MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Business Combinations—Purchase Method Procedures Team (Rohrkemper, ext. 284)
Subject:	Minutes of the April 14, 2004 Board Meeting **Date:** April 19, 2004
cc:	FASB: Bielstein, Smith, Petrone, Bossio, Lott, Tamulis, Munro, Pinson, Manders, Rohrkemper, Hamilton, Swift, Polley, Cropsey, McIntosh, Thompson, Gabriele, Sutay, Lapolla, FASB Intranet; IASB: Leisenring, Rees, Ryltsova, Kimmitt; CICA: Walsh; AICPA: Hekker; Purchase Method Procedures Resource Group Members and Observers

Topic: Issues pertaining to (1) Clarification and resolution of differing interpretations of the October 2003 FASB-IASB joint decision about which assets and liabilities should be considered part of the business combination accounting and (2) the effective date for the proposed Statements on business combinations and noncontrolling interests.

Basis for Discussion: "Effective Date of Business Combinations and Noncontrolling Interests Statements" memorandum, distributed on April 1, 2004 (Memo 1 of 2), "Revisiting What Is Considered Part of the Combination" memorandum, distributed on April 6, 2004 (Memo 2 of 2 and its attachment), IASB Agenda Paper 5B for the IASB's April 2004 Board meeting, IASB March 2004 Agenda Paper 12 (also referred to in Memo 2 of 2), and the Board audience handout.

Length of Discussion: 9:00 a.m. to 9:40 a.m.

Attendance:

Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott
IASB Board/Staff present:	Leisenring Rees, Ryltsova (by phone)
Board members absent:	None
Staff in charge of topic:	Bossio
Other staff at Board table:	Bielstein, Manders, Rohrkemper
Outside participants:	None

Summary of Decisions Reached (Action Alert):

The Board discussed clarifications and potential changes to the October 2003 FASB-IASB joint decision about which assets and liabilities should be considered part of the business combination and reached the following decisions:

a. As a general principle, the acquirer should recognize the assets acquired and liabilities assumed *as part of the combination* at their fair values at the acquisition date.
b. The substance of transactions entered into by parties to the combination (the acquirer, the acquiree, and the owners of the acquiree) should be assessed to determine whether they were arranged to achieve an accounting result favorable to the acquirer and, thus, should be excluded from the accounting for the combination. For example, a transaction should be excluded from the business combination if it was structured for the purpose of avoiding the expense recognition by the acquirer of (a) transaction costs incurred related to the combination or (b) termination or other post-combination exit costs.
c. The following factors (which are neither mutually exclusive nor individually conclusive) should be considered in assessing whether a transaction was arranged to achieve an accounting result favorable to the acquirer:
    1. The timing of the obligating event or transaction,
    2. The reason for the contract or transaction,
    3. The party that initiated the contract or transaction, and
    4. Whether the acquiree (or its owners) or the combined entity is the most significant beneficiary of the arrangement.

The Board also discussed the effective dates for the proposed Statements on purchase method procedures and noncontrolling interests and decided that both Statements should be effective for financial statements issued for fiscal years beginning after December 15, 2005. Earlier adoption would be encouraged provided that the provisions of both Statements are adopted at the same time.

Objectives of the Meeting:

The objectives of the meeting were to:

1. Consider the collaborative Group's recommendation for resolving differing interpretations of and concerns about the potential unintended consequences of the October 2003 FASB-IASB joint decision about which assets and liabilities should be considered part of the business combination accounting.

2. Obtain input from the FASB to share with the IASB about whether items that cause a likely buyer to reduce its price, but do not qualify as liabilities at the acquisition date, should be accounted for separate from goodwill.
3. Determine the effective dates for the proposed Statements on business combinations and noncontrolling interests.

Matters Discussed and Decisions Reached:

ISSUES RELATED TO THE OCTOBER 2003 FASB-IASB JOINT DECISION

At the February 25, 2004 FASB Board 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 about which assets and liabilities should be considered part of the business combination accounting (the joint decision) and reconcile different interpretations of FASB (Messrs. Crooch and Trott) and IASB (Messrs. Leisenring, Gélard, and McGregor) members about how that decision should be applied.
b. Address concerns and unintended consequences that were identified by external reviewers about an aspect of the joint decision.
c. Determine whether the Boards have a common understanding of and approach to differentiating items that meet the definition of a liability from those circumstances that do not give rise to a liability. More specifically, how to account for circumstances that (1) do not qualify as liabilities of the acquiree, (2) *seemingly*[1] do not qualify as liabilities assumed at the acquisition date, and (3) clearly involve negative factors (risks) that would affect (reduce) the price that a likely buyer would be willing to pay for the acquiree.

Mr. Crooch indicated that the process undertaken by the Group to reconcile the Boards' differing interpretations is consistent with the procedures agreed to by the joint Boards for their joint projects, and has served as an appropriate mechanism to resolve the outstanding issues.

[1] The term *seemingly* is used here because it appears that a liability does not exist for circumstances in which there is no *unconditional present obligation* (for example, before the enactment of a law that imposes an obligation). However, in certain specific cases there may be differing views about whether certain factors in the given case involve the necessary past event that results in a present obligation.

The Board's discussion of the Group's findings with respect to Items (a)–(c) are reported in the next three subsections of these minutes.

Which Assets and Liabilities Should Be Considered Part of the Business Combination: a General Principle

The staff reported that Group members:

- Doubted whether, under either the FASB or IASB interpretation, the joint decision would treat similar circumstances consistently
- Observed that the joint decision gives rise to issues about whether a liability exists the moment before a combination
- Agreed that in circumstances for which the business combination itself is the conditional event, those obligations (1) are no longer conditional at the acquisition date and (2) should be recognized as part of the liabilities assumed in the business combination[2]
- Reached consensus that both Boards should revisit the joint decision.

No Board members objected to the Group's suggestion to revisit the joint decision.

The staff asked the Board whether it supports the Group's suggestion for the following *general*[3] principle for recognition and measurement of assets acquired (other than goodwill[4]) and liabilities assumed:

> In a business combination, the acquirer recognizes the assets acquired and liabilities assumed *as part of the combination* at their fair values at the acquisition date.

No Board members objected to this general principle.

Mr. Crooch, as a member of the Group, agreed with its consensus for the reasons stated by the staff. He added that the October 2003 FASB-IASB joint decision, by focusing on the assets and liabilities of the acquiree that would be

[2] The Group agreed to provide an exception to this principle for circumstances in which there may be evidence of an abusive transaction (that is, a transaction entered into in order to shift expenses of the combined entity to the books of the acquired entity). The process of identifying abusive transactions is discussed later in this section.

[3] Exceptions to the fair value measurement principle would be retained as previously decided by the Boards for items such as deferred income taxes and pension, other postemployment benefit, and other employee benefit liabilities.

[4] Goodwill would continue to be measured as a residual; 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.

assets and liabilities *absent the prospect of a combination*, would have resulted in a "bright-line" test for abusive transactions, which, like all bright-line tests, could prompt some preparers to structure transactions in such a way as to circumvent the intent of the decision. On the contrary, the Group's general principle, when combined with the Group's approach for identifying abusive transactions (described below), is far less susceptible to such dubious transactions. Mr. Trott, also a member of the Group, agreed with Mr. Crooch and noted his support of the Group's recommendations.

Which Assets and Liabilities Should Be Considered Part of the Business Combination: Abusive Transactions versus Substantive Transactions

The staff noted that the Group had expressed concern about the application of the general principle to transactions entered into with the intent of achieving specific favorable accounting results—for example, shifting expenses[5] of the combined entity into the business combination accounting. To address this concern, the Group developed an approach for assessing transactions entered into by parties to the combination (the acquirer, the acquiree, and the owners of the acquiree) to determine whether the transactions may have been arranged to achieve specific favorable accounting results. Those transactions determined to have been arranged to achieve specific favorable accounting results should be excluded from the business combination accounting.

The Group's approach requires a judgmental assessment of the substance of a transaction to determine whether it had been arranged to achieve a specific favorable accounting result. The approach further provides the following factors to consider, to the extent that information is available, in making that assessment:

- **The timing of the obligating event or transaction.** An obligating event of the acquiree (acquired business) occurring prior to negotiations is a strong indication that the transaction relates to benefits to be received by the acquiree. In other words, a transaction that was entered into by the

[5] The Group expressed concern with the shifting of both "postcombination" expenses of the acquirer or combined entity (such as employee compensation costs) and expenses incurred by the acquirer prior to the combination (such as acquisition related transaction costs) to the acquiree (or its owners).

acquiree *prior to* the negotiations likely would be in contemplation of benefits that the acquiree expected to receive. Obligating events that occur *during* the negotiations of a combination may provide evidence that the transaction was entered into in contemplation of the business combination for purposes of achieving a specific favorable accounting result.

- **The reason for the contract or transaction.** The *motivation* behind the transaction should be considered (when available). For example, an acquiree would not be motivated to pay the acquirer's transaction costs unless it arranged to be compensated for that payment.
- **Which party initiated the contract or transaction.** A contract that is initiated by the acquiree generally is indicative of a benefit to be received by the acquiree. Careful consideration should be given as to whether the contract initiator is the acquiree or the acquiree's continuing management, as those two interests may be substantively different.
- **Whether the acquiree (or its owners) or the combined entity is the most significant beneficiary of the arrangement.** A transaction that will provide *benefits to others that are significantly greater than those to the acquiree* would be an indicator that the transaction should be excluded from the business combination.

Mr. Trott emphasized that the Group's approach relies on the judgment of those applying it, especially for circumstances in which the factors seem to contradict one another. He noted that such a reliance on judgment is typical of principle-based standards, which the Board has previously agreed are preferable to rules-based "bright-line" standards. He further noted that he would be open to recommendations from other Board members or constituents for additional factors that might aid in the assessment of the substance of transactions.

Ms. Seidman said she agrees with the Group's recommended approach. In particular, she found the application of the Group's approach to be more consistent with the general principles in business combinations than some of the outcomes in applying the October 2003 FASB-IASB joint decision. To test the consistency of application, Ms. Seidman recommended that the staff solicit comments on the application of the Group's approach from constituents, such as the members of the project's resource group, *before* exposing it for public comment in a proposed Statement. Board members agreed.

Mr. Schieneman also noted his support for the Group's approach and found the application of the Group's approach to the examples helpful. He noted that the Group and its supporting staff did not reach a consensus in a particular example and that he agreed with one of the two interpretations given in the analysis of that example. Mr. Bossio noted that one member of the Group (Mr. Gèlard of the IASB) offered an alternative to resolve differences for that particular type of example. He noted that, if desired, the Boards could add a presumption that any golden parachute awarded X days before the discussions for a combination began was awarded in contemplation of that combination. Mr. Bossio added that the Group did not suggest including such a bright-line. Mr. Schieneman acknowledged that due to the judgmental nature of the approach's application and the limitation of the written fact sets, such differences of opinion are inevitable and he reiterated his support for the judgmental approach proposed by the Group.

Mr. Batavick also noted his support for the Group's approach, particularly in light of the insufficiency of a bright-line rule in the face of the complexity of most business combinations. He also noted that he found the proposed factors sufficient, but that he would consider any suggestions for additional factors.

Issues Related To The Difference Between Liabilities Assumed In A Business Combination And Acquired Business Risks

The staff asked the Board to discuss whether those items that cause a likely buyer to reduce its price, but do not qualify as liabilities at the acquisition date, should be accounted for separate from goodwill in light of the most recent thinking from the IASB on the subject.

The staff noted that the IASB 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 nonoccurrence of one or more uncertain future events not wholly within the control of the entity. [March 2004 IASB Update, emphasis added.]

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.

Ms. Schipper said she continues to agree with the Board's earlier decision *not* to create a defined term for *contingencies* or *contingent liabilities* because the types of items that the terms seem to encompass—that is, forward-looking positive and negative uncertainties that affect purchase price—appropriately belong in goodwill. She stated that the primary arguments in favor of recognizing such items appear to stem from accountants' asymmetric fear of the recognition of negative goodwill based on the presumption that the future uncertainty will likely be a loss. Ms. Schipper pointed out that the presumption is substantially misplaced, and that in reality many future uncertainties likely will be gains—that is, business combinations just as often involve the acquisition of business opportunities as business risks. For this reason, Ms. Schipper concluded that the likelihood of negative goodwill appearing in a business combination would be highly unusual.

Mr. Trott agreed with Ms. Schipper's preference to include as part of goodwill any item that is *not* an obligation arising from past events, and, therefore, does not meet the definition of a liability. He also added that the likelihood of having negative goodwill is further diminished by the requirements in the proposed Statement on business combinations. Specifically, the requirement that any item that meets the definition of a liability be recorded at fair value in a business combination, even if it is not (or would not be) recorded under the recognition criteria described in FASB Statement No. 5, *Accounting for Contingencies*. He emphasized that such an approach would consider the uncertainty related to the timing and settlement as part of the *measurement* of the liability, not as *recognition* criteria (as in Statement 5). Mr. Trott recognized that this requirement would necessitate judgment in determining whether an obligating event has occurred, but noted that any robust approach would necessitate such a judgment. Mr. Crooch agreed.

No Board members supported an approach that would recognize items that do not meet the definition of a liability separately from goodwill.

ISSUES RELATED TO THE EFFECTIVE DATE OF THE PROPOSED STATEMENTS ON BUSINESS COMBINATIONS AND NONCONTROLLING INTERESTS

The staff stated that the Board's previous tentative decision was that the final Statements on business combinations (including combinations between mutual enterprises) and noncontrolling interests should be effective for fiscal periods beginning after December 15, 2004. Because the expected issuance of the Exposure Drafts of these Statements have been delayed until the second quarter of 2004 and the projected issuance of the final Statements is the first half of 2005, the staff asked the Board to revisit its tentative decision.

The staff identified the following alternatives:

> <u>Alternative A:</u> Both the final Statements on business combinations* and noncontrolling interests should be effective for entities with fiscal years beginning after June 15, 2005, with early adoption encouraged, provided that the provisions of both Statements are adopted at the same time.
>
> <u>Alternative B:</u> The final Statement on business combinations* should be effective June 15, 2005 and the final Statement on noncontrolling interests should be effective for entities with fiscal years beginning after December 15, 2005, with early adoption encouraged.
>
> <u>Alternative C:</u> Both the final Statements on business combinations* and noncontrolling interests should be effective for entities with fiscal years beginning after December 15, 2005, with early adoption encouraged, provided that the provisions of both statements are adopted at the same time.

* Including the Board's tentative conclusions on combinations between mutual enterprises.

The staff suggested that the provisions of both Statements be made effective concurrently, and thus recommended either Alternative A or Alternative C. Based on its earlier internal planning schedules the staff had recommended Alternative A, but noted that based on more current planning and the benefits of convergence, the staff now does not object to Alternative C.

Mr. Batavick said that he supports Alternative C because (a) both the business combinations and noncontrolling interests Statements would be made effective concurrently, (b) the effective dates would converge with the IASB's related Statements, which would allow for any practice issues following the issuance to be considered simultaneously by the FASB and the IASB, and (c) a December 15, 2005 effective date would allow credit unions, other mutual enterprises, and private companies additional time to consider the implications of the requirements in the proposed Statements, including their regulatory requirements.

Ms. Seidman agreed with Mr. Batavick and added that allowing time between the issuance date and the effective date is very important, given the extent of the changes proposed and that large groups of constituents have not yet demonstrated a familiarity with those changes.

Ms. Bielstein observed that transaction-based standards (such as FASB Statement No. 141, *Business Combinations*) typically have been made effective for *transactions* occurring after a specified date as opposed to for *fiscal years* ending after a specified date. She added that under Alternative C, two identical business acquired by identical acquirers on the same date could be accounted for under different purchase method procedures (under either existing procedures or those to be described in the proposed Statement) depending on the acquirers' fiscal year end.

The Board acknowledged Ms. Bielstein's observation but stressed the importance of linking the effective dates (and therefore application) of the proposed Statements on business combinations and noncontrolling interests. No Board members objected to Alternative C.

Follow-up Items:

Solicit comments on the application of the Group's approach from constituents, such as the members of the project's resource group, before exposing the proposed Statement.

General Announcements:

None.