INTRODUCTION

1. As part of the short-term convergence project, the IASB has been considering differences between IAS 12 *Income Taxes* and FASB Statement 109 *Accounting for Income Taxes* and developing tentative conclusions with the goal of achieving convergence on these two standards. At this joint meeting the IASB and FASB will discuss how to account for the tax effects of acquisitions of assets that are not accounted for as a business combination where the amount paid is different from the tax base of the asset acquired.

DESCRIPTION OF ISSUE

2. Both IAS 12 and Statement 109 take a similar basic approach to accounting for income taxes. The underlying approach in both standards is the balance sheet liability approach whereby an entity recognises deferred tax assets and liabilities for temporary differences (differences between the carrying amount of an asset or liability in the balance sheet and its tax base) and for operating loss and tax credit carryforwards.
3. Despite having a similar basic approach, there are several significant differences between IAS 12 and Statement 109. IAS 12 currently provides a general exception to the basic principle of recognising deferred tax assets and liabilities for temporary differences that arise from the initial recognition of an asset or liability whereas Statement 109 does not. Specifically, IAS 12 prohibits an entity from recognising a deferred tax liability or asset for taxable temporary differences that arise from the initial recognition of an asset or liability in a transaction which is (i) not a business combination, and (ii) at the time of the transaction affects neither accounting profit nor taxable profit (‘initial recognition exemption’). Furthermore, IAS 12 explicitly states that an entity does not subsequently recognise changes in this unrecognised deferred tax asset or liability.

4. Statement 109 does not provide specific accounting guidance for asset acquisitions that are not accounted for as business combinations. The US Emerging Issues Task Force (EITF) addressed this issue in EITF Issue 98-11 Accounting for Acquired Temporary Differences in Certain Transactions That Are Not Accounted for as Business Combinations. The EITF concluded that when accounting for the tax effect of single-asset acquisitions in which the amount paid differs from the tax base (or tax basis under US GAAP) of an asset, an entity should allocate the consideration paid between the asset and the related deferred tax asset or liability. The EITF also concluded that the simultaneous equations method\(^1\) should be used to determine the assigned value of the asset and the related deferred tax asset or liability.

**IASB DELIBERATIONS TO DATE**

5. At the April 2003 IASB meeting the IASB tentatively decided to eliminate the initial recognition exception, but expressed concern at converging with the accounting treatment prescribed by EITF 98-11. The primary concern expressed by the IASB was that the accounting treatment prescribed by EITF 98-11 could

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\(^1\) The simultaneous equation method allows an entity to solve for two unknown variables (in this case, the amount at which the asset is recorded and the related deferred tax asset or liability) based on two known relationships.
result, in certain circumstances, a deferred credit in the balance sheet that does not meet the definition of a liability\(^2\). At that time the FASB staff indicated that the FASB might be willing to move away from the accounting treatment prescribed by EITF 98-11. Accordingly, the IASB directed the IASB staff to work with the FASB staff to explore alternative solutions.

6. At its March 2004 meeting, the IASB deliberated the issue of accounting for the tax effects of acquisitions of assets that are not accounted for as a business combination where the amount paid is different from the tax base of the asset acquired. At that meeting, the IASB staff presented three potential methodologies for accounting for the tax effects of acquisitions of assets that are not accounted for as a business combination where the amount paid is different from the tax base of the asset acquired. Those methodologies are as follows:

- **View A** – recognise the deferred tax asset or liability as the difference between the consideration paid and the tax base multiplied by the tax rate; the resulting deferred tax benefit or expense is recognised immediately in profit or loss;

- **View B** - allocate the consideration paid between the asset and the related deferred tax asset or liability using the simultaneous equations method; and

- **View C** - allocate the consideration paid between the asset and the related deferred tax asset or liability using the simultaneous equations method; however, any tax benefit in excess of the cost of the related asset is recognised immediately in profit or loss.

7. The IASB tentatively concluded that in these situations, an entity should allocate the consideration paid between the asset and the related deferred tax asset or

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\(^2\) A deferred credit may arise if the tax base of the acquired asset is significantly greater than the cash purchase price such that the resulting deferred tax asset is greater than the cash purchase price. Because the initial carrying amount of the asset cannot be less than zero, the asset is recorded at zero and the excess of the amount assigned to the deferred tax asset over the cash purchase price paid for the asset is recorded as a deferred credit.
liability using the simultaneous equations method; however, any tax benefit in excess of the cost of the related asset is recognised immediately in profit or loss.

FASB DELIBERATIONS TO DATE

8. The FASB has recently begun its deliberations on the short-term convergence project on income taxes. The issue of accounting for the tax effects of acquisitions of assets that are not accounted for as a business combination where the amount paid is different from the tax base of the asset acquired is the first convergence issue being considered by the FASB in this project. The FASB discussed this issue at its Educational Session on April 13, 2004 and deliberated it at its Board Meeting on April 14, 2004.

9. At the FASB Board meeting the FASB staff presented five potential methodologies for accounting for the tax effects of acquisitions of assets that are not accounted for as a business combination where the amount paid is different from the tax base of the asset acquired. A brief summary of those methodologies are as follows:

Alternatives That Retain Simultaneous Equations to Calculate to FBB\(^3\)

- Alternative 1 — adopt the IASB’s proposed answer which is to compute asset values using the simultaneous equations and record any calculated deferred credits in income.
- Alternative 2 — retain EITF Issue 98-11 guidance
- Alternative 3 — compute asset and DTA/DTL (deferred tax asset/deferred tax liability) using simultaneous equations and record any calculated deferred credits as a purchase discount allowance to the DTA

\(^3\) ‘FBB’ is taken from EITF 98-11 and stands for Final Book Basis. It represents the amount that the asset is initially recognised at on the balance sheet.
Alternatives That Use Fair Value to Compute FBB

- Alternative 4 — record non-monetary asset at fair value, DTA/DTL using Statement 109 [IAS 12], and any calculated deferred credits as a gain on purchase
- Alternative 5 — record non-monetary asset at fair value, DTA/DTL using Statement 109 [IAS12], and any calculated deferred credits as a purchase discount allowance to the DTA

10. The FASB did not reach a firm decision on this issue and requested that it be included on the agenda for the joint IASB/FASB meeting. The primary reason for this is that the FASB staff presented five potential methodologies for accounting for the tax effects of acquisitions of assets that are not accounted for as a business combination where the amount paid is different from the tax base of the asset acquired which includes three methodologies that the IASB did not consider when it deliberated the issue in March 2004. Accordingly, the FASB wishes to allow the IASB to consider the additional methodologies.

JOINT MEETING

11. The staff’s goal for this joint meeting is to reach a high-quality converged solution on accounting for the tax effects of acquisitions of assets that are not accounted for as a business combination where the amount paid is different from the tax base of the asset acquired.

12. As discussed above, the FASB did not reach a firm decision on this issue and would like the IASB to consider the additional methodologies that were presented by the FASB staff. Accordingly, the IASB and FASB will discuss the five methodologies listed in paragraph 9.

13. To aid observers in following the Boards’ discussion, the attached Appendix provides a summary of examples that the Boards will likely discuss during this session.
**Appendix to Short-term Convergence - Income Taxes**

**Example of Accounting Alternatives**

<table>
<thead>
<tr>
<th>Assumptions - A-1, B-1, C-1</th>
<th>If held for use (HFU)</th>
<th>If held for sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPP</td>
<td>700,000</td>
<td>Calc FBB 433,333</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
<td>DTA/DTL 266,667</td>
</tr>
<tr>
<td>Tax Basis</td>
<td>1,100,000</td>
<td>DTA/DTL 240,000</td>
</tr>
<tr>
<td>Fair Value</td>
<td>500,000</td>
<td>FMV FBB 500,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>DTA/DTL 240,000</td>
</tr>
</tbody>
</table>

**Example A-1**

**Tangible asset held for use**

<table>
<thead>
<tr>
<th>IASB approach</th>
<th>Debit</th>
<th>Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alternative 1</td>
<td>433,333</td>
<td>433,333</td>
<td>433,333</td>
<td>500,000</td>
</tr>
<tr>
<td>DTA</td>
<td>266,667</td>
<td>266,667</td>
<td>266,667</td>
<td>240,000</td>
</tr>
<tr>
<td>DTA purch disc</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>(700,000)</td>
<td></td>
<td>(700,000)</td>
<td></td>
</tr>
<tr>
<td>Deferred tax liab</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred credit</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss / (Gain)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Example B-1**

**Tangible asset held for sale**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Debit</th>
<th>Credit</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>DTA</td>
<td>240,000</td>
<td>240,000</td>
<td>240,000</td>
<td>240,000</td>
<td>240,000</td>
</tr>
<tr>
<td>DTA purch disc</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>(40,000)</td>
<td></td>
<td>(700,000)</td>
<td></td>
<td>(700,000)</td>
</tr>
<tr>
<td>Deferred credit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss / (Gain)</td>
<td>(40,000)</td>
<td></td>
<td></td>
<td></td>
<td>(40,000)</td>
</tr>
</tbody>
</table>

**Example C-1**

**Financial asset with a readily determinable fair market value**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>ST Investmts</td>
<td>500,000</td>
</tr>
<tr>
<td>DTA</td>
<td>240,000</td>
</tr>
<tr>
<td>DTA purch disc</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Deferred credit</td>
<td></td>
</tr>
<tr>
<td>Loss / (Gain)</td>
<td>(40,000)</td>
</tr>
</tbody>
</table>

**Example D**

**Transfer of tax attribute alone**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA</td>
<td>5,000,000</td>
</tr>
<tr>
<td>DTA purch disc</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>(2,000,000)</td>
</tr>
<tr>
<td>Deferred credit</td>
<td></td>
</tr>
<tr>
<td>Loss / (Gain)</td>
<td>(3,000,000)</td>
</tr>
<tr>
<td>Description</td>
<td>Value</td>
</tr>
<tr>
<td>-------------------</td>
<td>-------</td>
</tr>
<tr>
<td>CPP</td>
<td>500</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>40%</td>
</tr>
<tr>
<td>Tax Basis</td>
<td>750</td>
</tr>
<tr>
<td>Fair Value</td>
<td>500</td>
</tr>
</tbody>
</table>
1. At their October, 2003 joint meeting, the FASB and the IASB (the Boards) affirmed their decision to include, as part of phase two of their joint short-term convergence project, a FASB-led issue addressing the differences in accounting for research and development expenditures.

2. At this joint meeting, the Boards will consider the scope of such a project.

3. The staff view is that any consideration of apparently narrow differences in accounting for research and development expenditures will inevitably lead both Boards to a reconsideration of fundamental asset recognition and measurement issues that apply to all internally generated intangible assets and to intangible assets in general. In addition, the staff does not believe that convergence around a high-quality solution that is acceptable to both Boards is a realistic short-term goal. Therefore, the staff recommendation is to remove research and development from the scope of the short-term convergence project.
INFORMATION FOR OBSERVERS

JOINT FASB/IASB MEETING: 21/22 APRIL 2004, LONDON

PROJECT: BUSINESS COMBINATIONS II

BUSINESS COMBINATIONS II—APPLICATION OF THE PURCHASE METHOD

The application of the purchase method is a joint project of the IASB and FASB. An important objective of the joint project is to achieve convergence between FASB and IASB guidance in the area of accounting for business combinations.

At this joint meeting the Boards will consider the decision reached at the October 2003 joint meeting of the FASB and the IASB about which assets and liabilities are to be considered part of the business combination accounting. The objective will be to reconcile FASB and IASB members’ interpretations of that decision.

The Boards will first discuss this issue at their separate April meetings (at the FASB meeting on 14 April 2004 and the IASB meeting on 21 April 2004). If the Boards reach the same conclusions at those separate meetings, it is unlikely that the issue will be discussed further at the joint meeting (the Boards’ conclusions will, however, be reported at the joint meeting). If the Boards reach different tentative conclusions at their separate meetings, those differences will be reported and discussed at the joint meeting, with the objective of establishing whether any new information might cause either Board to reconsider its tentative conclusion.
REVISITING WHAT IS CONSIDERED PART OF THE COMBINATION

BACKGROUND

At the February 25, 2004 FASB meeting, certain Board members and staff suggested that the Boards form a collaborative group of FASB and IASB Board and staff members (the Group) to:

a. Clarify the decision reached at the October 2003 joint meeting of the FASB and the IASB about which assets and liabilities are to be considered part of the business combination accounting, with the objective of reconciling FASB and IASB members’ different interpretations of that decision.

b. Consider the concerns and unintended consequences that were identified by external reviewers about an aspect of the October 2003 decision.

c. Determine whether the Boards have a common understanding of, and approach to differentiating, items that meet the definition of a liability and circumstances that do not give rise to a liability, and how to account in a business combination for circumstances that (1) do not give rise to liabilities but (2) involve negative factors (risks) that affect (reduce) the price that a buyer would be willing to pay for the acquiree.

The Group met and developed recommendations for items a and b, and will ask each of the Boards to consider those recommendations at their separate April meetings (FASB meeting - on 14 April 2004 and IASB meeting - on 21 April 2004). The Boards will also discuss item c.

a. WHICH ASSETS AND LIABILITIES SHOULD BE CONSIDERED PART OF THE BUSINESS COMBINATION: FUNDAMENTAL PRINCIPLE

The October 2003 joint decision was reported by each Board as follows:

IASB Decision Summary:

… [T]he Boards agreed to [include] in the business combination accounting:

- The fair values of the identifiable assets and liabilities of the acquiree immediately before the business combination, determined assuming that, from the acquiree’s perspective, there is no prospect of it being acquired in a business combination.

- The other identifiable assets arising from the business combination and liabilities assumed by the acquirer, but only provided they result from the actions or requirements of external parties (such as regulators, legislative provisions, etc).

FASB Action Alert:

The Boards decided that the following assets and liabilities, other than goodwill, should be included as part of the business combination accounting:

1 Minutes of the meeting are available at http://www.fasb.org/board_meeting_minutes/02-25-04_bcpm.pdf. (Refer to pages 13–14.)
• All identifiable assets and liabilities of the acquired business that meet the definition of an asset or a liability immediately before the combination and that would have been assets or liabilities absent the prospects of a business combination.

• Those identifiable assets acquired and liabilities assumed by the combined entity that arise from the combination as a result of actions and requirements of external parties—parties not within the control of either the acquirer or the acquired business. For example, actions of a regulator to induce a combination, requirements of laws that impose obligations as a result of a combination, and so forth.

In considering the October 2003 decision, members of the Group raised concerns about the application of the decision, in particular that it might result in similar circumstances being treated inconsistently when accounting for a business combination. For example, under the Boards’ decision that the fair values of the net assets acquired in a business combination should be determined assuming that there is no prospect of a business combination, a payment triggered by a business combination under a pre-existing contractual agreement with a third party would not have been considered a liability that is part of the business combination, even though it is a present obligation of the acquirer assumed in the business combination. Therefore, the Group agreed that both Boards should revisit the October 2003 decision.

Additionally, the Group observed that for business combinations in which the acquiree has contingent liabilities, issues arise when considering whether a liability exists the moment before a combination. Group members agreed that when the business combination itself is the event that causes a conditional obligation to become unconditional, that obligation (1) is no longer conditional at the acquisition date and (2) ought to be recognised as part of the liabilities assumed in the business combination.

As a result, the Group will ask the Boards to consider an approach to determining which assets and liabilities should be included as part of the business combination accounting that focuses on the circumstances that exist at the acquisition date. This would include circumstances stemming from the terms and conditions of the combination agreement between the seller and the buyer. More particularly, the Boards will be asked by the Group to consider adopting the following fundamental

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2 The IASB has tentatively agreed that a contingent liability should be defined as a “conditional obligation that arises from past events that may require an outflow of resources embodying economic benefits based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.”

3 An exception would be for those circumstances in which there is evidence of an ‘abusive’ transaction (ie a transaction that is structured to circumvent the principles regarding which assets and liabilities should be included as part of, and which should be excluded from, the business combination, so as to achieve favourable accounting results—for example, moving post-combination expenses of the acquirer to pre-combination expenses of the acquiree or its owner (seller)). The identification of abusive transactions is the subject of the second part of the Group’s recommendation and is discussed in part b of these Observer Notes.
principle for the recognition and measurement of assets acquired (other than goodwill) and liabilities assumed:

In a business combination, the acquirer shall recognise the assets acquired (other than goodwill) and liabilities assumed as part of the combination at their fair values at the acquisition date.  

b. WHICH ASSETS AND LIABILITIES SHOULD BE CONSIDERED PART OF THE BUSINESS COMBINATION: ABUSIVE TRANSACTIONS AND ASSESSING THE SUBSTANCE

The Group will suggest an approach for assessing transactions to determine whether they may have been arranged to achieve specific favourable accounting results—for example, moving post-combination expenses of the acquirer to pre-combination expenses of the acquiree or its owner (seller).

The Group noted certain concerns about the application of the fundamental principle, primarily the possibility of the acquirer or the combined entity shifting its expenses into the business combination accounting. These expenses could include both post-combination expenses of the combined entity and those incurred by the acquirer prior to the combination, such as acquisition related transaction costs. To address this concern, the Group developed an approach to assessing transactions entered into by parties to the combination (the acquirer, the acquiree, and the owners of the acquiree) to determine whether the transactions should be excluded from the business combination accounting.

The approach requires a critical assessment of whether a particular transaction is substantive to the combination, with transactions entered into during negotiations or in contemplation of a business combination likely to be more questionable. Because the approach is directed at identifying transactions entered into for the purpose of shifting expenses, its application (and the factors proposed to facilitate its application) would be directed at liabilities arising from transactions entered by (or on behalf of) the acquiree, the seller, the acquirer, or their related parties.

Specifically, the proposed approach would require a determination of whether the transaction relates to benefits received (or to be received) by:

(1) The acquiree, or
(2) The combined entity.

If the transaction relates to benefits received by the acquiree (or its owners), the associated liability is substantive and, therefore, should be included as part of the business combination accounting, assuming it satisfies the fundamental principle. However, if the transaction relates to benefits received or to be received by the combined entity, the associated liability is non-substantive to the combination and the acquirer should not recognise it as part of the business combination accounting.

Because this approach requires judgment—an assessment of whether transactions entered into relate to benefits received by the acquiree—the Group will also propose factors to consider in applying that

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4 Goodwill would be measured as a residual, being the excess of the fair value of the business acquired over the sum of the fair values of the assets acquired other than goodwill less the fair values of the liabilities assumed.

5 Exceptions to the fair value measurement principle would be retained, as previously decided by the Boards, for deferred income taxes and pension, other post-employment benefit, and other employee benefit liabilities.
judgment. Although the factors are related, they are not mutually exclusive and no factor is individually conclusive. To the extent that information is available, all factors should be assessed in applying judgment.

Those factors are:

a. The timing of the obligating event or transaction,
b. The reason for the contract or transaction,
c. Who initiated the contract or transaction, and
d. Whether the acquiree and its owners (or the acquirer or combined entity) is the most significant beneficiary of the arrangement.

In analysing the fundamental principle outlined in a and the approach to dealing with abusive transactions outlined above, the Boards will consider their application to a set of examples. Those examples are included in Attachment A (refer to pages 1-3 of Attachment A).

c. STANDALONE CONTINGENT LIABILITIES (CONTINGENCIES THAT ARE NOT LIABILITIES)

IAS 37 Provisions, Contingent Liabilities and Contingent Assets currently defines a contingent liability as

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognised because:
   (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
   (ii) the amount of the obligation cannot be measured with sufficient reliability.

The IASB has tentatively agreed to redefine a contingent liability as:

…a conditional obligation that arises from past events that may require an outflow of resources embodying economic benefits based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

[Emphasis added.]

This means that items that satisfy part (b) of the current definition of a contingent liability (ie present obligations that are not recognised) would no longer be defined as contingent liabilities. Instead, such items would be defined as unrecognised liabilities. They would therefore qualify as liabilities to be considered for recognition by an acquirer in a business combination.

The IASB has observed that in some (but not all) cases a contingent liability (conditional obligation) is accompanied by an associated unconditional obligation that satisfies the definition of a liability.\(^6\)

\(^6\) For example, an entity that issues a guarantee or provides a warranty has: (i) a contingent liability (conditional obligation) that becomes unconditional when the specified triggering event occurs (ie debtor defaults, product develops a fault) and (ii) an unconditional obligation that satisfies the definition of a liability because the entity has a present obligation to stand ready to perform under the terms of the contract.
Where a contingent liability is accompanied by an associated liability, an acquirer in a business combination would recognise the liability that is associated with the contingent liability and would not recognise separately the contingent liability itself (because the fair value of the contingent liability would be reflected in the fair value measurement of the accompanying liability).

The IASB has also observed that conditional obligations of an acquiree may not be accompanied by associated liabilities. For ease of reference, such contingent liabilities may be referred to as ‘standalone’ contingent liabilities. The IASB observed that contingent liabilities have a fair value and therefore affect the price an acquirer is prepared to pay for an acquiree. In addition, the IASB observed that in some cases, an acquirer might assume contingent liabilities and recognise a gain because of an insufficient amount of positive goodwill to absorb the fair values of those contingent liabilities. The IASB expressed a concern about circumstances in which an identifiable business risk exists at the acquisition date (ie contingent liability) that does not meet the definition of a liability, but which affects (reduces) the price that a buyer would be willing to pay for the acquiree.

The FASB, however, has decided not to use the term contingent liability, in part, because:

a. FASB Statement No. 5, Accounting for Contingencies, does not define the term.

b. Constituents may misunderstand the term to include possible liabilities.

c. Most importantly, the fundamental principle in the business combinations project limits recognition only to those items that qualify as assets or liabilities; thus, there is no compelling need to define any particular class of contingencies (contingent gains or contingent losses) that are not assets or liabilities.

The Boards will discuss the issues surrounding contingent liabilities to determine how to address concerns raised about circumstances in which an identifiable business risk exists at the acquisition date that does not meet the definition of a liability, but which affects (reduces) the price that a buyer would be willing to pay for the acquiree. The critical issue is whether or not there is a need to recognise and measure apart from goodwill any items (potential risks assumed) that do not qualify as a liability at the acquisition date. The concern about this issue seems most heightened when a potential risk becomes identifiable and measurable.

An example of a standalone contingent liability that the Boards may refer to in the discussion is as follows (Examples “New 6” and “New 7” on page 4 of Attachment A):

In September 2000, the European Commission enacted the end-of-life vehicle (ELV) directive. This directive required member states to set legislation to encourage re-use, recycling and other forms of recovery of ELVs. A key requirement of the directive is the free take-back of ELVs at no cost to the final vehicle owner. The EU directive does not set common EU-wide standards but leaves it to member states to define how the requirements should be implemented in their country. Under the directive, manufacturers (or importers of cars into member states) are financially responsible for at least a portion of the cost of the take-back of vehicles placed in service after July 2002 and all vehicles placed in service prior to July 2002 that are still in operation after 31 December 2006.

Therefore, in 2000 (and earlier), car manufacturers operating in Europe knew that they were very likely to be faced with legislation that would result in decommissioning
liabilities not only for vehicles sold in the future, but also, after 2006, for vehicles that they had already sold.

When the IASB considered this example in March, it decided that, prior to substantive enactment of the directive, European vehicle manufacturers and importers had a contingent liability for the conditional obligation to take back those vehicles that they had previously manufactured and which would be in operation after 2006. The IASB also decided that in this example there was no unconditional obligation that satisfied the definition of a liability. Therefore, outside of a business combination, the IASB agreed that, prior to substantive enactment of the directive, European vehicle manufacturers and importers should not recognise a liability, regardless of the likelihood of the directive being enacted.

Under the staff recommendation, an acquirer of a European car manufacturer or importer would not recognise a liability as part of the business combination for the obligation to take back cars, unless the directive had been substantively enacted by the date of the business combination. Instead, the fair value of the contingent liability would be subsumed into goodwill.

The FASB tentatively agreed at its meeting on 14 April 2004 that no exceptions should be made to the fundamental principle in the business combinations project that only those items that qualify as assets or liabilities should be recognised in a business combination separately from goodwill.
### Agreements that Exist Prior to Business Combination Negotiations

<table>
<thead>
<tr>
<th>Example</th>
<th>Part of the Combination under the Oct. 2003 Joint Decision?</th>
</tr>
</thead>
</table>
| L       | **Employee Benefits Part IV – Plan Obligations for which Payment is Conditioned on the Completion of the Business Combination**  
Acquirer Co. acquires 100% of Sub Co. Sub Co.’s has a pre-existing contractual agreement that requires Sub Co. to make payments to its employees in the event that Sub Co. is acquired. Are the payments... | No. |
| N        | Example 2: Target Co. seeks to hire a new chief executive (Candidate). The highly-desired and sought Candidate agrees to accept a position with Target provided that Target agrees to pay Candidate $10 million in the event that Target is acquired prior to Candidate’s voluntary retirement or resignation for certain specified causes not within the control of Target (a golden parachute contract). Ten years later, on December 30, 200X, it becomes virtually certain that Target is to be acquired by Acquirer Co. and that the closing will occur in the first week of January. Is the payment... | Not applicable. |
| E W 2    | Example 3: Target Co. is the target of a much-publicized hostile takeover bid by Acquirer Co. Certain key employees of Target, including the CEO, are concerned that the management of Acquirer Co. intends to replace the executives at Target with its own senior staff. Consequently, the CEO begins to seek employment elsewhere. Worried about its CEO’s departure during a critical moment, Target’s directors offer solace to its CEO by drawing up a golden parachute contract that guarantees the CEO $1 million if Target is acquired. A few weeks later, Acquirer raises its tender offer and Target is acquired anyway. Is the payment... | Not applicable. |
| G        | **Payments Triggered by a Business Combination Part I**  
Acquirer Co. acquires 100% of Sub Co. Sub Co. has an existing contractual agreement with one of its suppliers. That agreement requires Sub Co. to make a fixed payment to the supplier in the event Sub Co. is acquired in a business combination. These future payments meet the definition of a liability at the date of acquisition. Is the future payment to the supplier (which is triggered by the business combination)... | No. |
| B        | **Restructuring Reserves Part II**  
Acquirer Co. purchases 100% of Sub Co. Sub Co. planned to sell its Division A and met the criteria under existing guidance to recognize a liability for certain exit costs associated with the planned sale (IAS 37 or Statement 146). The sale of Division A to another buyer is pending. Acquirer Co. agrees to assume Sub Co.’s liability for the exit costs relating to the sale of Division A. Is Sub Co.’s liability... | Yes. |
| K        | **Employee Benefits Part III – Plan Amendments that are a Condition of the Business Combination**  
Acquirer Co. acquires 100% of Sub Co. It is asserted that Sub Co.’s owners require that as a condition of the business combination, Acquirer Co. improve the post-employment benefit plan for Sub Co.’s employees. Are the effects of the condition... | No. |
| N        | Example 4: Acquirer Co. is attempting to purchase Target Co. and has made a... | Not applicable. |
Example

A tender offer for Target’s shares at a modest premium. Acquirer would like to the CEO of Target to “sell” (push) the deal to Target’s shareholders and directors, who haven’t shown a great deal of enthusiasm for the “merger.” Accordingly, Acquirer promises to compensate the CEO in exchange for his best efforts in seeing to that the business combination is consummated. However, Acquirer would like to avoid recognition of a post-combination compensation expense. So prior to the closing date, Acquirer makes a “quiet” arrangement with the key directors of Target to set up a golden parachute for the CEO—that is, to induce him to sell the deal, an arrangement is made through Target’s directors that promises to pay CEO $10 million in the event that a business combination is consummated. As part of that arrangement, Acquirer agrees that any increase in the liabilities of Target as a result of the golden parachute agreement will not be included in potential downward adjustments to the previously negotiated and agreed upon purchase price. Is the payment . . .

Acquisition Expenses Paid by the Seller

Acquirer Co. seeks to acquire Target Co., a subsidiary of Seller Co. Acquirer Co. would like to avoid recognition of $1m expense for its costs incurred related to legal fees and due diligence associated with the deal. Prior to the closing date, Acquirer Co. makes deal with Seller Co. to pay $1m additional “consideration for Target Co.” if Seller Co. will assume the liabilities for Acquirer Co.’s acquisition related costs. Are Acquirer Co.’s acquisition related costs . . .

Not applicable.

Branding Part I

Acquirer Co. purchases 100% of Sub Co. from Trade Co. Sub Co. owns a fleet of trucks that are branded with Trade Co.’s name. Because Trade Co. will continue to operate other similar truck fleets, it insists that its brand name is removed from Sub Co.’s trucks as a condition of the combination. Is the requirement to remove Trade Co.’s brand name from Sub Co.’s trucks . . .

No.

Payments Triggered by a Business Combination Part II

A law is passed that requires the removal of asbestos. As part of that law, certain companies (including Sub Co.) are “grandfathered” and not required to remove the asbestos unless they are acquired in a business combination. Acquirer Co. acquires 100% of Sub Co., and as a result the combined entity is required to incur the costs to remove the asbestos. Is the obligation to remove the asbestos . . .

Yes.

Weak Bank—Strong Bank

To induce an acquisition of an acquiree (Weak Bank), as a condition of a combination agreement, a regulatory authority agrees to provide financial assistance in the form of cash, a receivable, or guarantees. That assistance is transferred to the acquirer (Strong Bank) or to the newly merged combined entity upon the closing of the combination agreement. Strong Bank and the owners of Weak Bank would not otherwise accept the terms of the combination without the inducement from the regulatory authority. That is, Strong Bank would not pay the amount it agreed to pay to the owners of Weak Bank or the owners of Weak Bank were unwilling to accept lower offers from Strong Bank and other potential buyers. Is the financial assistance from the regulatory authority . . .

Yes.

Not applicable.
### Example

<table>
<thead>
<tr>
<th>I</th>
<th>basis at market rates. Target owns all of the manufacturing assets in the building (including specialized machinery) in addition to a nearby warehousing and distribution facility. Because Target’s business relies on its continuing ability to use the manufacturing building, Acquirer arranges with Seller (as a condition of its acquisition of Target) to also acquire the building. The price of the building is not separately negotiated or identified in the acquisition agreement. At issue is whether Acquirer should consider the acquisition of the building as part of its acquisition of Target. Alternatively, Acquirer could “parse out” the fair value of the building and separately account for its acquisition of (1) Target as a business acquired in a business combination and (2) the manufacturing building as an asset acquisition. Is Acquirer Co.’s agreement to purchase the manufacturing building . . .</th>
</tr>
</thead>
</table>

### Constructive Obligations

<table>
<thead>
<tr>
<th>E</th>
<th>As a result of the business combination, Acquirer Co. assumes a liability of $16,000 that meets the definition of a constructive obligation. The constructive obligation arises because Acquirer Co. has a widely published policy that is historically honored. Under the policy, Acquirer Co. rectifies faults in its products and faults of acquired companies’ products even if these faults become apparent after the warranty period has expired. Sub Co. did not have a similar constructive obligation relating to product faults. Is the constructive obligation . . .</th>
</tr>
</thead>
</table>

### Measurement and Contemplated Commitments

| I | Employee Benefits Part I – Actuarial Assumptions
Acquirer Co. acquires 100% of Sub Co. Acquirer Co.’s actuarial assumptions for its postretirement benefit plan are different than those of Sub Co. Should the measurement of the post-retirement benefit obligation assumed be based on the acquirer’s actuarial assumptions as part of the combination? |
|---|---|

| J | Employee Benefits Part II – Contemplated or Expected Benefit Plan Amendments
Acquirer Co. acquires 100% of Sub Co. Acquirer Co. expects to change the terms of the acquiree’s post-employment benefit plan. Those changes are not made before the acquisition date. Should the effect of expected changes . . . |
|---|---|

| A | Restructuring Reserves Part I
Acquirer Co. purchases 100% of Sub Co. Acquirer Co. plans to sell one of Sub Co.’s divisions (Division A). Do the costs that Acquirer Co. expects to incur give rise to a liability that should be part of the business combination accounting? |
|---|---|

| D | Branding Part II
Acquirer Co. purchases 100% of Sub Co. from Trade Co. Sub Co. owns a fleet of trucks that are branded with the Sub Co.’s name. Acquirer Co. plans to integrate Sub Co. into its operations and plans to brand the trucks using its name. Trade Co. does not insist that the Sub Co. brand name on the trucks be removed. Are the costs to remove the Sub Co.’s brand name from Sub Co.’s trucks and replace it with its own brand name. . . |
|---|---|
Contingent Liabilities (conditional obligations)

<table>
<thead>
<tr>
<th>Example</th>
<th>Part of the Combination under the October 2003 Joint Decision?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>N</strong>&lt;br&gt;<strong>E</strong>&lt;br&gt;<strong>W</strong>&lt;br&gt;6 (From IASB March 2004 Agenda Paper 12)</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Assuming it is August 2000 (prior to the substantive enactment of the directive)</td>
<td>In September 2000, the European Commission enacted the end-of-life vehicle (ELV) directive. This directive required member states to set legislation to encourage reuse, recycling and other forms of recovery of ELVs. A key requirement of the directive is the free-take-back of ELVs at no cost to the final vehicle owner. The EU directive does not set common EU-wide standards but leaves it to Member States to define how the requirements should be implemented in their country. Under the directive, manufacturers (or importers of cars into Member States) are financially responsible for at least a portion of the cost of the take-back of vehicles placed in service after July 2002 and all vehicles placed in service prior to July 2002 that are still in operation in January 2007. Therefore, in 2000, car manufacturers operating in Europe knew that they were very likely to be faced with legislation that would result in decommissioning liabilities not only for ELVs sold in the future, but also, after 2007, for cars that they had already sold. (In fact the EU directive was widely trailed—we note that some entities highlighted the risk in their 1999 financial statements.)</td>
</tr>
<tr>
<td><strong>N</strong>&lt;br&gt;<strong>E</strong>&lt;br&gt;<strong>W</strong>&lt;br&gt;7 (Assuming it is after the substantive enactment of the directive)</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Assuming it is after the substantive enactment of the directive</td>
<td>Using the same facts as the above example. However, assume the EU directive has been substantively enacted.</td>
</tr>
</tbody>
</table>
The FASB, IASB, and ASB Boards met individually in March 2004 to discuss a proposal for a converged project plan that was submitted by the staff of the three Boards (collectively, the Group). There was not unanimous agreement of the Boards for the Group’s recommendation. Given that the Boards have agreed that convergence is an important goal with respect to these similar projects on reporting financial performance/comprehensive income, the Group developed an alternative plan (outlined below). The purpose of the Joint Meeting is for the Boards to discuss and collectively agree on the definitive path forward for this project. Ideally, upon completion of the meeting, the Group should know exactly what they will be working on and the priority in which the topics will be sequenced. Secondarily, the Group wishes to discuss the type and timing of Public Discussion Documents that may be the tangible product produced from the Group’s efforts.

Proposal:

The Group has prioritized the goals included within each Category as follows:

**Category A** includes all decisions related to the following:

1. Single statement of comprehensive income, which includes a subtotal similar to the concept of “net income from continuing operations” or “profit and loss” ¹
2. Agreement on the required primary financial statements
3. Agreement on the number of required years to be presented in comparative financial statements and disclosures
4. Agreement on whether presentation of the direct method should be required for the statement of cash flows.

**Category B** includes all decisions related to the following:

1. Whether there is value in the notion of “recycling” items between the subtotals of net income and other comprehensive income and, if so, to determine a basis for the types of transactions and events that should be recycled and when recycling should occur in the recognition process
2. Develop consistent principles for disaggregating information on each of the required financial statements

¹ This goal does not contemplate a change to any subtotals within the single statement that are currently required or used in practice

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.
3. Define the totals and subtotals to be reported on each of the required financial statements (including categories such as business and financing).

Questions for the Boards:

Categories and their Tangible Deliverables

1. Do Board members agree with the Group’s proposed placement of the goals into Category A and Category B? If not, what changes do Board members believe are necessary and what additional principles would Board members suggest for making the split between the categories?

2. Do Board members agree with the Group’s proposed priority of completion of the goals within each category? If not, what changes do Board members believe are necessary?

3. Should the Group work on Category A and Category B issues concurrently? If not, which Category do Board members believe should be completed first?

4. Should a tangible deliverable (Exposure Draft, Public Discussion Document) be issued upon completion of the deliberations for each category? Should the tangible deliverable be issued before completion of the issues for both Category A and Category B have been deliberated?

5. If Board members believe that a tangible deliverable should be issued (either for each category or the categories combined) what type of tangible deliverable should be issued?

6. If Board members believe that a tangible deliverable should be issued (either for each category or the categories combined) what should be the timing associated with issuing that deliverable?

General

7. Do Board members agree that an external advisory group should be formed and if so, should a single advisory group be formed for all the Boards?

   o Points that each Board should consider:

   a. How many people should form the advisory group?
   b. What are the selection criteria for the advisory group?
   c. When should the advisory group start to work with the Group?
   d. What is the nature and level of frequency of interaction with the Group?
   e. Do Board members believe that it is feasible to consult on the issues in Category A before those in Category B have been similarly exposed? If not, do the issues in Category B have to be fully developed before consultation is launched on Category A or would an indication of the Boards’ thinking and the progress of research to that point suffice?

8. Would Board members consider excluding certain industries (such as financial institutions) from the scope of this project?
The purpose of today’s meeting is to consider further the definition of revenues and other components of comprehensive income. The objective of the meeting is to ascertain what should be included in or excluded from the definition of revenues.

The Boards will discuss four topics related to the definition of revenues. First, the Boards will discuss the distinctions between components of comprehensive income such as revenues and gains and the merits of such distinctions. Second, the Boards will consider whether the production of readily marketable commodities gives rise to a component of comprehensive income, and whether that component is a revenue, a gain, or some other type of comprehensive income. Third, the Boards will consider whether engaging a third party to perform on behalf of a reporting entity by means of subcontracting or outsourcing ultimately gives rise to revenue and related matters of display in the financial statements. Finally, the Boards will discuss whether nonreciprocal transfers from other entities to the reporting entity should be included in the definition of revenues or in a different component of comprehensive income, and the related implications of the latter for the definition of revenues.

**DISTINCTION BETWEEN REVENUES AND GAINS**

**Usefulness of the Distinction**

Standard setters generally acknowledge that the distinctions such as those between revenues and gains are useful, and none argue that distinctions should be prohibited. Making distinctions such as those between revenues and gains helps explain *how* and *why* net assets have increased. That is because:

1. Different components of comprehensive income may arise from different sources having different characteristics, such as transactions with customers as opposed to those with other parties.
2. Some components may be recurring and others may not be recurring.
3. Some components may arise from activities or events over which the reporting entity has control, whereas others may arise from events over which the reporting entity has little or no control.
4. Some components may arise from value-adding activities, whereas others may arise from other value changes, such as those relating to price changes.

Assessment of the Present Distinction between Revenues and Gains

There may be some significant differences between the items presently included in revenues. For example, revenues from a reporting entity’s provision of goods or services to its customers relate to value-for-value exchanges with those customers, while revenues from nonreciprocal transfers do not relate to value-for-value exchanges with customers.

Further, FASB Concepts Statement 6 treats gains as a “catch-all” category of items that are not revenues, and many of the items included in gains have little in common. For example:

1. Some gains result from exchange transactions, while others may result from nonreciprocal transfers.
2. Many gains are nonrecurring, but some may be recurring.
3. Many gains are not controllable by the reporting entity or its management, but others may be subject to at least some degree of control.
4. Some gains are recognized on a net basis, whereas others cannot be described in terms of a net or gross basis (that is, the net amount is equal to the gross amount).

In addition, the current distinctions that Concepts Statement 6 and the IASB Framework make between revenues and gains are somewhat ambiguous and difficult to operationalize. For example, what constitutes a particular reporting entity’s “ongoing major or central operations” or its “ordinary activities” is somewhat subjective, and different entities may interpret their activities differently. Moreover, the difference between ordinary and nonordinary activities is not clear.

Questions for the Boards

1. Do the Boards agree that distinctions between components of comprehensive income such as revenues and gains provide useful information to investors and creditors?
2. Do the Boards agree that the present distinction between revenues and gains is somewhat ambiguous and difficult to operationalize?
READILY MARKETABLE COMMODITIES

In practice today, certain increases in assets that result from a reporting entity’s production activities are recognized as revenues or gains. Those increases typically stem from the creation or enhancement of inventory assets that are readily marketable commodities, such as certain minerals (especially rare metals) and agricultural products. Contracts with customers are not required for increases in those assets to be recognized.

Do Increases in Assets Resulting from Production Give Rise to Comprehensive Income?

The FASB’s existing conceptual guidance specifically indicates that revenues may arise from enhancements of certain assets as the result of a reporting entity’s productive efforts. The IASB’s existing conceptual guidance does not specifically indicate whether revenues may arise from that source.

The standards-level guidance in the United States and internationally pertinent to this issue is relatively sparse. Some of that is longstanding guidance, while other of it is relatively recent. Moreover, certain practices appear also to be longstanding ones. That guidance and those practices generally are limited to items that may be described as readily marketable commodities.

Most asset increases resulting from productive activities presently do not meet the criteria for recognition because of:

1. Uncertainties about whether an increase in an asset giving rise to a component of comprehensive income has in fact occurred.

2. Uncertainties about the measure of that asset and the measure of the corresponding component of comprehensive income.

Those are the two principal hurdles that must be overcome for recognition. However, for readily marketable commodities such as precious metals, biological assets, and agricultural produce, the increases can be determined to have occurred because they can be physically observed, and the ready marketability of those assets means that they can be measured reliably.
What is the Nature of the Component of Comprehensive Income Resulting from Production?

Because an increase in an asset is recorded as a debit, the issue is what the corresponding credit should be. If there is no corresponding increase in a liability or an investment by owners, that credit reflects an increase in comprehensive income. Thus, the question is which component of comprehensive income it is. Is it a revenue, a gain, or some other type of comprehensive income?

Producing readily marketable commodities is both an “ordinary activity” and an “ongoing major or central” activity that relates to producing goods or rendering services. It is the primary or principal activity for reporting entities that produce such commodities because those commodities are saleable with little or no significant effort. That is consistent with the meanings of revenue in the Framework and Concepts Statement 6.

An alternative view of revenues is that revenues may arise only when the reporting entity has entered into a contract with a customer for the provision of goods and services. That view effectively limits the changes in assets and liabilities that give rise to revenues to those increases in assets relating to the reporting entity’s contractual rights vis-à-vis its customers and those decreases in liabilities relating to its contractual obligations vis-à-vis its customers. However, if revenues were defined in accordance with the alternative view, that would not resolve the matter of how to describe the component of comprehensive income that results from production activities.

Were the Boards to decide that increases in readily marketable commodities should not give rise to revenues, those increases would have to be described as a gain or as some other type of comprehensive income, such as “income from production” or “production income.”

Additionally, once production is completed, the recognition of production income would cease. That raises the question about “post-production” situations in which the value of the goods changes between when they are produced and when they are ultimately sold, as well as what should be recognized at date of sale.
Questions for the Boards

1. Do the Boards agree that increases in assets as the result of production can give rise to a component of comprehensive income (acknowledging that those increases would not be recognized unless they can reliably be determined to have occurred and that those assets can be reliably measured)?

2. Do the Boards agree that such increases in assets as the result of production give rise to revenue? If so, do the Boards agree that revenue should be defined consistent with Concepts Statement 6 rather than the alternative?

3. If such increases in assets do not give rise to revenue, do the Boards agree that it gives rise to some other type of comprehensive income such as “income from production” or “production income” rather than a gain?

4. With reference to “post-production” components of comprehensive income:
   a. Do the Boards agree that any difference in the fair value of assets upon completion of production and the ultimate selling prices of those readily marketable commodities constitutes “selling revenue” if that difference relates to selling and delivery efforts?
   b. Do the Boards agree that any difference in the fair value of assets upon completion of production and the ultimate selling prices of those readily marketable commodities constitutes a gain if that difference relates to changes in market prices?

SUBCONTRACTING OR OUTSOURCING

Reporting entities often engage third parties to perform certain of their production, sales, or delivery activities by means of subcontracting or outsourcing. For purposes of this discussion, subcontracting refers only to instances in which there is a customer contract, and outsourcing refers to instances in which there is procurement without a customer contract.

The Boards will discuss whether information regarding a reporting entity’s subcontracting and outsourcing activities is useful to investors and creditors and whether the information should be provided in financial statements. The Boards also will consider whether engaging a third party to perform on behalf of a reporting entity by means of subcontracting or outsourcing gives rise to revenue.
Subcontracting with Legal Layoff

Subcontracting with legal layoff occurs when a reporting entity engages a third party to perform by having it legally assume the entity’s contractual obligations to its customer. As a result, the reporting entity no longer is obligated to the customer when the third party performs the obligation.

At its December 18, 2002 meeting, the FASB tentatively decided that a reporting entity should not recognize revenues for the performance by third parties of its obligations to deliver goods or render services to its customers if those obligations are legally assumed by those parties. The IASB has yet to decide this issue.

Subcontracting without Legal Layoff

Subcontracting without legal layoff occurs when a reporting entity engages a third party to perform without having that party legally assume the entity’s contractual obligations to its customer.

The Boards will discuss whether subcontracting without legal layoff gives rise to revenue for the reporting entity. Some believe that revenues arise because the reporting entity is “on the hook” for those obligations. That view is consistent with the approach to liability extinguishment in FASB Statement No. 140, Accounting for Transfers and Services of Financial Assets and Extinguishment of Assets. Others believe that revenues for the reporting entity do not arise because performance by the reporting entity directly and performance by other subcontractors are different economic activities.

Outsourcing

In outsourcing, a reporting entity is simply procuring goods from another entity, such as parts to be assembled into a finished good. The Boards will consider whether procurement affects the revenues that the reporting entity generates or only its expenses.

Display

The Boards will consider whether information about subcontracting and outsourcing should be provided in the income statement. The Boards will discuss the following examples for displaying the information:
Subcontracting with Legal Layoff

REVENUES:
   Revenues Originally Contracted for $1,000
   Less: Revenues Legally Laid Off to Subcontractors $100
   Revenues $900

Subcontracting without Legal Layoff

REVENUES:
   Revenues from Performance by the Reporting Entity $700
   Revenues from Performance by Subcontractors $200
   Revenues $900

EXPENSES:
   Subcontracting Expenses $200

Alternatively, if the Boards decide that subcontracting without legal layoff does not give rise to revenues for the reporting entity, the display of information about the extent of the reporting entity’s subcontracting could be as illustrated above for subcontracting with legal layoff.

Questions for the Boards

For Both Boards:

1. Do the Boards agree that information about a reporting entity’s subcontracting and outsourcing activities is useful to investors and creditors?

2. Do the Boards agree that information about subcontracting and outsourcing should be provided in the income statement?

3. Do the Boards agree that, consistent with the liability extinguishment guidance in Statement 140, revenues arise for a reporting entity from the performance by a third party of a contractual obligation to a customer for which the reporting entity continues to be obligated?

4. Do the Boards agree that outsourcing does not reduce the amount of revenues?

5. Do the Boards agree with the enhanced display?

For the IASB:

Do revenues arise for a reporting entity from the performance by a third party of a contractual obligation to a customer for which the reporting entity was previously obligated but is no longer obligated?
NONRECIPROCAL TRANSFERS

There are two classes of transactions giving rise to positive components of comprehensive income. One class is exchange transactions\(^1\), in which the reporting entity provides or is obligated to provide goods or services to its customers. The other class is nonreciprocal transfers, in which the reporting entity receives gifts, donations, or grants from benefactors without directly giving value in exchange.

Definition of a “Nonreciprocal Transfer Received”

The Boards will consider whether the following definition of nonreciprocal transfer received (adapted from Concepts Statement 6) should be used as the “working definition” that will be used in the course of the project:

A nonreciprocal transfer received is a transaction in which an entity receives an asset or cancellation of liabilities without directly giving value in exchange.

Usefulness of the Distinction between Exchange Transactions and Nonreciprocal Transfers

The Boards will consider whether distinguishing exchange transactions and nonreciprocal transfers provides useful information to investors and creditors. Some of the differences between them are:

1. Exchange transactions are “value-for-value” events whereas nonreciprocal transfers are not.
2. Increases in comprehensive income resulting from exchange transactions with customers may be more likely to recur from period to period than increases in comprehensive income resulting from nonreciprocal transfers from benefactors, because nonreciprocal transfers may be more discretionary in nature.
3. The efforts required of the reporting entity and the costs that it incurs to generate exchange transactions may be quite different in nature and amount from those to generate nonreciprocal transfers.
4. The margins associated with exchange transactions may be different from those associated with nonreciprocal transfers.
5. The asset investments required to generate exchange transactions with customers may be significantly larger than those to generate nonreciprocal transfers.

\(^1\) Exchange transactions are also described as reciprocal transfers.
Implications for Defining Revenues

If revenues do not include nonreciprocal transfers, a working definition of revenues might be as follows:

Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from the entity’s production, sale, and delivery of products (goods and services)² to customers.

If revenues are to be distinguished from other sources of comprehensive income on the basis of creating and providing goods and services to customers, the term customer must be defined. The Boards will consider whether to adopt the following working definition of customer:

A customer³ is either an individual or a business that purchases the entity’s products (goods or services).

Analysis of Certain Nonreciprocal Transfers

The Boards will consider the accounting for the following types of nonreciprocal transfers: (1) contributions other than government grants and subsidies, (2) contributions in the form of government grants and subsidies, and (3) inflows of assets from winning a lawsuit. Based on the analyses, the Boards will consider confirming the policies in FASB Statement 116, Accounting for Contributions Received and Contributions Made, and IAS 41, Agriculture, that (a) nonreciprocal transfers are distinct economic events, regardless of the intent to compensate for particular outflows of assets and, therefore, (b) government grants and subsidies should be accounted for on a “gross basis.” Further, the Boards will consider whether inflows of assets from winning a lawsuit do not meet the definition of the proposed definition of revenues and whether they should be accounted for and disclosed in the same manner as other nonreciprocal transfers.

Description of Nonreciprocal Transfers

Finally, the Boards will discuss how to classify items of comprehensive income arising from nonreciprocal transfers if they are excluded from revenues. Specifically, the Boards will discuss whether they should be distinguished from gains.

² Services are defined in the broad sense, and includes right to use.
³ A customer may also be a shareholder, creditor, or employee that is not acting in that capacity.
Questions for the Boards

1. Do the Boards agree with defining a nonreciprocal transfer received as “a transaction in which an entity receives an asset or cancellation of liabilities without directly giving value in exchange”?

2. Do the Boards agree that distinguishing between exchange transactions and nonreciprocal transfers as positive components of the reporting entity’s comprehensive income provides useful information to users of financial statements?

3. Do the Boards agree that the difference to users of financial statements between the significance of exchange transactions and nonreciprocal transfers is likely to be so marked that nonreciprocal transfers should be excluded from revenues?

4. Do the Boards agree that a working definition of revenues should be “inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from the entity’s production, sale, and delivery of products (goods and services) to customers”?

5. Do the Boards agree that a customer should be defined as either an individual or a business that purchases the entity’s products (goods or services)?

6. Do the Boards agree to confirm the policies in Statement 116 and IAS 41 that:
   - nonreciprocal transfers are distinct economic events, regardless of the intent to compensate for particular outflows of assets? and, therefore,
   - government grants and subsidies should be accounted for on a “gross basis”?

7. Do the Boards agree that inflows from winning a lawsuit do not meet the proposed definition of revenues and should be accounted for and disclosed in the same manner as other nonreciprocal transfers?

8. Do the Boards agree that increases in comprehensive income arising from nonreciprocal transfers should be distinguished from gains?