Financial Accounting Standards Board

Business Combinations: Applying the Acquisition Method
Board Meeting Handout

September 20, 2006

Topic: Intangible Assets

The purpose of this meeting is to discuss the accounting for intangible assets acquired as part of a business combination. Specifically, the staff will ask the Board (1) whether the staff should explore the use of an entity-specific measurement attribute for intangible assets acquired in a business combination and (2) to affirm that all **identifiable** intangible assets acquired in a business combination can reliably be measured.

SECTION 1: COMMENT LETTER SUMMARY

Question 16 of the FASB's and the IASB's joint Exposure Draft, *Business Combinations,* asked:

> *Do you believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognized separately from goodwill? If not, why? Do you have any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics:*
>
> *a. The intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability*
>
> *b. Cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole?*

The majority of respondents disagreed. Those respondents' comments can be summarized as follows:

a. There likely will have been no, or only a few, past exchange transactions on which to base a fair value measurement because active markets are likely to be uncommon for intangible assets. This will require preparers to estimate the price in a hypothetical exchange transaction, therefore reducing the reliability of the measurement.

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b. It will be extremely difficult to determine the fair value of intangible assets without using valuation techniques. Some respondents questioned whether valuation techniques result in reliable information because they are subjective, rely on estimates and significant judgement, and involve various assumptions, which can dilute measurement reliability.

c. An identifiable intangible asset might not be able to be measured reliably if the cash flows/economic benefits that it generates are linked to the cash flows/economic benefits generated by the business as a whole.

d. Some identifiable intangible assets are not transferable without third-party consent or regulatory approval. Some also might legally be prohibited from being sold or transferred (such as those containing personal information about an entity's customers).

e. The proposal is inconsistent with the IASB's *Framework,* which requires reliability of measurement for the recognition of an asset. The IASB should not depart from the *Framework* without due process solely for convergence purposes. Some constituents concurred with the alternative view expressed in the IASB's Exposure Draft on business combinations, which states that once the reliability criterion is removed, there is no limit to the unreliability of measurements that may be reported for separate intangible assets acquired in a business combination.

Respondents also identified a number of specific examples of intangible assets that they believe might not be able to be measured reliably.

A minority of respondents agreed that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognized separately from goodwill. Those respondents:

a. Agreed with the Board that recognizing identifiable intangible assets separately from goodwill provides users of financial statements with better information than subsuming those assets in goodwill.

b. Stated that entities should not be able to avoid the separate recognition of intangible assets simply because it is more difficult to measure their fair values.

c. Expressed concern about the potential for non-amortization of finite-lived intangible assets if they are subsumed in goodwill.

d. Suggested that the Board provide guidance on how to measure the fair values of identifiable intangible assets acquired in a business combination.

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SECTION 2: STAFF ANALYSIS

Issue A—Should Intangible Assets Be Recognized Separately from Goodwill?

Because a few respondents to the Exposure Draft stated that the costs of separately recognizing intangible assets do not outweigh the benefits, the staff sought the input of financial statement users on the IASB's Analysts' Representative Group and the FASB's Business Combinations Resource Group. The staff asked the users:

a. Do you agree with the Boards that an estimate of fair value and the separate recognition of intangible assets, rather than subsuming them in goodwill, provides better information to users of financial statements, even though a significant degree of judgement could be involved in determining those fair values?

b. Do you treat separately recognized intangible assets differently from goodwill?

Responses from users were mixed. Some users agreed that the separate recognition of intangible assets provides better information to users of financial statements and noted that in their analyses they treat intangible assets differently from goodwill. Other users stated that the information provided by recognizing intangible assets separately from goodwill might be useful in some, but not all, circumstances. Those users identified reliability and the costs of separate recognition of intangible assets as concerns. Several users stated that in their analyses they do not treat separately recognized intangible assets differently from goodwill.

In the staff's view, identifiable intangible assets have economic characteristics that are different from the economic characteristics of goodwill. Therefore, the staff supports presenting identifiable assets separately from goodwill on the basis that it improves the decision usefulness of financial statements.

Does the Board affirm that identifiable intangible assets should be recognized separately from goodwill (assuming that there is a relevant and reliable measurement attribute)?

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Issue B—Should a *Current Exchange Value* or an *Entity-Specific Value* Be Used to Measure Intangible Assets?

Both IFRS 3, *Business Combinations,* and FASB Statement No. 141, *Business Combinations,* require intangible assets to be measured at fair value (the staff is aware that practice under Statement 141 has been mixed). The Exposure Draft also proposes a fair value measurement attribute for intangible assets, which is consistent with the measurement principle agreed to by the Boards. However, through recent discussions in the FASB Staff Position project on the measurement of non-financial assets, the staff is aware that some Board members are not convinced that a current exchange value is the appropriate measurement attribute for intangible assets. Those Board members suggest that an entity-specific measurement might be more relevant. Additionally, some Board members and constituents question whether the benefits of measuring identifiable intangible assets in Level 3 of the fair value hierarchy exceed the costs of added valuation complexity when an observable market does not exist.

The staff does not recommend that the Board change the measurement attribute for intangible assets acquired in a business combination. However, the staff seeks the Board's input on whether it would like the staff to explore the use of entity-specific measurements for intangible assets acquired in a business combination.

Does the Board agree that an identifiable intangible asset acquired in a business combination should be measured at a current exchange value or does the Board want the staff to explore an entity-specific measurement attribute on the basis of:

- ***a. Relevance***
- ***b. Reliability***
- ***c. Cost-benefit considerations?***

If the Board wants the staff to explore an entity-specific measurement attribute for intangible assets, what should be the scope of that exception? (For example, all intangible assets, intangible assets for which Level 1 and Level 2 inputs are not available, and so on?)

In addition, constituents expressed concern about a lack of guidance related to the subsequent measurements of assets an entity does not intend to use and for the subsequent measurement of intangible assets that the acquirer will use for a period significantly less than its economic useful life. The staff will ask the Board whether the staff should explore providing guidance for those issues in the final business combinations Statement.

Does the Board believe the staff should explore providing guidance as part of the business combinations project for the situations described above?

Issue C—Can the Current Exchange Value of Identifiable Intangible Assets Be Measured Reliably?

In Statement 141, the Board concluded that *identifiability* (that is, an intangible asset arises from contractual-legal rights or is separable) is the condition that establishes a reliability of measurement threshold for the separate recognition of intangible assets. Therefore, the Board concluded that if an intangible asset is identifiable, its fair value can be measured reliably.

IFRS 3 is different. At the time IFRS 3 was developed, the IASB believed that there might be a class of identifiable intangible assets that cannot be measured reliably. Therefore, IFRS 3 requires that an intangible asset must be identifiable **and** reliably measurable to be recognized separately from goodwill. Paragraph 38 of IAS 38 *Intangible Assets*, identifies the circumstances in which an intangible asset might not be able to be measured reliably (when either (a) the asset is not separable or (b) there is no history or evidence of exchange transactions for the asset or similar assets), but it does not specify what causes a measurement to be unreliable in those circumstances.

As noted in the comment letter summary, respondents gave examples of several intangible assets that, in their view, cannot be measured reliably. The staff followed up with some valuation experts regarding those examples and the valuation experts stated that all identifiable intangible assets can be measured reliably at fair value. As a result, the staff believes that Level 1, 2, or 3 inputs will always be available to measure identifiable intangible assets.

Does the Board agree that inputs in Level 1, 2, or 3 of the fair value hierarchy will always be available to measure identifiable intangible assets, and, therefore, an identifiable intangible asset can always be measured with sufficient reliability?

Issue D—Alternatives if the Board Decides that Some Identifiable Intangible Assets Might Not Be Able to Be Measured Reliably at a Current Exchange Value

If the Board decides that some identifiable intangible assets cannot be measured at a current exchange value with sufficient reliability, the Board will need to decide how those intangible assets should be treated.

Alternative A—Subsume the intangible assets into goodwill.

Alternative B—Aggregate the intangible assets into a unit of account that can be measured reliably at a current exchange value.

Alternative C—Measure the intangible assets at a measurement attribute other than a current exchange value.

Alternative A is to subsume into goodwill those intangible assets that cannot be measured reliably at a current exchange value. If the Board agrees with the staff on Issue A (that is, that separating intangible assets from goodwill provides more decision useful information), then the Board might want to consider Alternative B or C rather than Alternative A.

Alternative B is to provide guidance that would permit entities to aggregate individual intangible assets that cannot be measured reliably at a current exchange value into a group of assets that can be measured reliably at a current exchange value. The final business combinations Statement could include guidance similar to that in paragraph 36 of IAS 38, which states:

> An intangible asset acquired in a business combination might be separable, but only together with a related tangible or intangible asset. For example, a magazine's publishing title might not be able to be sold

> separately from a related subscriber database, or a trademark for natural spring water might relate to a particular spring and could not be sold separately from the spring. In such cases, **the acquirer recognizes the group of assets as a single asset separately from goodwill if the individual fair values of the assets in the group are not reliably measurable.** [Emphasis added.]

Alternative C is to measure those intangible assets that cannot be measured reliably at a current exchange value using a different measurement attribute.

If the Board does not agree that all **identifiable** ***intangible assets can be measured separately at a current exchange value, should identifiable intangible assets that cannot be measured with sufficient reliability be:***

a. ***Subsumed into goodwill***

b. ***Aggregated in a unit of account that can be measured reliably at a current exchange value***

c. ***Measured using a measurement attribute other than a current exchange value?***

Financial Accounting Standards Board

Board Meeting Handout

Financial Statement Presentation

September 20, 2006

PURPOSE

The purpose of this Board Meeting is for the Board to continue discussing application of the project's working principles. The goal is for the Board to further develop the basic "working" format for the financial statements (the sections and categories for each financial statement) that will be included in the Preliminary Views document. Application of the working principles to the statement of changes in equity will not be addressed until the Board has reached decisions on the statements of financial position, comprehensive income, and cash flows. Therefore, for purposes of this meeting, the *financial statements* refer to those three financial statements. The discussions on the overall working format are focused on non-financial institutions. Financial statement presentation for financial institutions will be considered once all of the issues related to non-financial institutions have been addressed.

Note: the paragraph and issue numbers in this handout correspond to paragraph numbers in the Board memorandum used as the basis for discussion.

SUMMARY OF RECOMMENDATIONS

The following table illustrates the sections and categories that are recommended by the staff [¶2].

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
Business ◆ Operating assets and liabilities ◆ Strategic investments	**Business** ◆ Operating income ◆ Strategic investment income	**Business** ◆ Operating cash flows ◆ Strategic investment cash flows
Discontinued operations	**Discontinued operations**	**Discontinued operations**
Income taxes	**Income taxes**	**Income taxes**
Financing ◆ Financing liabilities ◆ Treasury assets ◆ Equity	**Financing** ◆ Financing expenses ◆ Treasury income	**Financing** ◆ Financing cash flows ◆ Treasury cash flows ◆ Equity cash flows

ISSUE 1—FINANCING AND TREASURY

During the discussions at the Board meetings in July regarding financing liabilities and treasury assets, the Boards were broadly in agreement with an approach that would present information

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through the eyes of management. That is, an approach that would classify items based on their function so that an entity could exclude from the treasury category or the financing section items that management views as operating assets and liabilities [¶4].

Issue 1A—Presentation of Treasury Assets

In July, the staff recommended that treasury assets should be reported within the business section. The IASB agreed with that recommendation and some FASB members expressed a preference for it as well [¶5]. As suggested by the Boards in July, the staff spoke with users of financial statements to get a better understanding of how they analyze financing activities. Those users indicated that they include treasury assets as a part of their analysis of financing activities, rather than as a part of their analysis of business activities. This supports the staff's changed view that it would be more useful to present treasury assets in the same section as financing activities rather than in the business section alongside operating assets and liabilities [¶8].

The staff recommends that the treasury category be reported within the financing section, and that a gross presentation of the financing section be required [¶10].

Question for the Board (Issue 1A):

Should financing liabilities, treasury assets, and related activities be presented gross in the same section in the statements of financial position, comprehensive income, and cash flows?

Issue 1B—Approach to Defining Financing Liabilities and Treasury Assets

At their July meetings, the Boards agreed that the financing section should include all equity items but not all liabilities and that the treasury category need not include all financial assets [¶11]. The Boards differed, however, on whether financing liabilities and treasury assets should be defined broadly, with allowable exclusions, or defined more narrowly. At the September meetings the staff will be asking for Board concurrence on the staff's recommended approach to developing those definitions. The two possible approaches are described below [¶12].

The *broad definition* approach defines financing liabilities and treasury assets broadly and allows entities to exclude items as a matter of accounting policy. Guidance would be provided on items that could be excluded. Financing liabilities and treasury assets as reported by management on the face of the financial statements could be reconciled to the broad definition in the notes. This approach was recommended by the staff and favored by the IASB in July [¶13]. The *narrow definition* approach attempts to define financing liabilities directly. The accounting standard would directly describe the amounts to be reported in the financing section, as opposed to giving a broad definition and describing allowable exclusions. This narrow definition approach was preferred by the FASB over the broad definition approach, and the FASB members asked the staff to consider further how it could be implemented [¶14].

The staff recommends that financing liabilities and treasury assets be defined narrowly, and thereby subjectively, for purposes of presenting information on the face of the financial statements [¶17].

Question for the Board (Issue 1B):

Should financing liabilities and treasury assets be defined narrowly for the purposes of presentation on the face of the financial statements?

ISSUE 2—STRATEGIC INVESTMENT CATEGORY

During the July Board meetings, some members of each Board indicated that the definition of treasury assets was too broad because some assets included in that definition, equity method investments in particular, are clearly not viewed as assets that offset financing liabilities. Those Board members suggested that the staff consider a category for strategic investments that would be reported in the business section, separate from the treasury category [¶18].

A draft AICPA Statement of Position (SOP) clarifying the scope of the Audit and Accounting Guide, *Investment Companies*, includes the following definition of *strategic investments*:

> Investments held for strategic operating purposes in order to obtain benefits (other than current income, capital appreciation, or both) from investees that are unavailable to noninvestor entities that are not related parties to the investee [¶31].

The staff recommends the following:

a. A strategic investment category be presented within the business section in each of the financial statements
b. A *strategic investment* be defined as an equity investment held for strategic operating purposes in order to obtain benefits (other than current income, capital appreciation, or both) from investees that are unavailable to a noninvestor entity that is not a related party (as defined in accounting literature) to the investee (consistent with forthcoming SOP)
c. Goodwill (as defined in accounting literature) be classified in the strategic investment category unless the equity investment that an entity retains as a result of a business combination does not meet the definition of a strategic investment (which should be rare).
d. Assets that do not meet the definition of a strategic investment that give rise to investing cash flows under current guidance should be classified in other categories (such as treasury assets or operating assets) [¶36].

Questions for the Board (Issue 2):

a. Should certain financial assets be classified in the business section?

b. Should there be a category within the business section other than the operating category? If so, should an entity have some flexibility in determining the assets to be classified in that category?

c. Which of the following assets should be included in that separate category?

Financial Assets

1) Held-to-maturity securities
2) Available-for-sale securities
3) Investments in subsidiaries (statement of comprehensive income and statement of cash flows only for consolidated subsidiaries)
4) Investments in affiliates/associates
5) Investments in joint ventures (statement of comprehensive income and statement of cash flows only for proportionately consolidated investments)

Non-Financial Assets

6) Goodwill
7) Other investments (for example, investments in artwork and idle land)

ISSUE 3—INCOME TAXES

Presentation of Income Taxes

When discussing the presentation of income taxes in the financial statements, the Boards need to consider whether income tax is (a) integral to the transaction or event that gives rise to income taxes (the underlying transaction) or (b) a transaction separate from the underlying transaction [¶46].

View A: Integral to the Underlying Transaction

Under the view that income taxes are integral to the related transaction, View A would present the taxes and transaction in the same category [¶47]. A strict application of View A would lead to the conclusion that the proposed financial statement presentation model should present income taxes in each category, based on the classification of the underlying transactions [¶51].

View B: Separate from the Underlying Transaction

Under the view that income taxes are separate from the related transaction, View B would present taxes and transactions separately [¶52]. A strict application of View B would lead to the conclusion that the proposed financial statement presentation model should present income taxes as a separate section (that is, along with the business and financing sections) because income taxes arise from not only those items reported in the business section but also from items reported in the financing (and possibly other) sections [¶56].

In line with View B, **the staff recommends** that income taxes be presented as a separate section (along with the business and financing sections) in the financial statements. This effectively eliminates intraperiod tax allocation, which means that:

a. There would be no need for a pre-tax subtotal, such as "income from continuing operations", in the statement of comprehensive income.
b. The results of discontinued operations would no longer be presented net of applicable income taxes (those results would be presented on a pre-tax basis). (The presentation of discontinued operations is discussed in Issue 4.)
c. OCI items will no longer be presented on an after-tax basis. Accordingly, changes in tax rates would no longer raise the issue of "truing up" OCI for prior periods or the accumulated OCI on the statement of financial position (the so-called "backwards tracing" issue) [¶62].

The staff also recommends that income taxes related to transactions with owners **not** be recognized directly in equity but be included in comprehensive income. Those amounts should be presented in the income tax section of the statement of comprehensive income. The staff acknowledges that this recommendation to change the **accounting** for income taxes related to transactions with owners may be beyond the scope of the financial statement presentation project [¶63].

Question for the Board (Issue 3):

Should:

a. Income taxes be presented as a separate section (along with the business and financing sections) in the financial statements, thereby eliminating the need for intraperiod tax allocation and the presentation of discontinued operations and OCI items on a net-of-tax basis?
b. Income taxes related to transactions with owners **not** be recognized directly in equity? If so, should income taxes related to transactions with owners be recognized in the income taxes section in the statement of comprehensive income?

ISSUE 4—DISCONTINUED OPERATIONS

Issue 4A—Definition of a Discontinued Operation

The size of a *component* classified as a discontinued operation is different in IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* (2004), and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* and could be considered smaller in Statement 144 [¶66]. While converging the definition of discontinued operations is arguably outside the scope of a project on financial statement presentation, the staff notes that, while this project may result in a seemingly converged and improved **presentation** of discontinued operations, there will be a false sense of comparability until the definitions are converged [¶68].

Question for the Board (Issue 4A):

Should converging the definition of discontinued operations be in the scope of the financial statement presentation project? If yes, should that definition be addressed in the current Phase B or in new, later phase of the project?

Issue 4B—Presentation of Discontinued Operations

The staff identified the following alternatives for presenting the assets and liabilities related to a discontinued operation and the changes in those assets and liabilities in the financial statements:

a. **Alternative A**–in a **separate section** in each financial statement, along with the business and financing sections
b. **Alternative B**–in a **separate category within the *business* section** (in addition to the "operating" category).
c. **Alternative C–within the appropriate categories and subcategories** (for example, include operating assets and liabilities of discontinued operations in the "short-term operating" or the "long-term operating" subcategory; treasury assets of a discontinued operation in the treasury category, and so forth) [¶71].

The staff recommends that discontinued operations should be presented in the financial statements in a separate section and should not be classified as a category/subcategory within a section (Alternative A) [¶76].

Question for the Board (Issue 4B):

Should discontinued operations continue to be presented separately in the financial statements and information related to a discontinued operation be displayed as a separate section in the financial statements?

Issue 4C—Presenting Information about a Discontinued Operation

The staff recommends that long-lived assets, and assets and liabilities within disposal groups classified as held for sale be presented in the discontinued operation section of the **statement of financial position**, with the assets presented separately from the liabilities and not offset. In addition, **the staff recommends** that the Boards retain the current requirement that the major classes of discontinued assets/liabilities be disclosed in the notes to the financial statements. This recommendation retains the current presentation requirements of IFRS 5 and Statement 144, but changes the location of that presentation to the discontinued operations section of the statement of financial position [¶82].

The staff recommends that, consistent with IFRS 5, an entity should disclose a single amount in the discontinued operation section of the **statement of comprehensive income** comprising the total of:

a. the profit or loss of the discontinued operation and
b. the gain or loss recognized on the measurement to fair value less costs to sell or on the disposal of the assets or disposal groups constituting the discontinued operation.

An entity should disclose the components of the profit or loss (revenue and expenses) and the components of the gain or loss (from remeasurement or disposal) either on the face of the statement or in the notes. (As recommended in Issue 3, those amounts should be on a pre-tax basis.) This recommendation retains the current presentation requirements of IFRS 5 and Statement 144 and clarifies what information is required to be presented on the face of the statement of comprehensive income and what information may be presented in the notes [¶83].

The staff recommends that cash flows from a discontinued operation be presented as a single line in the discontinued operation section of the **cash flow statement**. This recommendation would change the presentation required by IFRS 5, as separation of those cash flows into their respective categories (operating and financing, for example) would no longer be required. However, **the staff recommends** that if an entity wants to present discontinued operation cash flows by category in the notes, that it be required to do so for each period presented [¶84].

Question for the Board (Issue 4C):

Should:

a. The assets of a discontinued operation and the liabilities of a discontinued operation be presented separately and not be offset?

b. The income statement effects be presented as one amount on the face of the income statement and further disaggregated either on the face of the statement or in the notes?

c. The cash flows from a discontinued operation be presented as a single amount in the statement of cash flows?

ISSUE 5—DISAGGREGATION WORKING PRINCIPLE

Issue 5A—Should the Disaggregation Working Principle be Revised?

Based on discussions at the May brainstorming sessions with Board advisors, it was apparent to the staff that the intent of the disaggregation working principle was not clear. In the staff's view, this working principle was intended to convey that items should be reported at the "highest" level that is useful for predictive purposes, bearing in mind that reporting information that is too highly aggregated is not useful [¶88].

The staff recommends that the working principle be revised as follows:

> Financial statements should present information in a manner that *disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows* [¶89].

Question for the Board (Issue 5A):

Should the disaggregation working principle be revised to read**: "**Financial statements should present information in a manner that disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows"?

Issue 5B—What Other Information Should be Disaggregated in the Financial Statements?

Currently paragraph 83 of IAS 1 provides the following guidance for disaggregation of line items in the statement of comprehensive income: "Additional line items, headings, and subtotals shall be presented on the face of the income statement when such presentation is relevant to an understanding of the entity's performance." Paragraph 84 of IAS 1 goes on to explain that because the effect of an entity's various activities, transactions, and other events differ in frequency, potential for gain or loss, and predictability, disclosing the components of financial performance assists in an understanding of the financial performance achieved and in making projections of future results [¶118]. Some users have indicated in conversations with the staff that the requirements in IAS 1 do not always result in as much disaggregation of items as they would find useful. They note that because the guidance in IAS 1 is subjective (principles-based), oftentimes too many items with different characteristics are aggregated together [¶119].

At a minimum, **the staff recommends** that the language in paragraphs 83 and 84 of IAS 1 be included in the financial statement presentation standard and be applied to each of the financial statements. **The staff also recommends** that the financial presentation standard include a bright-line rule for when items should be presented as a separate line item and not aggregated [¶120].

Question for the Board (Issue 5B):

Should the financial statement presentation standard provide guidance similar to that in IAS 1 for disaggregating items in the financial statements and supplement that guidance with a "bright line" rule for when items should be presented as a separate line item?

Issue 5C—Should Information in the Statement of Comprehensive Income be Presented by Function or Nature?

Users who support reporting individual line items by nature state that it is important to understand the factors that can increase or decrease the value of an entity or impact its future profitability [¶96]. Users who support reporting information based on function suggest that it provides useful information about the allocation of resources to the various activities (functions) of an entity, thus allowing users to understand and predict the relationship between revenues and other expenses [¶98]. Although information presented by function is generally more descriptive of an entity's overall operations, information presented by nature is useful in predicting future cash flows. The staff contends that it may be unnecessary to choose between the *function of expense method* and *nature of expense method* and that a combination of the two methods may be the best [¶101].

There are a variety of ways in which this dual disaggregation scheme could be presented in the comprehensive income statement. One approach (Approach 1) would be to require that, at a minimum, certain components of cost of sales be reported by nature within the functional presentation. In addition, an entity would be encouraged to break out any other costs or expenses that are important in understanding their business [¶102]. Approach 2 is more principles-based in that it would require cost of goods sold to be disaggregated in a manner that would reconcile beginning and ending inventory. In essence, it would require cost of goods sold to be broken down into broad sub-classifications that are widely used in cost accounting (Approaches 1 and 2 are illustrated below.) [¶105].

Approach 1

Sales		X
Cost of sales		
Personnel costs	X	
R&D	X	
Depreciation	X	
Amortization	X	
Employee benefits	X	
Pensions	X	
Other	X	
Cost of Sales		**(X)**
Gross profit		***(X)***
Other income		X
Distribution costs		(X)
Administrative exp		(X)
Other expenses		(X)
Profit		**X**

Approach 2

Sales			X
Cost of sales			
Beginning Finished Goods		X	
Cost of Goods Purchased		X	
Cost of Goods Manufactured			
Beginning WIP	X		
Direct Materials	X		
Direct Labor	X		
Direct Expenses	X		
Overhead	X		
Less: Ending WIP	(X)		
Total Cost of Goods Manufactured		X	
Less: Ending Finished Goods		(X)	
Cost of Sales			**(X)**
Gross profit			***X***
Other income			X
Distribution costs			(X)
Administrative exp			(X)
Other expenses			(X)
Profit			**X**

The staff recommends that line items be presented in the statement of comprehensive income by function and that cost of goods sold be further disaggregated in a manner that would reconcile beginning and ending inventory (Approach 2) [¶108]. **The staff also recommends** that entities be encouraged to separately present any costs or expenses by nature that are important in understanding the business [¶109].

Question for the Board (Issue 5C):

Should information be presented on the statement of comprehensive income by function with supplemental information provided by nature about cost of goods sold and other items important to understanding an entity's business (as described above)?

Issue 5D—Presentation on a Gross or Net Basis

U.S. GAAP cites specific items/accounts that should be reported either on a gross basis or on a net basis (that is, offset). However there is no **general** guidance as to whether items in the financial statements should be presented on a net or a gross basis. IAS 1, on the other hand, requires that assets and liabilities, and income and expenses **not** be offset unless required or permitted by a standard or an interpretation [¶110].

The staff recommends that assets and liabilities and income (revenues and gains) and expenses (expenses and losses) be shown on a gross basis except when:

a. net presentation is required or permitted by a standard other than the financial statement presentation standard or
b. there is no incremental value in the additional information provided in a gross presentation; for example, a gain on the sale of a piece of equipment that is ancillary to the business would be shown net rather than presenting the fair value (price paid) and its cost [¶116].

Question for the Board (Issue 5D):

Should information be required to be presented in the financial statements on a gross basis except when required or permitted by another standard or when the additional information in a gross presentation provides no incremental value?

ISSUE 6—COMPARABILITY WORKING PRINCIPLE

The working principles the Boards agreed to in March and April include two principles related to comparability: financial statements should present information in a manner that allows for comparability (a) over time and (b) across entities. The staff noted that the comparability working principles were embodied in the qualitative characteristics of financial reporting [¶121].

The staff recommends eliminating the two working principles related to comparability as they are encompassed by the qualitative characteristics of financial reporting [¶123].

Question for the Board (Issue 6):

Should the working principles not include the notion of comparability as that notion is encompassed in the qualitative characteristics of financial reporting?

ISSUE 7—EXTRAORDINARY ITEMS

At the August 28, 2002 Board meeting, the FASB decided that the effects of extraordinary, unusual, and infrequently occurring events and transactions should not be presented as a separate functional category in the statement of comprehensive income as currently required under U.S. GAAP. The Board decided that the effects of such events and transactions should be presented within the financial statement category to which the events or transactions relate [¶124].

The staff recommends that the FASB affirm its decision to not present the effects of extraordinary items as a separate functional category in the statement of comprehensive income, but rather to present those items within the financial statement category to which the event or transaction relates [¶126]. The FASB's 2002 decision was to eliminate the **presentation** of extraordinary items in a separate section or category in the statement of comprehensive income. However, it is not clear to the staff that the Board discussion included eliminating the **concept** of extraordinary items from U.S. GAAP. **The staff recommends** that, to more fully converge with IAS 1, the FASB eliminate the extraordinary item concept in Opinion 30 [¶128].

Question for the Board (Issue 7):

Should the effects of extraordinary items not be presented as a separate section or category in the statement of comprehensive income, but rather presented within the financial statement category to which the events or transactions relate? Further, should the concept of "extraordinary items" be eliminated from U.S. GAAP?

Financial Accounting Standards Board

Board Meeting Handout

Financial Instruments: Due Process Document—Scope

September 20, 2006

PURPOSE

The purpose of this Board meeting is to discuss the initial scope of the financial instruments due process document (DPD). The Board will also discuss which financial instruments might be excluded from the scope and which other items might be included.

SCOPE BASED ON THE CHARACTERISTICS OF CONTRACTUAL RIGHTS AND OBLIGATIONS

The Board will consider two possible ways of describing the scope of the DPD. One possibility is to base the scope on the definition of financial instruments, which includes contracts with requirements to deliver or exchange cash or other financial instruments. An alternative is to describe the scope as contracts for which the probable outcomes (but not necessarily the required outcome) will be settlements in cash or other financial instruments.

Questions for the Board:

a. **Should the scope of the DPD be based on the definition of a financial instrument or on similar probable outcomes?**

b. **If neither of those is the appropriate scope, what scope would you propose?**

c. **If you are not prepared to answer those questions, what additional information do you need?**

POSSIBLE CHANGE TO THE DEFINITION OF FINANCIAL INSTRUMENTS

The definition of *financial instruments* includes does not include statutory or regulatory obligations and rights to deliver or exchange financial instruments. Such rights and obligations are as enforceable as contracts (if not more so). Some rights and obligations (such as deferred taxes and uncertain tax liabilities) involve uncertainties that raise issues not raised by financial instruments. Most of these rights and obligations have been dealt with by one or both Boards on an individual basis.

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Questions for the Board:

a. Should legal but noncontractual obligations to deliver cash and legal but noncontractual rights to receive cash be included in the definition of a *financial instrument?*

b. If not, should they be included in the scope of the DPD?

c. If you are not prepared to answer those questions, what additional information do you need?

SCOPE BASED ON A DEFINITION OF A *FINANCIAL INSTRUMENT*

In setting the initial scope of the DPD, the two Boards could choose to use their separate existing definitions due to constituent familiarity with them. However, convergence is desirable and the existing definitions could use improvement.

A staff recommendation for the definition of *financial instruments* to be included in the DPD is set out below:

A *financial instrument* is:

a. cash

b. evidence representing a residual or other ownership interest in an entity

c. a contractual obligation of one party to deliver a financial instrument to a second party and a corresponding contractual right of the second party to require receipt of that financial instrument in exchange for no consideration other than release from the obligation

d. a contractual obligation of one party to exchange financial instruments with a second party and a contractual right of the second party to require an exchange of financial instruments with the first party.

A *financial asset* is a financial instrument that is an asset.

A *financial liability* is a financial instrument that is a liability.

A financial instrument classified by an entity in the equity section of its balance sheet (or statement of financial position) is neither a financial asset nor a financial liability to that entity.

That definition is similar to the definition in the FASB Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*.

One difference between that definition and the existing definition is the reference to contractual rights and obligations instead of contracts. The reasons for the recommended change is that the existing definition implies that if a single contract contains two (or more) separate sets of rights and obligations, then the two sets of rights and obligations are one financial instrument even if one or more sets would not be financial instruments by themselves.

Questions for the Board:

a. **Is the recommended definition appropriate?**

b. **If not, what would you change?**

c. **If you are not prepared to answer these questions yet, what additional information do you need?**

FINANCIAL INSTRUMENTS TO CONSIDER EXCLUDING

The Boards should explicitly consider whether to exclude the following items from the scope of the DPD:

a. Investments in consolidated subsidiaries, consolidated variable interest entities (FASB only), and associates (equity method investees in FASB terms) or joint ventures

b. Contingent consideration in business combinations

c. Leases

d. Royalty contracts and other contracts for rights to use assets (revenue recognition issues)

e. Pensions and other post employment benefits

f. Financial instruments classified as equity by the reporting entity

g. Insurance and related contracts

h. Contracts related to share-based payments

i. Contracts that are financial instruments by definition but are not recognized under current GAAP

j. Other strategic investments

k. Receivables from and payables to brother-sister entities and other affiliated, but not consolidated, entities

Questions for the Board:

a. Which, if any, of the items listed above should be excluded from the scope of the DPD?

b. If you are not prepared to answer that question yet, what additional information do you need?

OTHER CONTRACTS TO CONSIDER INCLUDING

The staff has identified the following three broad categories of contracts that are not financial instruments by definition, but that the Boards should consider including in the scope of the DPD:

a. Contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument,

b. Financial instrument servicing contracts, and

c. Other contracts to deliver/exchange products or services that are otherwise similar to financial instrument contracts.

Questions to the Board:

a. Should net settleable contracts, financial instrument servicing contracts, or contracts that are very similar to related financial instrument contracts be included in the scope of the DPD?

b. Are there other categories of contracts that should be considered for inclusion in the scope of the DPD?

c. If you are not prepared to answer these questions yet, what additional information do you need?

Financial Accounting Standards Board

Board Meeting Handout
Ratification of EITF Consensuses and Tentative Conclusions
September 20, 2006

Ratification of EITF Tentative Conclusions

At today's meeting, the staff will request that the Board consider ratifying consensuses reached on three Issues and tentative conclusions reached on four other Issues at the September 7, 2006 EITF meeting. Upon ratification of the four tentative conclusions, a draft abstract for each Issue will be exposed for a comment period that will end on October 13, 2006.

Task Force Consensuses:

1. **Issue No. 06-1, "Accounting for Consideration Given by a Service Provider to Manufacturers or Resellers of Equipment Necessary for an End-Customer to Receive Service from the Service Provider "**—The Task Force affirmed as a consensus the tentative conclusion reached at the June 15, 2006 EITF meeting that if the consideration given by a service provider to a manufacturer or reseller (that is not a customer of the service provider) can be linked contractually to the benefit received by the service provider's customer, a service provider should use the guidance in EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)," to determine the characterization of the consideration. In applying that guidance, the service provider should characterize the consideration given to a third-party manufacturer or reseller based on the form of consideration directed by the service provider to be provided to the service provider's customer. If the form of the consideration is stipulated to be anything other than "cash consideration" (as defined in Issue 01-9), then the form of the consideration should be characterized as "other than cash" consideration for purposes of applying Issue 01-9. If the service provider does not control the form of the consideration provided to the service provider's customer, the consideration should be characterized as "other than cash" consideration.

   In addition, the Task Force also affirmed as a consensus that this Issue should be effective for the first annual reporting period beginning after June 15, 2007. Earlier adoption is permitted for financial statements that have not yet been issued. Entities should recognize the effects of applying the consensus in this Issue as a change in accounting principle through retrospective application to all prior periods unless it is impracticable to do so.

2. **Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"—**The Task Force affirmed as a consensus the tentative conclusion reached at the June 15, 2006 EITF meeting that for an endorsement split-dollar life insurance arrangement that provides a benefit to an employee that extends to postretirement periods, an employer should recognize a liability for future benefits in accordance with FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, or APB Opinion No. 12, *Omnibus Opinion—*

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1967, (depending on whether a substantive plan is deemed to exist) based on the substantive agreement with the employee.

In addition, the Task Force also affirmed as a consensus that this Issue should be applied to fiscal years beginning after December 15, 2007, with earlier application permitted. Entities should recognize the effects of applying the consensus in this Issue through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption, or (b) a change in accounting principle through retrospective application to all prior periods.

3. **Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*"—**The Task Force affirmed as a consensus the tentative conclusion reached at the June 15, 2006 EITF meeting that a policyholder should consider any additional amounts included in the contractual terms of the policy in determining the *amount that could be realized* under the insurance contract. When it is probable (as defined in FASB Statement No. 5, *Accounting for Contingencies)* that contractual terms would limit the amount that could be realized, the Task Force agreed that these contractual limitations should be considered when determining the realizable amounts. Those amounts that are recoverable by the policyholder at the discretion of the insurance company should be excluded from the amount that could be realized. The Task Force observed that amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy should be discounted in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*. The Task Force also affirmed as a consensus that a policyholder should determine the amount that could be realized under the insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). The Task Force noted that any amount that is ultimately realized by the policyholder upon the assumed surrender of the final policy (or final certificate in a group policy) shall be included in the amount that could be realized under the insurance contract.

   At the September 7, 2006 EITF meeting, the Task Force reached a consensus that a policyholder should not discount the cash surrender value component of the amount that could be realized when contractual restrictions on the ability to surrender a policy exist. However, the Task Force observed that if the contractual limitations prescribe that the cash surrender value component of the amount that could be realized is a fixed amount, then the amount that could be realized should be discounted in accordance with Opinion 21.

   The Task Force affirmed as a consensus that this Issue should be effective for fiscal years beginning after December 15, 2006. Earlier application is permitted as of the beginning of a fiscal year for periods in which interim or annual financial statements have not yet been issued. Entities should recognize the effects of applying the consensus in this Issue through either (a) a change in accounting principle through a cumulative effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods.

Task Force Tentative Conclusions:

1. **Issue No. 06-6, "Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments"—**The Task Force reached a tentative conclusion that the change in the fair value of an embedded conversion option resulting from an exchange of debt instruments or a modification in the terms of an existing debt instrument should not be included in the cash flow test of whether the terms of the new debt instrument are *substantially different* from the terms of the original debt instrument under EITF Issue No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments.” However, a separate analysis must be performed if the cash flow test under Issue 96-19 does not result in a conclusion that a substantial modification or exchange has occurred. Under that separate analysis, a substantial modification or exchange has occurred and the issuer should apply extinguishment accounting if the change in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is at least 10 percent of the carrying value of the original debt instrument immediately prior to the modification or exchange. Additionally, a modification or exchange of debt instruments that adds a substantive conversion option or eliminates a conversion option that was substantive at the date of the modification or exchange would always be considered *substantial* and debt extinguishment accounting would be required in those circumstances. The Task Force decided that for purposes of evaluating whether an embedded conversion option was substantive on the date it was added to or eliminated from a debt instrument, the factors described in EITF Issue No. 05-1, “Accounting for the Conversion of an Instrument That Became Convertible upon the Issuer’s Exercise of a Call Option,” should be considered.

   The Task Force also reached a tentative conclusion that when a convertible debt instrument is modified or exchanged in a transaction that is not accounted for as an extinguishment, an *increase* in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) should reduce the carrying amount of the debt instrument (increasing a debt discount or reducing a debt premium) with a corresponding increase in additional paid-in capital. However, a *decrease* in the fair value of an embedded conversion option resulting from a modification or exchange should not be recognized.

   The Task Force reached a tentative conclusion that this Issue should be applied to future modifications or exchanges of debt instruments that occur beginning in the first interim or annual reporting period beginning after Board ratification. Earlier application of this Issue is permitted for modifications or exchanges of debt instruments in periods for which financial statements have not yet been issued. Retrospective application to previously issued financial statements is not permitted.

2. **Issue No. 06-7, "Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*"—**The Task Force reached a tentative conclusion that an issuer should account for a previously bifurcated conversion option in a convertible debt instrument if the embedded conversion option no longer meets the bifurcation criteria in Statement 133 by reclassifying the carrying value of the liability for the conversion option to shareholders’ equity. Any debt discount related to the conversion option recorded at the issuance of the

convertible debt should continue to be amortized. The Task Force also reached a tentative conclusion that this Issue should be applied to all previously bifurcated conversion options in convertible debt instruments whose terms no longer meet the bifurcation criteria in interim or annual periods beginning after December 15, 2006, irrespective of whether the debt instrument was entered into prior or subsequent to the effective date of this Issue. Earlier application of this Issue is permitted in periods for which financial statements have not yet been issued. Retrospective application to previously issued financial statements is permitted.

3. **Issue No. 06-8, "Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66, *Accounting for Sales of Real Estate*, for Sales of Condominiums"—**The Task Force reached a tentative conclusion that in assessing the collectibility of the sales price pursuant to paragraph 37(d) of Statement 66, an entity should evaluate the adequacy of the buyer's initial and continuing investment in order to conclude that the sales price is collectible. The Task Force agreed that an entity can meet the continuing investment criterion in paragraph 12 of Statement 66 by requiring the buyer to either (a) make additional payments during the construction term at least equal to the level annual payment to fund principal and interest on a customary mortgage for the remaining purchase price of the property or (b) increase the minimum initial investment by an equivalent aggregate amount. The remaining purchase price should be determined by reference to the sales price of the property. Based on the Task Force's tentative conclusion for transactions within the scope of this Issue, if an entity is unable to meet the criteria in paragraph 37, including an assessment of collectibility using the initial and continuing investment tests described in paragraphs 8-12 of Statement 66, then an entity should use the deposit method to recognize profit as described in paragraphs 65-67 of Statement 66. The Task Force also reached a tentative conclusion that this Issue should be effective for the first annual reporting period beginning after March 15, 2007. Earlier application is permitted as of the beginning of a fiscal year. Entities should recognize the effect of this Issue as a change in accounting principle through a cumulative effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position at the beginning of the year of adoption.

4. **Issue No. 06-9, "Reporting a Change in (or the Elimination of) a Previously Existing Difference between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee"—**The Task Force reached a tentative conclusion that the parent or investor should report a voluntary change to (or the elimination of) a previously existing difference between the parent's reporting period and the reporting period of a consolidated entity or between the reporting period of an investor and that of an equity method investee in the parent's or investor's consolidated financial statements as a change in accounting principle through retrospective application in accordance with the provisions of FASB Statement No. 154, *Accounting Changes and Error Corrections*, unless it is impracticable to do so pursuant to paragraph 11 of Statement 154. The Task Force also reached a tentative conclusion that this Issue should be effective for future changes beginning in the first interim or annual reporting periods following Board ratification. Earlier application is permitted in periods for which financial statements have not yet been issued.