REVISED MINUTES

To:	Board Members
From:	Business Combinations—Purchase Method Procedures Team (Hamilton, ext. 330)
Subject:	Minutes of the June 9, 2004 Board Meeting **Date:** June 17, 2004
cc:	FASB: Bielstein, Smith, Petrone, Bossio, Lott, Tamulis, Munro, Pinson, Manders, Rohrkemper, Hamilton, Swift, Polley, Cropsey, McIntosh, EBC Team, Thompson, Gabriele, Sutay, Lapolla, Getz, FASB Intranet; IASB: Leisenring, Rees, Ryltsova, Kimmitt; CICA: Walsh; AICPA: Hekker; Purchase Method Procedures Resource Group Members and Observers

Topic: Issues pertaining to (1) interaction between the EBC project and this project, (2) whether the scope of this project should be expanded to consider the accounting for groups of assets or net assets that do not constitute a business, and (3) proposed clarifications to the definition of a business and revisions to its related application guidance.

Basis for Discussion: "Equity-Based Compensation, Memo No. 63: Business Combinations II" memorandum, distributed June 3, 2004, and "Definition of a Business and Related Guidance" memorandum, distributed on June 3, 2004, and the Board audience handout.

Length of Discussion: 9:00 a.m. to 10:15 a.m.

Attendance:

Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott
IASB Board/Staff present:	Leisenring, Kimmitt (by phone)
Board members absent:	None
Staff in charge of topic:	Bossio, Tamulis, Zeyher
Other staff at Board table:	Bielstein, Cassel, Tovey, Hamilton
Outside participants:	None

Summary of Decisions Reached (Action Alert):

The Board discussed several clarifying matters relating to the accounting for equity-based compensation awards (EBC) exchanged in a business combination in which it is presumed that the acquiring entity has an obligation to issue replacement awards. The Board decided that such exchanges would be accounted for as follows:

- Depending on the circumstances, a portion (or all) of the fair value of the acquirer-replacement award should be recognized as consideration paid in the business combination rather than compensation cost in postcombination financial statements.
- The fair value of equity-based awards issued by the acquirer and acquiree would be determined using the fair-value-based measurement method of FASB Statement No. 123, *Accounting for Share-Based Payments,* as it would be amended by the Exposure Draft on share-based payments issued on March 31, 2004.
- If the fair value of the acquirer's replacement award attributable to past services exceeds the fair value of the replaced acquiree awards attributable to those services, the excess is compensation cost to be recognized immediately by the acquirer. If not, depending on the circumstances, the acquirer shall recognize a portion (or all) of the replacement award as a liability or an equity instrument, as appropriate, as part of the consideration paid in the business combination.
- In determining the remaining fair value of the replacement award attributable to past services, the total service period is the period that begins with the service inception date for the acquiree's award and ends with the service completion date for the replacement award. The portion attributable to past services is equal to the remaining fair value of the replacement award (or settlement) multiplied by the ratio of the past service period to the total service period. The amount, if any, which represents future compensation cost is the remaining fair value of the replacement award (or settlement) multiplied by the ratio of the future service period to the total service period. The future service period begins on the date the business is acquired (acquisition date).
- The requisite service period of awards issued by the acquirer should reflect any explicit, implicit, and derived service periods (consistent with the requirements of Statement 123(R)).

The Board decided not to expand the scope of this project to consider the accounting for acquisitions of groups of assets or net assets that do not constitute a business. The Board suggested, however, that the Notice to

Recipients in the forthcoming Exposure Draft on business combinations include questions soliciting feedback regarding that decision.

The Board provided the following clarification to the definition of a business and revisions to related application guidance:

- Clarified the definition of a business to emphasize that the assessment is based on the present capability of the acquired set.

> A business is an integrated set of activities and assets <u>that is capable of being</u> conducted and managed for the purpose of providing:
>
> a. A return to investors; or
> b. Lower costs or other economic benefits directly and proportionately to owners, members, or participants.
>
> A business consists of (1) inputs, (2) processes applied to those inputs, and (3) resulting outputs that are or will be used to generate revenues.

- Revised the description of inputs, processes applied to inputs, and outputs and clarified that the first two of those three elements are required in order for an acquired set of activities and assets to be considered a business (and affirmed that outputs are not required).
- Eliminated the requirement to assess whether a missing element is minor and the related guidance and examples.
- Added application guidance stating that an acquired set of activities and assets would be presumed to be a business if the *going-concern* element of goodwill (as described in paragraph B102 of FASB Statement No. 141, *Business Combinations*) is present in the set.

<u>Objectives of the Meeting</u>:

The objectives of the meeting were to:

- Clarify the staff's understanding of the Board's tentative decisions and views as discussed at the April 7, 2004 Board meeting and determine how the fair value of acquirer replacement awards[1] should be allocated between purchase price[2] and postcombination compensation cost of the acquirer.

[1]Acquirer replacement awards refer to the exchange of acquiree EBC awards for acquirer awards in a business combination. The replacement awards can be in the form of cash, EBC liabilities, or EBC awards.

[2]Allocation to purchase price refers to either (a) the amount that should be part of the consideration paid in the business combination (for an EBC equity award) or (b) the assumed liability of the acquiree recognized by the acquirer (for an EBC liability award).

- Reconsider, at the request of the IASB, whether the scope of this joint project should be expanded to consider the accounting for groups of assets or net assets that do not constitute a business and, if so, whether the Board's consideration and deliberations of the related technical issues should be undertaken and completed prior to the release of the forthcoming Exposure Drafts on business combinations and on noncontrolling interest.
- Discuss proposed clarifications to the definition of a business and revisions to its related application guidance.

Matters Discussed and Decisions Reached:

TOPIC 1: INTERACTION BETWEEN THE EBC PROJECT AND THE PURCHASE METHOD PROCEDURES PROJECT

Ms. Zeyher indicated that discussion of this topic is based, in part, on the following staff assumptions relating to Board decisions from the April 7, 2004 Board meeting:

a. As part of the business combination, the acquirer has an obligation to replace (or settle) the outstanding awards held by employees of the acquiree. Otherwise, any EBC award granted to employees of the acquiree would result in compensation cost to the acquirer as opposed to consideration paid in the business combination (purchase price).

b. To the extent the acquiree's EBC award represents an equity interest in the acquiree, a portion of the fair value of the acquirer-replacement EBC award should be recognized as consideration paid in the business combination. Both vested (in which "vested" is shorthand for "the requisite service has been rendered") and nonvested EBC awards may represent an equity interest in the acquiree.

c. The fair value of the acquiree awards being replaced (whether vested or nonvested) should be compared to the fair value of the acquirer replacement awards at the acquisition date. If the fair value of the replacement exceeds the fair value of the acquiree awards, that incremental fair value is postcombination compensation cost of the acquirer.

d. To the extent that there is additional service explicitly required in order to vest in the acquirer replacement awards, a portion of the fair value of the replacement award would be recognized as compensation cost of the acquirer.

Issue 1

The staff asked the Board to affirm the staff's interpretation (as presented below) of the following Board decision made at the April 7, Board meeting

> When determining "fair value" for the exchange of EBC awards in a business combination, the Statement 123 fair-value-based measurement method (as amended) should be used.

The Board unanimously agreed that the staff's interpretation of its decision was correct.

Issue 2

The staff recommended that, consistent with the EBC Exposure Draft, the requisite service period for acquiree awards replaced by the acquirer subsequent to a business combination should take into account any explicit, implicit, and derived service periods for purposes of determining the vesting status of the awards. The vesting status of replacement awards is a key factor in determining the allocation of the fair value[3] of the replacement award between purchase price and compensation cost.

The Board unanimously agreed with the staff's recommendation.

Issues 3–6

Ms. Zeyher stated that the remaining issues attempt to clarify the staff's recommendations on how to allocate the fair value of replacement awards subsequent to a business combination between purchase price and compensation cost.

Issue 3

Ms. Zeyher stated the staff believes that acquirer awards (for which no future service is required) granted to employees of the acquiree to replace awards (for which all requisite service was rendered prior to the combination) issued by the acquiree (acquiree vested awards for acquirer vested awards) represent the

[3] The remaining fair value is the amount left after all incremental fair value is allocated to compensation cost.

acquisition of an equity interest and, therefore, 100 percent of the remaining fair value should be included in the purchase price.

The Board unanimously approved the staff's recommendation.

Issue 4

Ms. Zeyher introduced three views to account for acquirer awards (for which future service is required) granted to employees of the acquiree to replace awards (for which all requisite service was rendered prior to the combination) issued by the acquiree (acquiree vested awards for acquirer nonvested awards):

View A: If the requisite service period of the acquiree award was completed prior to the business combination, and there is a requisite service period associated with the acquirer replacement award subsequent to the business combination, then the entire remaining fair value should be allocated to compensation cost.

View B: Outstanding awards held by employees of the acquiree (for which all requisite service was rendered prior to the combination) that are replaced by awards issued by the acquirer (for which there is a requisite service period) represent the acquisition of an equity interest in a business combination. However, as there is a service period associated with the acquirer replacement award, there also is compensation cost related to future services between the acquirer and the employees of the acquiree. Therefore, the remaining fair value should be allocated between the purchase price and compensation cost. The allocation would calculate the amount allocated to compensation cost as the remaining fair value multiplied by the fraction of the requisite service period of the replacement award divided by the total requisite service period. The total requisite service period is the portion of the requisite service period served prior to the consummation date plus the requisite service period of the replacement award. The amount allocated to compensation cost would be recognized over the requisite service period of the replacement award.

View C: View C is similar to View B; however, the allocation between the purchase price and compensation cost would be based on the total service period. The fraction of the remaining fair value to be allocated to compensation cost is the requisite

> service period of the replacement award divided by the total service period. View C calculates the total service period as the total amount of service served, even if greater than the requisite service period, prior to the consummation date plus the requisite service period of the replacement award.

Ms. Zeyher indicated that the staff recommends View C, in part, because it produces consistent accounting treatment for both liability and equity awards.

Mr. Trott stated that he believes that an equity award and a liability award are fundamentally different and should be accounted for differently. He believes that a liability award requires remeasurement while an equity award does not. He then stated his preference for a View B model when accounting for equity awards and believes that services rendered beyond the requisite service period that prevent an option from expiring should not be incorporated into the determination of the amount to be allocated. Mr. Trott stated that he would support View C when accounting for liability awards.

In response to Mr. Trott's comments, Mr. Cassel declared that View C avoids remeasurement and disregards the original fair value of the award (the acquiree award). He continued that View C attempts to value the replacement award (the acquirer award) and the acquiree's accounting for the award is irrelevant at the date of the business combination. Furthermore, he believes View C values an award based on its status as of the date of the business combination. Mr. Trott indicated his agreement with Mr. Cassel's assessment that the acquirer should value the replacement award as of the acquisition date and not at the initial grant date of the award.

Mr. Crooch attempted to provide additional clarity to Mr. Cassel's comments by stating that View C, in essence, considers the replacement awards issued by the acquirer as essentially purchasing the acquiree awards through the issuance of unvested options.

Mr. Cassel stated those who support View C believe that an identical cash SAR (liability award) and an equity award, at the date of the business combination, should have identical accounting treatment.

Mr. Crooch believes, in situations in which the acquiree award was vested and the acquirer award (the replacement award) is not vested, the entire value of the award should be recognized as compensation cost over the service period of the replacement award (View A). Mr. Trott indicated that he believes in this scenario the acquirer has acquired a fully earned equity interest related to the vested acquiree awards that needs to be accounted for.

Mr. Cassel stated that an underlying principle of the allocation of the value of awards between purchase price and compensation cost in an acquisition is that the acquirer has an obligation to replace awards previously issued by the acquiree.

Ms. Seidman stated she also supports View C, in part, because it is a simpler articulation of the principle that the allocation of value between purchase price and compensation cost should be based on past service and future service associated with the award, even if the past service is more than what was required to fully vest the award.

Mr. Schieneman stated that if the Board was not also assessing Issues 5 and 6, he would recommend View A; however, to ensure consistency of accounting for Issues 4–6, his preference is View B. He would not object to View C because it provides consistent accounting for equity and liability awards.

Mr. Tovey mentioned to the Board that the IASB staff supports View B on this issue.

Ms. Schipper responded that the IASB staff's position is predicated on maintaining consistency with the FASB's Exposure Draft on share-based payments as it relates to the notion of requisite service. She stated that the FASB must decide whether the FASB would emphasize that consistency or consistent accounting for equity and liability replacement awards issued in a business combination.

Mr. Herz asked the Board if it had any objections to View C. The Board had no objections to View C.

Issue 5

Ms. Zeyher introduced proposed accounting for acquirer awards (for which future service is required) granted to employees of the acquiree to replace awards (for which all requisite service was not rendered prior to the combination) issued by the acquiree (acquiree nonvested awards for acquirer nonvested awards).

Ms. Zeyher stated that acquiree nonvested awards replaced by acquirer nonvested awards represent an exchange of nonvested acquiree awards that contain elements of both an equity interest in the acquiree and compensation cost related to future services between the acquirer and the employees of the acquiree. Therefore, the remaining fair value should be allocated between purchase price and compensation cost. She stated that the allocation between compensation cost and purchase price would be similar to the allocation discussed in Issue 4. She stated that the staff believes that for equity and liability awards the amount of equity interest or assumed liability cannot exceed the vesting percentage of the acquiree award. That is, a portion of the remaining fair value of the acquirer-replacement award should be recognized as consideration paid in the business combination, but only to the extent that the EBC award represents an equity interest in the acquiree.

The Board unanimously agreed with the staff's recommendation.

Issue 6

Ms. Zeyher introduced proposed accounting for acquirer awards (for which future service is not required) granted to employees of the acquiree to replace awards (for which all requisite service was rendered prior to the combination) issued by the acquiree (acquiree nonvested awards for acquirer vested awards).

Ms. Zeyher stated that the staff believes that this scenario represents an exchange of nonvested acquiree awards that contain elements of both an equity interest in the acquiree and compensation cost related to the portion of the replacement award that does not represent the replacement of an equity interest in the acquiree. In these cases, the allocation to purchase price should be limited to the vesting percentage of the acquiree awards, similar to Issue 5.

Ms. Schipper commented that such a transaction is essentially similar to accounting for a vesting acceleration event.

The Board unanimously agreed with the staff's recommendation.

Mr. Herz asked the staff what documentation this guidance would be exposed with. The staff stated it will research various options, will determine where this guidance should be exposed, and will address this issue outside of Board discussions.

TOPIC 2: WHETHER THE SCOPE OF THIS JOING PROJECT SHOULD BE EXPANDED TO CONSIDER THE ACCOUNTING FOR GROUPS OF ASSETS OR NET ASSETS THAT DO NOT CONSTITUTE A BUSINESS

Ms. Tamulis stated that at its May 19, 2004 meeting, the IASB reconsidered issues related to the definition of a business. During that discussion, certain IASB members raised the issue about whether to broaden the scope of the purchase method procedures project to include acquisitions of groups of assets.

The IASB concluded that, conceptually, acquisitions of all groups of assets should be accounted for the same way. Therefore, the IASB decided to ask the FASB to reconsider whether the scope of the joint purchase method procedures project should be expanded to consider the accounting for groups of assets that do not constitute a business.

Ms. Tamulis stated that, in concept, the staff agrees that acquisitions of all groups of assets should be accounted for in the same way and it believes the Boards should explore whether similar accounting for businesses and groups of assets is feasible in practice. However, the staff expressed its concerns that there are a number of technical issues related to broadening the scope of the project that would need to be deliberated and that deliberating those issues likely would further delay issuance of the Exposure Drafts on business combinations and noncontrolling interests.

The staff recommended that if the Boards wish to jointly address accounting for groups of assets, the issues be addressed in a separate project that is undertaken after the Exposure Drafts are issued.

Mr. Batavick stated the he supports the staff's recommendation because he does not want to further delay the purchase method procedures project.

Mr. Trott also supported the staff's recommendation. He suggested that this question be included in the Notice to Recipients in the business combinations Exposure Draft. By including a question in the Notice to Recipients, the Board could obtain input from constituents about issues related to accounting for acquisitions of groups of assets. Based on that input, the Board could then decide whether to add a project to the agenda to consider whether to conform the accounting for acquisitions of business and asset groups that do not constitute businesses.

Mr. Herz stated that while he believes accounting for groups of assets and business acquisitions should be consistent, he believes the Board should first determine appropriate purchase accounting and later address whether asset purchases should be accounted for in the same way as business acquisitions.

Ms. Seidman agreed that the accounting for groups of assets should not be addressed in this project. She expressed concern that the FASB has an Exposure Draft outstanding for nonmonetary exchanges that provides exceptions to fair value measurement (1) if the fair value of neither nonmonetary asset is determinable or (2) if the exchange lacks commercial substance; whereas in a business combination, there are no exceptions to the requirement to fair value the business acquired. She questioned whether the addition of such a project at this time would necessitate that the exceptions in the Exposure Draft be reconsidered or whether similar exceptions would be added to the business combinations guidance. She also suggested that any questions in a Notice to Recipients ought not suggest that the Board is committed to adding such a project.

Ms. Schipper stated that in a business combination, the form of consideration used to acquire a business does not impact the accounting. A business can be acquired by giving cash, monetary assets, nonmonetary assets, or even a business. No matter what the form of consideration given to acquire a business, the accounting would be the same. However, under current and proposed asset acquisition guidance for groups of assets, the form of consideration could result in different accounting for the asset acquisition if the assets given are nonmonetary. If the Board considers conforming the accounting for acquisitions of businesses and asset groups, this issue would need to be considered.

The Board unanimously supported the staff's recommendation not to expand the scope of this project to consider the accounting for groups of assets or net assets that do not constitute a business. However, the Board agreed that the notice to recipients in the forthcoming Exposure Draft on business combinations should ask constituents to comment on this issue.

TOPIC 3: PROPOSED CLARIFICATIONS TO THE DEFINITION OF A BUSINESS AND REVISIONS TO ITS RELATED APPLICATION GUIDANCE

The staff noted that despite recent efforts by both the FASB and the IASB to converge toward a definition of a business[4] and related guidance, several issues still remain. These issues are the result of (a) FASB members' comments on the examples contained in the February 19 draft of the proposed Statement on business combinations to test the application guidance, (b) the staff's analysis of those comments and examples, and (c) subsequent decisions and requests made by the IASB at its May 19 meeting.

To resolve these issues, the staff recommended that the Board further modify the definition of a business and related guidance in the following respects:

1. *Clarify the definition of a business to emphasize that the assessment is based on the present capability of the acquired set.* The staff noted its belief that the definition would be consistent with the Boards' intent and that it could be improved by explicitly stating in the definition the notion that the assessment of whether an acquired set meets the definition of a business must be based on the present *capacity* of the set. That is, an acquirer should asses the acquired set as it exists at the acquisition date rather than how it was used by the seller or how it might be used by the acquirer.
2. *Remove the application guidance, including the related examples, for assessing whether a missing element is minor.* The staff expressed concern that the part of the guidance requiring an acquiring entity to assess whether a missing element or elements are minor is misdirected and places emphasis on otherwise insignificant factors in the determination of whether an acquired set is a business. The staff also found examples based on determining whether the missing elements of the set are minor to be unnecessarily complicated.
3. *Better describe the meaning of inputs, processes applied to inputs, and outputs and clarify that the first two of those three elements are required in order for an acquired set of activities and assets to be considered a business (and affirm that outputs are not required).* The staff pointed out that this approach seems to strike the right balance between principles-based standards and guidance sufficient to ensure reasonably consistent application in practice. Furthermore, the

[4] At its meeting on February 4, 2004, the FASB decided to modify the definition of a business and related guidance in EITF Issue No. 98-3 "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business." At the May 19, 2004 IASB meeting, the IASB decided to revise its definition of a business to converge, in all material respects, with the definition reached at the FASB's February 4 meeting. The minutes from those meetings are available on the FASB and IASB websites, respectively.

recommended guidance more definitively describes the key elements of a business, instead of relying on a list of illustrative examples.

4. *Consider adding a presumption that if the going-concern element of goodwill is present in an acquired set of activities and assets, the set shall be presumed to be a business.* The staff noted that if an acquiring entity can observe the "going-concern" element of goodwill in an acquired set, that it is highly likely that the acquired set is a business. The staff also noted that in such circumstances it generally will be clear that the definition of a business has been met and there would be little need for reliance on presumptions or indicators. Nonetheless, the IASB has deemed such a presumption necessary. The staff pointed out that convergence on this issue might be desirable, and that although it sees little benefit from the inclusion of such a presumption, it also sees little harm.

The staff's proposed definition of a business and working draft of related guidance is included with these minutes as Appendix A (pages 25–28).

The staff noted that acceptance of these clarifications would closer align the FASB guidance with IASB guidance; however, the staff's recommendation—that the Board clarify the definition of a business to emphasize that the assessment is based on the present capability of the acquired set—could cause divergence if that recommendation is not also accepted by the IASB. The staff also pointed out that the FASB's and the IASB's guidance is not entirely convergent because the FASB will provide more guidance than the IASB. The staff noted that the FASB will provide more guidance because the IASB and FASB are starting from different places. The FASB already has provided guidance that outlines what constitutes a business in Issue 98-3, but the IASB does not have any similar guidance. The staff recommended that the FASB provide more guidance than the IASB because the FASB would need to reeducate its constituents, whereas the IASB does not. However, the staff noted that as an alternative, the Board could eliminate the guidance in order to converge with the IASB (at least for purposes of the Exposure Draft).[5]

Mr. Bossio noted that during the Board's most recent discussion of the definition of a business on February 4, certain Board members expressed concern that the definition was too vague and could allow an entity to make the determination of

[5] To converge with the IASB, the Board would retain only the current definition of a business, guidance clarifying what constitutes a development stage enterprise, and the inclusion of the presumption that if the going-concern element of goodwill exists an acquired set is a business.

whether a group of assets is a business based on whether it preferred to account for the transaction as a business combination or as an asset acquisition. He added that the package of recommendations is directed at clarifying the definition and eliminating that vagueness.

Ms. Seidman asked for clarification of the staff's proposed requirement that a set must have inputs and processes applied to inputs in order for it to be considered a business. Mr. Bossio clarified that the proposed requirement was not intended to imply that *all* inputs and *all* processes applied to inputs must be acquired in order for an acquired set to be considered a business. He stated that, for example, administrative systems are not necessary because those processes are not applied to inputs to generate outputs. He stated that, based on comments received from members of the FASB, the IASB, and the Canadian Standards Board, the staff intends to update the working draft of the guidance to further clarify that all that is necessary for an integrated set to be considered a business is inputs and processes applied to those inputs that generate or have the ability to generate economic benefits for investors, owners, members, or participants. Ms. Seidman noted that that clarification would be helpful.

Ms. Seidman also expressed concern about adding a presumption that if the going-concern element of goodwill is present in an acquired set of activities and assets, the set is presumed to be a business. She believes that issue was one identified by the purchase method procedures resource group as a potential cause of practice problems. Ms. Tamulis clarified that resource group members did not state that such a presumption was *the cause* of practice problems, but that it was rarely relied on in practice as a means of assessing whether an acquired set meets the definition of a business.

Messrs. Schieneman and Crooch expressed a concern, which was previously noted during the Board's December 10, 2003 meeting, that the presumption that a transferred set is a business if goodwill is present gives rise to circular logic since, in practice, goodwill is measured as a residual amount in a business combination. Ms. Kimmitt pointed out that the IASB defines goodwill by its nature rather than by its measurement attribute (that is, a residual amount). The staff noted that its recommendation to focus on the *going-concern* element of goodwill, like the IASB's presumption, would focus on the nature of goodwill.[6] Therefore, the staff's recommendation would be closely convergent with the guidance of the IASB.

Ms. Schipper stated that this presumption is similar to the requirement in Issue 98-3, which states that in order for an acquired set to be considered a business it must be *self-sustaining*. She noted that the Board decided at its February 4 meeting against having a self-sustaining requirement in the revised definition of a business. She believes that observing the existence of the going-concern element of goodwill is likely to be difficult. Ms. Schipper stated that this presumption is unlikely to be frequently applied; however, she believes the presumption should be included in the guidance for the purposes of convergence.

Mr. Trott stated that convergence is of paramount importance and recommended accepting the presumption relating to the going-concern element of goodwill on the condition that the IASB consider revising its definition of a business to converge with the FASB's revised definition—that is, clarified to emphasize that the assessment is based on the present capability of the acquired set. Mr. Trott said he supports all of the staff's recommendations.

Mr. Herz asked if any Board members opposed any of the staff's recommendations, including the removal of paragraph A6 and the staff's proposed examples from the guidance (see Appendix A, pages 25–28 of these minutes). Ms. Seidman and Mr. Crooch expressed reservations about the inclusion of the presumption within the guidance; however, no Board members opposed the package of recommendations.

<u>Follow-up Items:</u>

The objectives of the meeting were met.

<u>General Announcements:</u>

None

[6] *Goodwill* is defined in IFRC 3, *Business Combinations,* by its nature as "future economic benefits arising from assets that are not capable of being individually identified and separately recognized," rather than as a residual amount.

Appendix A: Board Meeting Handout

Business Combinations: Purchase Method Procedures
June 9, 2004

At today's meeting the Board will:

Issue A: Clarify the staff's understanding of the Board's tentative decisions and views of Board members as discussed at the April 7, 2004 Board meeting and determine how the fair value of acquirer replacement awards[7] should be allocated between purchase price[8] and postcombination compensation cost of the acquirer.

Issue B: Reconsider, at the request of the IASB, whether the scope of this joint project should be expanded to consider the accounting for groups of assets or net assets that do not constitute a business and, if so, whether the Board's consideration and deliberations of the related technical issues should be undertaken and completed prior to the release of the forthcoming Exposure Drafts on business combinations and on noncontrolling interest.

Issue C: Discuss proposed clarifications to the definition of a business and revisions to its related application guidance.

ISSUE A

BACKGROUND

This discussion assumes the following based on the Board's tentative decisions (made at the April 7, 2004 Board meeting):

a. As part of the business combination, the acquirer has an obligation to replace (or settle) the outstanding awards held by employees of the acquiree. Otherwise, any equity-based compensation (EBC) award granted to

[7]Acquirer replacement awards refer to the exchange of acquiree EBC awards for acquirer awards in a business combination. The replacement awards can be in the form of cash, EBC liabilities, or EBC awards.

[8]Allocation to purchase price refers to either (a) the amount that should be part of the consideration paid in the business combination (for an EBC equity award), or (b) the assumed liability of the acquiree recognized by the acquirer (for an EBC liability award).

employees of the acquiree would result in compensation cost to the acquirer as opposed to consideration paid in the business combination (purchase price).

b. To the extent the acquiree's EBC award represents an equity interest in the acquiree, a portion of the fair value of the acquirer-replacement EBC award should be recognized as consideration paid in the business combination. Both vested (in which "vested" is shorthand for "the requisite service has been rendered") and nonvested EBC awards may represent an equity interest in the acquiree.

c. The fair value of the acquiree awards being replaced (whether vested or nonvested) should be compared to the fair value of the acquirer replacement awards (replacement) at the acquisition date. If the fair value of the replacement exceeds the fair value of the acquiree awards, that incremental fair value is postcombination compensation cost of the acquirer.

d. To the extent that there is additional service explicitly required in order to vest in the acquirer replacement awards, a portion of the fair value of the replacement award would be recognized as compensation cost of the acquirer.

STAFF RECOMMENDATION

Issue 1: Does the Board agree that when determining "fair value" for the exchange of EBC awards in a business combination, the Statement 123 fair-value-based measurement model should be used as opposed to a fair value measurement model per the purchase method procedures project?

*Staff Recommendation**:*** When determining "fair value" for the exchange of EBC awards in a business combination, the Statement 123 fair-value-based measurement model should be used as opposed to a fair value measurement model per the purchase method procedures project.

Appendix A: Board Meeting Handout

Issue 2: Should the requisite service period subsequent to the business combination take into account explicit, implicit, and derived service periods?

Staff Recommendation: Assumption d, above, discusses the requirement of an *explicit* service condition in order to allocate a portion of the fair value of the replacement awards to compensation cost of the acquirer. The staff recommends that consistent with the EBC Exposure Draft, the requisite service period subsequent to the business combination should take into account any explicit, implicit, and derived service periods for purposes of determining the "vesting" status of the awards to allocate the remaining fair value[9] between purchase price and compensation cost.

Issues 3–6 attempt to clarify how to allocate the remaining fair value between purchase price and compensation cost. There are four types of exchanges of EBC awards in a business combination:

a. The requisite service period of the acquiree awards was completed prior to the business combination (vested acquiree awards).
b. The requisite service period of the acquiree awards was not completed prior to the business combination (nonvested acquiree awards).
c. There is no requisite service period associated with the acquirer replacement awards subsequent to the business combination (vested replacement awards).
d. There is a requisite service period associated with the acquirer replacement awards subsequent to the business combination (nonvested replacement award).

Issues 3–6 are described in the chart in Appendix 1. The examples assume that the acquiree's employee was granted an EBC award with a four-year cliff vesting service condition. At the acquisition date, the examples assume that the

[9] The remaining fair value is the amount left after all incremental fair value is allocated to compensation cost.

Appendix A: Board Meeting Handout

acquiree EBC award has a fair value (as calculated under FASB Statement No. 123, *Accounting for Stock-Based Compensation)* of $100. In addition, it assumes that the acquirer replacement award has a fair value (as calculated under Statement 123) of $100.

The chart in Appendix 2 describes the same scenarios as Appendix 1, and has the same assumptions as Appendix 1, except that the acquiree's employee was granted a cash SAR with a four-year cliff vesting service condition.

Issue *3: How should the remaining fair value be allocated between compensation cost and purchase price for outstanding awards held by employees of the acquiree (for which all requisite service was rendered prior to the combination) that are replaced with awards issued by the acquirer (for which future service is not required) (acquiree vested for acquirer vested)?*

Staff Recommendation: A vested acquiree award replaced by a vested acquirer award represents the acquisition of an equity interest and, therefore, 100 percent of the remaining fair value would be included in the purchase price.

Issue 4: How should the remaining fair value be allocated between compensation cost and purchase price for outstanding awards held by employees of the acquiree (for which all requisite service was rendered prior to the combination) that are replaced with awards issued by the acquirer (for which future service is required) (acquiree vested for acquirer nonvested)?

View A: If the requisite service period of the acquiree award was completed prior to the business combination, and there is a requisite service period associated with the acquirer replacement award subsequent to the business combination, then the entire remaining fair value should be allocated to compensation cost.

View B: Outstanding awards held by employees of the acquiree (for which all requisite service was rendered prior to the combination) that are replaced by awards issued by the acquirer (for which there is a requisite service period) represent the acquisition of an equity interest in a business combination. However, as there is a requisite service period associated with the acquirer replacement award, there also is compensation cost related to future services between the acquirer and the employees of the acquiree. Therefore, the remaining fair value should be allocated between the purchase price and compensation cost. The allocation would calculate the amount allocated to compensation cost as the remaining fair value multiplied by the fraction of the requisite service period of the replacement award divided by the total requisite service period. The total requisite service period is the portion of the requisite service period served prior to the consummation date plus the requisite service period of the replacement award. The amount allocated to compensation cost would be recognized over the requisite service period of the replacement award.

View C: View C is similar to View B; however, the allocation between the purchase price and compensation cost would be different. The fraction of the remaining fair value to be allocated to compensation cost is the requisite service period of the replacement award divided by the total service period. View C calculates the total requisite service period as the total amount of service served, even if greater than the requisite service period, prior to the consummation date plus the requisite service period of the replacement award.

Staff Recommendation: The staff recommends View C.

Issue 5: How should the remaining fair value be allocated between compensation cost and purchase price for outstanding awards held by employees of the acquiree (for which all requisite service was not rendered prior to the combination) that are replaced with awards issued by the acquirer (for which future service is required) (acquiree nonvested for acquirer nonvested)?

Staff recommendation: Outstanding awards held by employees of the acquiree (for which all requisite service was not rendered prior to the combination) that are replaced with awards issued by the acquirer (for which future service is required) represent an exchange of nonvested acquiree awards that contain elements of both an equity interest in the acquiree and compensation cost related to future services between the acquirer and the employees of the acquiree. Therefore, the remaining fair value should be allocated between purchase price and compensation cost.

The amount allocated to compensation cost would be the remaining fair value multiplied by the fraction—that is, the requisite service period of the replacement award divided by the total requisite service period (the portion of the requisite service period served prior to the consummation date plus the requisite service period of the replacement award). The amount allocated to compensation cost would be recognized over the requisite service period of the replacement award.

However, the staff believes that the amount of equity interest (for an EBC equity award) or the amount of the assumed liability (for an EBC liability award) cannot exceed the vesting percentage of the acquiree award. That is, a portion of the remaining fair value of the acquirer-replacement award should be recognized as consideration paid in the business combination, but only to the extent that the EBC award represents an equity interest in the acquiree.

Issue 6: How should the remaining fair value be allocated between compensation cost and purchase price for outstanding awards held by employees of the acquiree (for which all requisite service was not rendered prior to the combination) that are replaced with awards issued by the acquirer (for which no future service is required) (acquiree nonvested for acquirer vested)?

Staff Recommendation: Outstanding awards held by employees of the acquiree (for which all requisite service was not rendered prior to the combination) that are replaced with awards issued by the acquirer (for which no future service is required) represent an exchange of nonvested acquiree awards that contain elements of both an equity interest in the acquiree and compensation cost related to the portion that does not represent the replacement of an equity interest in the acquiree. Therefore, the remaining fair value should be allocated between purchase price and compensation cost.

As there is no requisite service period of the replacement award to calculate the portion of the remaining fair value that should be allocated to compensation cost, the staff believes that the amount of equity interest (for an EBC equity award) or the amount of the assumed liability (for an EBC liability award) cannot exceed the vesting percentage of the acquiree award. That is, a portion of the remaining fair value of the acquirer-replacement award should be recognized as consideration paid in the business combination, but only to the extent that the EBC award represents an equity interest in the acquiree. The balance represents compensation cost that would be recognized by the acquirer immediately, as there is no requisite service period associated with the acquirer replacement awards.

ISSUE B

BACKGROUND

At the December 17, 2003 meeting, the FASB Board considered expanding the scope of the purchase method procedures project to include acquisitions of groups of assets (and related liabilities). At that meeting, the Board decided not to expand the scope of the project because expanding the scope:

- Would delay issuance of the Exposure Drafts and final Statements since the staff would need to explore the accounting implications of such a scope expansion.
- Could result in divergence from the IASB's scope since it did not explore a similar scope expansion at that time.

Appendix A: Board Meeting Handout

At its May 19, 2004 meeting, the IASB reconsidered issues related to the definition of a business and discussed whether to conform the definition agreed to by the IASB to the definition agreed to by the FASB. During that discussion, the issue was raised about whether to broaden the scope of the purchase method procedures project to include acquisitions of groups of assets. The IASB concluded that, conceptually, acquisitions of all groups of assets should be accounted for the same way. Therefore, the IASB decided to ask the FASB to reconsider whether the scope of the joint purchase method procedures project should be expanded to consider the accounting for groups of assets that do not constitute a business.

STAFF RECOMMENDATION

In concept, the staff agrees that acquisitions of all groups of assets should be accounted for in the same way. While the staff believes the Boards should explore whether similar accounting for businesses and groups of assets is feasible in practice, the staff is concerned that expanding the scope of the project would further postpone the issuance of the forthcoming Exposure Drafts and would introduce additional controversial issues that would further postpone the issuance of the final Statements. If the Boards wish to jointly address accounting for groups of assets, the staff recommends that the issues be addressed in a separate project that is undertaken after the Boards receive valuable input from their constituents on the forthcoming Exposure Drafts and perform additional preagenda research to identify the issues to be addressed and their relationship to issues that are or were being addressed in other agenda projects.

Appendix A: Board Meeting Handout

ISSUE C

The staff will ask the Board to decide whether to:

a. Remove application guidance for assessing whether an acquired set of activities and assets is a business based on whether a missing element is minor (that is, can be replaced with little difficulty and no significant cost).
b. Provide guidance that (1) describes inputs and processes applied to inputs and (2) clarifies that they are required elements of a business and that they must be capable of being conducted and managed for the purpose of providing (a) a return to investors or (b) lower costs or other economic benefits directly and proportionately to owners, members, or participants.
c. Affirm and clarify that resulting outputs used to generate revenues normally are present but are not required at the acquisition date. Rather, consistent with the conclusions of the FASB and IASB regarding development stage companies, the guidance should make clear that a business might exist that has the inputs and processes applied to inputs but does not yet have the resulting outputs.
d. Reconsider whether to include within the application guidance an observation that if either or both of the components of core goodwill are present in an acquired set of activities and assets, the set is presumed or likely to be a business.
e. Clarify the definition of a business to make explicit and, thus, emphasize that assessing whether an acquired group of activities and assets is a business requires an assessment of the *capability* of that acquired group.

STAFF RECOMMENDATION

The staff's recommendations for the definition of a business and related guidance are that the Board:

5. Remove the application guidance for assessing whether a missing element is minor.
6. Better describe the meanings of inputs, processes applied to inputs, and outputs and clarify that the first two are required in order for an acquired set of activities and assets to be considered a business (and affirm that outputs are not required).

Appendix A: Board Meeting Handout

7. For purposes of convergence, consider adding a presumption that if the going-concern element of goodwill is present in an acquired set of activities and assets, the set shall be presumed to be a business.
8. Clarify the definition of a business to emphasize that the assessment is based on the present capability of the acquired set.

Proposed revisions to the definition of a business and related guidance are as follows (marked for <u>additions</u> or ~~deletions)~~:

Proposed Definition of a Business and Related Guidance (Staff Draft)

<u>Definition</u>:

A business is an integrated set of activities and assets <u>that is capable of being</u> conducted and managed for the purpose of providing:

a. A return to investors; or
b. Lower costs or other economic benefits directly and proportionately to owners, members, or participants.

A business consists of (1) inputs, (2) processes applied to those inputs, and (3) resulting outputs that are or will be used to generate revenues.

Appendix A: Board Meeting Handout

Guidance:

According to this Statement, in order for an acquisition of a group of activities and assets (an acquired set) to be accounted for as a business combination, the acquired set must constitute a *business*. This Statement defines a business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing (a) a return to investors~~,~~ or (b) lower costs or other economic benefits directly and proportionately to owners, members, or participants.* A business consists of (1) inputs, (2) processes applied to those inputs, and (3) resulting outputs that are or will be used to generate revenues.

*Previously, the guidance in EITF Issue No. 98-3, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business” was used to determine whether the net assets acquired constituted a business. However, this Statement replaces and nullifies the guidance in that Issue.

If the going-concern element of core goodwill is present in an acquired set of activities and assets, the set shall be presumed to be a business.

To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs—that are or will be used to create outputs that generate or will have the ability to generate economic benefits to investors, owners, members, or other participants. The third element—outputs—generally is present but is not essential. The nature of the elements of a business vary by industry and by how an entity structures its operations, including the stage of its development. The three elements of a business are defined as follows for the purposes of this Statement:

Financial Accounting Standards Board

Appendix A: Board Meeting Handout

- Inputs: Any resource, when a process is applied to it, that generates or has the ability to generate economic benefits for investors, owners, members, or other participants (for example, long-lived assets, including intangible assets or rights to the use of long-lived assets, intellectual property, the ability to obtain access to necessary materials or rights, and employees.

- Processes: Systems, standards, protocols, conventions, and rules applied to inputs to create outputs that generate or will have the ability to generate economic benefits for investors, owners, members, or other participants (for example, strategic management process, operational process, and resource management processes). These processes typically are documented; however, an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to those inputs to generate outputs.

- Outputs: The result of inputs and processes applied to those inputs that generate or have the ability to generate economic benefits for investors, owners, members, or other participants

If the acquired set is missing an element or elements that prevent the group of activities and assets from being capable of being conducted and managed for either of the two purposes noted in paragraph A5, the acquired set is not a business.

The assessment of whether a transferred set is a business is to be based on whether it is capable of being conducted and managed as a business by any *willing acquirer*.* Also, whether a seller operated the group of activities and assets as a business prior to the sale is not relevant to the evaluation of whether a group of activities and assets is a business.

* The term *willing acquirer* is used with the same meaning as *willing parties* in the Board's project on Fair Value Measurement. In the [Month] 2004 Exposure Draft, *Fair Value Measurements*, "willing parties are presumed to be marketplace participants representing buyers and sellers that are (a) independent of the entity, that is, they are not related parties, (b) knowledgeable, having a common level of understanding about factors relevant to the asset or liability and the transaction, and (c) able to transact in the same market(s), having the legal and financial ability to do so" (paragraph 5).

Some development stage entities may not yet have outputs that generate or will have the ability to generate economic benefits for investors, owners, members, or other participants. In that case, other factors should be

Appendix A: Board Meeting Handout

assessed to determine whether such a development stage entity is a business. Those factors would include whether the entity:

a. Has commenced planned principal activities
b. Has employees, intellectual property, and other inputs and processes
c. Is operating under a plan to produce outputs
d. Has the ability to obtain access to customers that will purchase the outputs.

The staff notes that if the proposed definition of a business is accepted by the Board, the clarification may eliminate the need for the shaded guidance. Thus, the staff also asks the Board to consider and indicate whether it prefers to retain or eliminate that guidance.

Financial Accounting Standards Board

Appendix A: Board Meeting Handout

Appendix 1 to Handout

EBC Equity Award

Issue	Acquiree Award Status	Replace-ment Award Status	Requisite Service Provided as of Acquisition Date (Acquiree Award)	Fair Value of Acquiree Award at Acquisition Date	Requisite Service Period Associated with Acquirer Replace-ment Awards	Fair Value of Acquirer Award at Acquisition Date	Amount Allocated to Purchase Price	Amount Allocated to Compen-sation Cost
3	*Vested*	*Vested*	4 years	$100	0 years	$100	$100	$0
4	*Vested*	*Non-vested*	4 years[10]	$100	3 years	View A: $100 View B: $100 View C: $100	View A: $0 View B: $57 View C: $70	View A: $100 View B: $43 View C: $30
5	*Non-vested*	*Non-vested*	2 years	$100	(a) 2 years (b) 3 years (c) 1 year	(a) $100 (b) $100 (c) $100	(a) $50 (b) $40 (c) $50	(a) $50 (b) $60 (c) $50
6	*Non-vested*	*Vested*	2 years	$100	0 years	$100	$50	$50

[10]Assume the business combination occurs three years after the employee has vested. Because the award was out of the money, the employee has worked a total of seven years from the grant date, but has not exercised the EBC award.

Appendix A: Board Meeting Handout

Appendix 2 to Handout

Cash SAR

Issue	Acquiree Award Status (per above)	Replace-ment Award Status (per above)	Requisite Service Provided as of Acquisition Date (Acquiree Award)	Amount of Liability on Acquiree's Books at Acquisition Date	Requisite Service Period Associated with Acquirer Replace-ment Awards	Amount of Liability on Acquirer's Books at Acquisition Date	Amount Allocat-ed to Purchase Price	Amount Allocated to Compen-sation Cost
3	Vested	Vested	4 years	$100	0 years	$100	$100	$0
4	Vested	Non-vested	4 years[11]	$100	3 years	View A: $100 View B: $57 View C: $70	View A: $0 View B: $57 View C: $70	View A: $100 View B: $43 View C: $30
5	Non-vested	Non-vested	2 years	$50	(a) 2 years (b) 3 years (c) 1 year	(a) $50 (b) $40 (c) $50	(a) $50 (b) $40 (c) $50	(a) $50 (b) $60 (c) $50
6	Non-vested	Vested	2 years	$50	0 years	$100	$50	$50

Note: The numbers in this chart are for illustrative purposes only and assume that there is no change in the fair value of the replacement award subsequent to the business combination.

[11] Assume the business combination occurs three years after the employee has vested. Because the award was out of the money, the employee has worked a total of seven years from the grant date, but has not exercised the cash SAR.