also apply to contracts to acquire **interests in associates and joint ventures**. Many of these respondents referred to paragraph 20 of IAS 28 referencing "the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate."

20. The staff believes the reference to paragraph 20 of IAS 28 needs to be read in conjunction with the surrounding paragraphs. The staff believes the intention of IAS 28.20 is to express the principle that transactions akin to "intercompany transactions" need to be eliminated within the consolidated financial statements of the reporting entity. IAS 28 states:

> 20 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 the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.
>
> 21 A group's share in an associate is the aggregate of the holdings in that associate by the parent and its subsidiaries. The holdings of the group's other associates or joint ventures are ignored for this purpose. When an associate has subsidiaries, associates, or joint ventures, the profits or losses and net assets taken into account in applying the equity method are those recognised in the associate's financial statements (including the associate's share of the profits or losses and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies (see paragraphs 26 and 27).

21. Further, in a business combination, the acquirer is purchasing a business, as defined in IFRS 3. In contrast, the acquisition of an interest in an associate is the acquisition of a financial interest in another entity over which the reporting entity has significant influence (but not control). The acquisition of an interest in an associate is the acquisition of a financial instrument that will be presented in the statement of financial position on one line (and not the acquisition of a business that will be consolidated within all aspects of the financial statements of the group). This is consistent with the Board's conclusions reached regarding impairment losses in investments in associates as noted in the *Improvements to IFRSs* issued in May 2008 and stated in BC27 of IAS 28.

22. One respondent commented that use of the word **"vendor"** in the scope exemption may be misinterpreted when applied around the world. "…the wording in paragraph 2(g) describes the parties to such forward contracts as being the 'acquirer and vendor'. It is unclear who qualifies as a 'vendor'. Generally, such forward contracts are either between an acquirer and an acquiree or an acquirer and another shareholder. Using the term vendor appears to restrict the scope exception to only forward contracts between an acquirer and vendor. We therefore recommend…" removing the reference to 'between an acquirer and a vendor'.

23. The scope exemption is meant to apply to both the acquirer and the entity or entities from which the acquirer is obtaining control. The staff notes that the term "vendor" is included in the existing version of paragraph 2(g) – it was not added by the exposure draft proposals. However, although IFRS 3includes numerous references to the acquirer, when the acquirer transfers consideration, obtains controls, etc., the staff also notes that there is no defined term for the other party or parties to the business combination transaction. The staff believe the reference to 'vendor' can be replaced with 'selling shareholders' as that term is used in Appendix B of IFRS 3 to avoid confusion while maintaining the principle of the standard. The staff has incorporated this change into the updated draft in Appendix A.

24. A few respondents commented that the **transition provisions** should be clarified stating, "We note that an entity shall apply this amendment prospectively for annual periods beginning on or after 1 January 2010. Thus, we understand that put or call options, excluded from the scope of IAS 39 and existing at the opening balance of the period beginning on or after 2010, will have to be recognised in the balance sheet as derivatives measured at fair value, with effect in equity. We believe the Board should clarify that point."

25. Another respondent states, "…we would strongly recommend that it is applied prospectively to new transactions occurring on or after 1 Jan 2010. Since the change would be fundamental, we consider that transaction[s] entered into in accordance with the current standards should be 'grandfathered!'"

26. The staff believes the amendment should be applied prospectively to contracts outstanding when the amendment is adopted. The staff continues to believe that retrospective application is not appropriate as it would require the use of hindsight in many instances. This is also true for retrospective application to contracts that are currently outstanding. The staff has clarified the draft wording in Appendix A to state that adoption is prospective for all unexpired contracts as of the adoption date (vs. prospective for new contracts entered into after the adoption date).

SUMMARY OF STAFF RECOMMENDATIONS

27. The staff recommends that the Board proceed with the amendment to clarify the application of IAS 39 paragraph 2(g).

28. The staff recommends that the proposed basis for conclusions clarify why paragraph 2(g) does not apply to contracts to acquire investments in associates and other similar transactions.

29. The staff recommends keeping the effective date and prospective application transition as proposed in the exposure draft. Additionally, the staff recommends clarifying that the amendment applies to all contracts outstanding as of the effective date (not contracts entered into after the effective date).

30. The staff's recommended draft wording for paragraph 2(g) and a draft basis for conclusions are included as appendices:

    a. Appendix A shows the proposed amendment with revisions from the currently effective standard identified, and

    b. Appendix B shows revisions from the previously issued exposure draft.

31. The staff also recommends that the proposed amendment be finalised for inclusion within the final *Improvements to IFRSs* expected to be issued in April 2009.

QUESTIONS FOR THE BOARD

32. **Does the Board agree with the staff recommendations in paragraphs 27 to 31? If not, how would the Board like to proceed?**

33. **Does the Board agree with the proposed drafting changes in Appendix A? If not, what does the Board recommend?**

Appendix A – Draft Wording (showing changes from currently effective standard)

Proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement*

Paragraphs 2(g) is amended (new text is underlined and deleted text is struck through) and paragraph 103H is added.

Scope

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

(a) ...

(g) <u>any forward </u>contract~~s~~ between an acquirer and a ~~vendor~~<u> selling shareholder </u>to buy or sell an acquiree <u>that will result</u> in a business combination at a future <u>acquisition </u>date. <u>The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to close the transaction.</u>

(h) ...

Effective date and transition

103H *Improvements to IFRSs* issued in April 2009 amended paragraph 2(g). An entity shall apply the amendment prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

Amendment to Basis for Conclusions on IAS 39 *Financial Instruments: Recognition and Measurement*

After paragraph BC24, a heading and paragraphs BC24A – BC24E are added.

Business combination forward contracts

BC24A The Board was advised that there was diversity in practice regarding the application of the exemption in paragraph 2(g) of IAS 39. Paragraph 2(g) applies to particular contracts arising from a business combination and results in those contracts not being accounted for as derivatives while, for example, necessary regulatory and legal processes are being completed.

BC24B As part of the *Improvements to IFRSs* issued in April 2009, the Board concluded that paragraph 2(g) should be restricted to forward contracts between an acquirer and a selling shareholder to buy or sell an acquiree in a business combination at a future acquisition date and should not apply to option contracts, whether or not currently exercisable, that on exercise will result in control over an entity.

BC24C The Board concluded that paragraph 2(g) is to exempt contracts for business combinations that are firmly committed to be completed from the provisions of this Standard. Once consummated, the business combination will follow the provisions of IFRS 3. Paragraph 2(g) applies only when completion of the business combination is not dependent on further actions of either party (and only the passage of a normal period of time required). Option contracts allow one party to control the occurrence or non-occurrence of future events depending on whether the option is exercised.

BC24D Several respondents to the exposure draft expressed the view that the proposed amendment should also apply to contracts to acquire investments in associates referring to paragraph 20 of IAS 28. However, the acquisition of an interest in an associate represents the acquisition of a financial instrument. The acquisition of an interest in an associate does not represent an acquisition of a business with subsequent consolidation of the constituent assets. The Board noted that paragraph 20 of IAS 28 explains only the methodology used to account for investments in associates. This should not be taken to imply that the principles for business combinations and consolidations can be applied by analogy to accounting for investments in associates and joint ventures. The Board concluded that paragraph 2(g) should not be applied by analogy to contracts to acquire investments in associates and similar transactions. This conclusion is consistent with the conclusion the Board reached regarding impairment losses in investments in associates as noted in the *Improvements to IFRSs* issued in May 2008 and stated in BC27 of IAS 28.

BC24E Some respondents to the exposure draft raised concerns about the proposed requirement to apply the amendment prospectively. The Board noted that determining the fair value of a currently outstanding contract when its inception was prior to the effective date of this amendment would require the use of hindsight and may not achieve comparability. Accordingly, the Board decided not to require retrospective application. The Board also rejected prospective application of the amendment only to new contracts entered into after the effective date because that would create a lack of comparability between contracts outstanding as of the effective date and contracts entered into after the effective date. Therefore, the Board concluded that the effective date of the amendment to paragraph 2(g) should be applied prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010.

Appendix B – Draft Wording (showing changes from Exposure draft issued in August 2008)

Proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement*

Paragraphs 2(g) is amended (new text is double-underlined and deleted text is double-struck through) and paragraph 103H is added.

Scope

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

(a) ...

(g) any forward contract ~~that results from an agreement entered into before the acquisition date (ie before the date on which the acquirer obtains control of the acquiree)~~ between an acquirer and a ~~vendor,~~ selling shareholder to buy or sell an acquiree that will result in a business combination~~, to buy or sell an acquiree~~ at a future acquisition date~~ and at a specified price (or on a specified price basis)~~. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and close the transaction.

(h) ...

Effective date and transition

103H *Improvements to IFRSs* issued in April 2009 amended paragraph 2(g). An entity shall apply the amendment prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.