MINUTES

Financial Accounting Standards Board

To: Board Members

From: Business Combinations—Purchase Method Procedures Team (Rohrkemper, ext. 284)

Subject: Minutes of the July 9, 2003 Board Meeting **Date:** July 9, 2003

cc: FASB: Bielstein, Smith, Petrone, Bossio, Tamulis, Munro, Pinson, Manders, Wilson, Rohrkemper, Swift, Polley, Cropsey, McIntosh, Thompson, Gabriele, Sutay, Lapolla, FASB Intranet; IASB: Leisenring, Lloyd, Ryltsova, Kimmitt; CICA: Walsh; AICPA: Hekker; Purchase Method Procedures Resource Group Members and Observers

Topic: Business Combinations—Whether an Intangible Asset Subsumed in Goodwill Because It Did Not Meet the Criteria for Separate Recognition at the Acquisition Date Should Subsequently Be Reclassified from Goodwill, and Allocation Issues Related to the Full Goodwill Method

Basis for Discussion: Two memorandums dated June 27, 2003 and audience handout

Length of Discussion: Starting Time: 9:00 a.m. Concluding Time: 10:05 a.m.

Attendance:

Board members present: FASB: Herz, Crooch (by phone), Schieneman, Schipper, Seidman, Trott

IASB: Leisenring

Board members absent: None

Staff in charge of topic: Bossio, Tamulis
Other staff at Board table: Bielstein, Manders, Wilson, Rohrkemper

Outside participants: Ryltsova (by phone)

JULY 9, 2003 BOARD MEETING—ACTION ALERT:

The Board decided that an intangible asset that is included in the amount recorded as goodwill because it does not meet the criteria for separate recognition at the acquisition date should *not* be reclassified from goodwill if that intangible asset subsequently meets those criteria. Board members suggested that in drafting the Exposure Draft of the standard, the staff include:

1. Guidance for identifying and recognizing customer relationship assets existing at the acquisition date that are associated with contract negotiations that are ongoing but incomplete at that date.

2. An acknowledgment that events that occur shortly after the acquisition date, such as a contract signing, should be carefully considered to determine whether they provide substantive evidence of the existence of an intangible asset at the acquisition date that, in fact, meets the criteria for recognition separate from goodwill.

The Board also discussed how to allocate between the controlling and noncontrolling interests goodwill that arises in an acquisition of a less than 100 percent controlling interest and subsequent goodwill impairment losses if the full goodwill method is used for initial recognition. The Board decided:

1. The goodwill initially allocated to the controlling interest should be calculated as the difference between the *fair value of the ownership interest acquired* and the controlling interest's share in the fair value of the identifiable net assets acquired. The remainder of the goodwill should be allocated to the noncontrolling interests. The *fair value of the ownership interest acquired* should be measured as:

    a. The fair value of the consideration paid by the acquirer on the acquisition date, if any

    b. Plus the fair value on the acquisition date of the acquirer's previous investment in the acquiree, if any.

2. The guidance in paragraphs 34 and 35 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, applies regardless of whether an acquired subsidiary is wholly or partially owned. That guidance requires goodwill to be assigned to the reporting unit expected to obtain the benefits of the synergies of the combination even though other assets or liabilities of the acquired entity may not be assigned to that reporting unit.

3. If an entity has one or more partially owned subsidiaries, goodwill impairment losses should be allocated on a pro rata basis using the relative carrying values of goodwill. Goodwill impairment losses should be allocated:

   a. First, to the components of the reporting unit, if the partially owned subsidiary is part of a larger reporting unit, and also

   b. To the controlling and noncontrolling interests of the partially owned subsidiary.

   For example, if the partially owned subsidiary is part of a larger reporting unit, the portion of the impairment loss allocated to that subsidiary would be determined by multiplying the goodwill impairment loss by the proportion of the carrying value of the goodwill assigned to that subsidiary over the carrying value of the goodwill assigned to the reporting unit as a whole. The amount of the impairment loss allocated to the partially owned subsidiary would then be allocated to the controlling and noncontrolling interests based on the relative carrying values of goodwill allocated to those interests.

The staff also announced that issuance of the Exposure Drafts addressing Business Combinations: Purchase Method Procedures, Combinations between Mutual Enterprises, and Combinations of Not-for-Profit Organizations is now expected in the fourth quarter of 2003.

Matters Discussed and Decisions Reached:

Intangible Assets Subsumed in Goodwill That Become Separately Recognizable after the Acquisition Date

The Board discussed whether an intangible asset that is included in the amount recorded as goodwill because it does not meet the criteria for separate recognition at the acquisition date should be reclassified from goodwill if it meets those criteria subsequent to the acquisition date. According to FASB Statement No. 141, *Business Combinations*, an intangible asset is recognized apart from goodwill if the intangible asset arises from contractual or other legal rights, or is separable.[1] The staff recommended, and the Board agreed, that intangible assets that do not meet the criteria for separate recognition apart from goodwill at the acquisition date, but subsequently meet those criteria, should *not* be reclassified from goodwill. [Five Board members agreed; one did not: GSS.]

[1] According to paragraph 39 of Statement 141, an intangible asset is considered separable if it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so), either individually or in combination with a related contract, asset, or liability.

Ms. Schipper stated that events that occur subsequent to the acquisition date should not result in remeasurement of acquired assets and liabilities. Ms. Schipper noted that information gathering is not instantaneous; it may take some time to gather the information necessary to determine the fair value of an asset or liability as of the acquisition date. However, that information should pertain to events or circumstances that existed as of the acquisition date in order to enter into the measurement of the fair value of the acquired asset or liability at that date.

Ms. Schipper also noted that for items in the process of becoming an asset, the maturation process could be subject to manipulation. For example, contracting parties can frequently impact the timing of the contract signing. If the fair value of a signed contract is separately recognized as an intangible asset, and that contract subsequently becomes worthless, then that intangible asset would be written off. If the fair value of a pending contract that has not matured is subsumed in goodwill, and that contract subsequently becomes worthless, then the value of that contract will be written off through the goodwill impairment test.

Mr. Trott agreed with Ms. Schipper. However, he raised one concern. Mr. Trott suggested that the staff examine whether "customer relationships" that are ongoing constitute a separately recognizable intangible asset pursuant to the guidance issued in EITF Issue No. 02-17, "Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination." He observed that although a particular contract for a particular customer that is pending at the acquisition date would be subsumed in goodwill, the value of the relationship with that customer may satisfy the criteria for recognition separate from goodwill.

Mr. Leisenring raised additional concerns about the possibility of contracts that are essentially complete but (possibly intentionally) awaiting a perfunctory signature. If not legally binding, those contracts would fail to meet the criteria for separate recognition at the acquisition date. Goodwill would be inflated by the fair value of those contracts, and the recognition of a possibly amortizable asset would be avoided. He believes that the goodwill impairment test is not sufficiently robust to prevent that type of abuse. Mr. Schieneman agreed with Mr. Leisenring that the goodwill impairment test is insufficient in preventing that type of abuse. They both indicated that the staff recommendation does not sufficiently address their concern.

Ms. Seidman agreed with the staff's recommendation. She found no basis for the Board to make an exception for only intangible assets that become recognizable after the acquisition date. She also stated that a one-year subsequent allocation period is not a reasonable solution because it is an arbitrary “bright line” and much too long a period for the concerns discussed.

Mr. Herz also agreed with the staff’s recommendation. However, he suggested that the staff include in the standard an acknowledgment that events that occur shortly after the acquisition date, such as a contract signing, should be carefully considered to determine whether they provide substantive evidence of the existence of an intangible asset at the acquisition date that, in fact, meets the criteria for recognition separate from goodwill. No Board member objected.

In addition, the Board suggested that the staff include in the Exposure Draft guidance for identifying and recognizing customer relationships that may be associated with contract negotiations that are ongoing but pending at the acquisition date. This guidance would be consistent with the guidance in Issue 02-17.

Issues Related to Applying the Full Goodwill Method in an Acquisition of a Less Than 100 Percent Controlling Interest

Before discussing the specific allocation issues associated with applying the full goodwill method, the Board discussed whether that method should continue to be pursued or whether a purchased (controlling interest) goodwill method should be explored.[2] The Board decided to continue pursuing the full goodwill method. However, the Board requested that the staff analyze the issues and complexities that would arise under the purchased goodwill method.

Allocating the full amount of goodwill between the controlling and the noncontrolling interests in an acquisition of a less than 100 percent controlling interest in a subsidiary

The staff recommended, and the Board decided, that the goodwill allocated to the controlling interest on the acquisition date should be calculated as the difference between the *fair value of the ownership interest acquired* and the controlling interest’s share in the fair value of the identifiable net assets acquired. The remainder of the goodwill should be allocated to the noncontrolling interests.

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[2] Under the full goodwill method, goodwill is measured as the difference between the fair value of the acquired entity taken as a whole and the sum of the fair values of all of the identifiable net assets acquired on the acquisition date. If an entity acquired a controlling interest in a partially owned subsidiary, the *full amount of goodwill* would include goodwill related to the interests of noncontrolling shareholders in that acquired subsidiary. Under the purchased goodwill method, goodwill is measured as the difference between the fair value of the ownership interest acquired and the acquirer’s ownership interest in the fair value of the identifiable net assets acquired. *Purchased goodwill* would include goodwill related to the controlling shareholders only.

The *fair value of the ownership interest acquired* should be measured as:

a. The fair value of the consideration paid by the acquirer on the acquisition date if control is obtained in a single purchase transaction.

b. The fair value at the acquisition date of the acquirer's previous investment in the acquiree if control is obtained without the acquirer paying consideration on that date.

c. The fair value of the consideration paid by the acquirer plus the fair value at the acquisition date of the acquirer's previous investment in the acquiree if control is obtained as part of a step acquisition.

Mr. Herz emphasized that this proposed method of allocating the full amount of goodwill is consistent with the assumption that the controlling interest is paying a premium for the control rights that accompany the purchase. [All Board members agreed.] It was also noted that the application of the proposed method is internally consistent and compatible with other decisions reached by the FASB and IASB. Moreover, although the IASB did not formally reach a decision on items 2 and 3 above, the IASB reached the same decision for a single purchase transaction (item 1 above).

The Board also clarified that the guidance in paragraphs 34 and 35 of Statement 142 applies regardless of whether the acquired subsidiary is wholly or partially owned. That guidance requires goodwill to be assigned to the reporting unit expected to obtain the benefits of the synergies of the combination even though other assets or liabilities of the acquired entity may not be assigned to that reporting unit. [All Board members agreed.]

Subsequent allocation of goodwill impairment losses if the full amount of goodwill was recognized at the acquisition date

The Board first decided to provide specific guidance on the allocation of goodwill impairment losses to controlling and noncontrolling interests rather than to leave the allocation method up to preparer judgment. Mr. Schieneman believes that any guidance would be mechanical and arbitrary and may not be applicable in certain situations. He believes that the Board should indicate only that losses should be allocated on a reasonable and consistent basis. Mr. Herz agreed that no one allocation method would be the best method for all circumstances. However, he noted that, in the interest of comparability, the Board should select one allocation method (even if it is arbitrary) because the allocation alternatives suggested by the staff were relatively simple. [Five Board members agreed; one did not: GSS.]

The staff recommended, and the Board agreed, that an entity with one or more partially owned subsidiaries should allocate goodwill impairment losses on a pro rata basis using the *relative carrying values of goodwill*. Goodwill impairment losses should be allocated (a) first to the components of the reporting unit, if the partially owned subsidiary is part of a larger reporting unit, and then (b) to the controlling and noncontrolling interests of the partially owned subsidiary. For example, if the partially owned subsidiary is part of a larger reporting unit, the portion of the impairment loss attributable to that subsidiary would be determined by multiplying the impairment loss by the proportion of the carrying value of the goodwill pertaining to that subsidiary over the carrying value of the goodwill of the reporting unit as a whole. The amount of the impairment loss allocated to the partially owned subsidiary would then be allocated to the controlling and noncontrolling interests based on the relative carrying values of goodwill allocated to those interests. [All Board members agreed.]

Follow-up Items:

At the Board's request, the staff will analyze the issues and complexities that arise if the purchased goodwill method was selected for initial measurement and recognition of goodwill rather than the full goodwill method.

General Announcements:

The staff also announced a change from the third quarter to the fourth quarter of 2003 for the expected issuance of the Exposure Drafts addressing Business Combinations: Purchase Method Procedures, Combinations between Mutual Enterprises, and Combinations of Not-for-Profit Organizations. [No Board members objected.]