

**Board Meeting Handout
Business Combinations: Purchase Method Procedures
April 7, 2004**

At today's meeting, the Board will discuss:

- A. Certain issues related to the accounting for stock options in a business combination.
- B. Whether and how to conform the initial measurement guidance in paragraphs 18–21 of FASB Interpretation No. 46 (Revised 2004), *Consolidation of Variable Interest Entities*, and the measurement guidance in proposed FASB Statement No. 141 (Revised 2004), *Business Combinations*.

**CERTAIN ISSUES RELATED TO THE ACCOUNTING FOR STOCK OPTIONS
IN A BUSINESS COMBINATION**

Issues:

Issue 1—Obligations of the acquirer.

Issue 2—Exchange of award with similar terms.

Issue 3—Fair value measurement versus fair-value-based measurement.

Issue 4—How should the replacement of acquiree EBC awards concurrent with a business combination be considered in determining the purchase price in a business combination?

Issue 5—How to measure the portion of the replacement award's fair value that is recognized as compensation cost.

Issue 6—Accounting for subsequent "adjustments" to purchase price.

Issue 1—Obligations of the Acquirer

The Board will discuss whether a replacement award in a business combination needs to occur concurrent with the business combination. The Board also will discuss the scope of the issue and whether the scope includes only the issuance of replacement awards that are an obligation of the acquirer.

Issue 2—Exchange of Award with Similar Terms

The Board will discuss (a) whether this issue would apply only to those replacement awards that are similar in nature to the original acquiree awards and (b) whether to the extent that the nature of the replacement award is different from the acquiree's awards that are being replaced, those awards would be accounted

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

for under the FASB proposed Statement, *Share-Based Payment*, as new awards of the acquirer.

Issue 3—Fair Value Measurement versus Fair-Value-Based Measurement

The Board will discuss the difference between a true fair value measurement as compared to a fair-value-based measurement under the proposed Statement, *Share-Based Payment*. For example, in the business combination project contingent pay-out arrangements that are equity settled are measured at their fair value at the grant date and are not remeasured. The EBC project measures fair value under the modified grant date method which allows for subsequent adjustments for forfeitures and actual outcomes of performance conditions.

Issue 4—How Should the Replacement of Acquiree EBC Awards Concurrent with a Business Combination Be Considered in Determining the Purchase Price in a Business Combination?

View A—The full fair value of all awards of the acquiree that are replaced by the acquirer concurrent with the business combination are to be considered in the determination of purchase price. This view does not take into account the vesting status of the awards. However, if the fair value of the replacement award exceeds the fair value of the acquiree awards, that incremental value is always compensation cost.

View B—None of the awards of the acquiree that are replaced by the acquirer concurrent with a business combination are to be considered in the determination of purchase price. This view does not take into account the vesting status of the awards.

View C—The fair value of all awards of the acquiree that are replaced by the acquirer concurrent with a business combination are to be allocated among purchase price and compensation cost.

Issue 5—How to Measure the Portion of the Replacement Award's Fair Value That Is Recognized as Compensation Cost

View A—The acquirer should compare the fair value of the acquiree awards being replaced (whether vested or unvested) at the acquisition date with the fair value of the replacement at the acquisition date. If the fair value of the replacement award exceeds the fair value of the acquiree awards, that incremental value is compensation cost. The total amount of compensation cost to be recognized by the acquirer would be the sum of the unrecognized compensation cost of the original award, if any, measured at the original grant date plus any incremental fair value calculated above. The compensation cost would be recognized over the remaining future service period, if any. Any difference between the fair value of

the replacement award and the total amount of measured compensation cost would be recognized as purchase price.

View B—An exchange of EBC awards in a business combination should be accounted for as an allocation between compensation cost and purchase price similar to the FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, model; to the extent the requisite service has been provided and compensation cost has been recognized, those “vested” awards would be considered purchase price. To the extent that additional service is required, those “nonvested” awards would be allocated between compensation cost and purchase price. In addition, if the fair value of the replacement exceeds the fair value of the acquiree awards, that incremental value is always compensation cost.

View C—An exchange of EBC awards in a business combination should be accounted for as an allocation between compensation cost and purchase price following the Interpretation 44 model; however, only those acquiree awards that are fully vested would be allocated to purchase price. If the fair value of the replacement exceeds the fair value of the acquiree awards, that incremental value is always compensation cost.

Issue 6—Accounting for Subsequent “Adjustments” to Purchase Price

The Board will discuss whether there would be any subsequent adjustment to the purchase price once the fair value, or a portion of the fair value, has been allocated to the purchase price in a business combination. If not, then subsequent events affecting EBC awards issued in a business combination would be accounted for in accordance with FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as amended by the proposed Statement, and there would not be a one-year allocation period to any EBC awards (EBC liabilities or EBC equity awards).

WHETHER AND HOW TO CONFORM THE INITIAL MEASUREMENT GUIDANCE IN PARAGRAPHS 18–21 OF INTERPRETATION 46(R) AND THE MEASUREMENT GUIDANCE IN PROPOSED STATEMENT 141(R)

At the February 25, 2004 meeting, the Board requested that the staff explore conforming the initial measurement guidance in paragraphs 18–21 of Interpretation 46(R) and the measurement guidance in proposed Statement 141(R). The issues are:

Issue 1—Initial measurement provisions for measuring the assets and liabilities of a VIE that is a business.

Issue 2—Initial measurement provisions for measuring the assets and liabilities of a VIE that is *not* a business.

Issue 3—Conforming the guidance for common control transactions.

Issue 1—Initial Measurement Provisions for Measuring the Assets and Liabilities of a VIE That Is a Business

The Board will discuss:

- Should primary beneficiaries who obtain control of variable interest entities (VIEs) that are businesses apply the requirements of proposed Statement 141(R) or the existing requirements of Interpretation 46(R) (or a combination of both)
- Whether the guidance in paragraph 20 of Interpretation 46(R) should be incorporated into proposed Statement 141(R)
- Clarification to proposed Statement 141(R).

Should primary beneficiaries who obtain control of VIEs that are businesses apply the requirements of proposed Statement 141(R) or the existing requirements of Interpretation 46(R) (or a combination of both)?

The Board will consider the following alternatives:

Alternative One—If an enterprise becomes the primary beneficiary of a VIE that is a *business*, the recognition, measurement, and disclosure provisions of proposed Statement 141(R) should apply.

Alternative Two—Include a scope exception in proposed Statement 141(R) for business combinations in which control of a business is obtained and that business is also a VIE. Continue to provide initial measurement guidance in Interpretation 46(R) for primary beneficiaries that obtain control of VIEs that are businesses. Therefore, the assets, liabilities, and noncontrolling interests of the VIE upon initial consolidation would be recognized at fair value.

The implications of **Alternative One** are:

- The primary beneficiary would be required to measure the fair value of a newly consolidated VIE on the date the primary beneficiary obtains control of the VIE.
- The VIE's assets and liabilities would be measured at fair value, except for those assets and liabilities that would not be required to be measured at fair value under proposed Statement 141(R) (for example, operating leases, deferred tax assets and liabilities, and liabilities for employee benefits).
- The excess of the fair value of the primary beneficiary's interest in the VIE over the consideration exchanged for that interest ("negative goodwill") would first reduce the amount of goodwill that otherwise would be determined in accordance with proposed Statement 141(R), and any remaining excess would be recognized as a gain rather than as a pro rata adjustment to the newly consolidated assets.

- Previously held noncontrolling ownership interests in the VIE would be remeasured to fair value (with gain or loss recognition) on the date the primary beneficiary obtains control of the VIE.
- The primary beneficiary would be required to apply the disclosure requirements in proposed Statement 141(R).

Should the guidance in paragraph 20 of Interpretation 46(R) be incorporated into proposed Statement 141(R)

The Board will discuss whether the guidance in paragraph 20 of Interpretation 46(R) should be incorporated into proposed Statement 141(R). Paragraph 20 of Interpretation 46(R) requires that the primary beneficiary of a VIE initially measure assets and liabilities that it has transferred to that VIE *at, after, or shortly before* the date that the enterprise became the primary beneficiary at the same amounts at which the assets and liabilities would have been measured if they had not been transferred. (No gain or loss would be recognized.) The guidance that will be provided in proposed Statement 141(R) related to common control transactions is sufficient for assets and liabilities transferred *after* the acquisition date. Proposed Statement 141(R) also will require that if assets or liabilities are transferred as part of the consideration in a business combination, but remain within the consolidated group, the gain or loss on those assets or liabilities will be eliminated in the consolidated financial statements. The Board will consider whether proposed Statement 141(R) should be modified for transfers of assets or liabilities *at or shortly before* the acquisition date.

Clarification to proposed Statement 141(R)

Previously, the Board decided that if a business combination resulted from a step-acquisition in which the acquiring entity, at the acquisition date, had a *previously acquired noncontrolling investment* in the acquired entity, that preacquisition investment should be remeasured at its fair value at the acquisition date, and any unrealized holding gains or losses should be recognized in consolidated net income of the period.

The Board will discuss what it meant by *previously acquired noncontrolling investment*. That is, the Board will discuss whether previously acquired noncontrolling investment was intended to be limited to previously acquired equity investments or all previously acquired investments (such as investment in debt securities of the acquiree).

Issue 2—Initial Measurement Provisions for Measuring the Assets and Liabilities of a VIE That Is *Not* a Business

The Board will consider:

- What initial measurement guidance should the primary beneficiary use to measure the VIE's assets (other than goodwill), liabilities, and noncontrolling interests upon initial consolidation?
- If an enterprise becomes the primary beneficiary of a VIE that is not a business, should the difference between (a) the consideration paid, if any, and the reported amount of previously held interests and (b) the net amount of the VIE's recognized assets, liabilities, and noncontrolling interests be recognized as a gain or loss (not an extraordinary gain or loss)?
- Should paragraph 20 of Interpretation 46(R) be retained for VIEs that are not businesses?

What initial measurement guidance should the primary beneficiary use to measure the VIE's assets (other than goodwill), liabilities, and noncontrolling interests upon initial consolidation?

The Board will consider the following alternatives:

Alternative One—Primary beneficiaries should use the guidance in proposed Statement 141(R) for measuring the *identifiable* assets and liabilities of any newly consolidated VIE, even if the VIE is not a business, with one exception. That exception is that additional intangible assets could be recognized because, similar to asset purchases under Statement 142, intangible assets would not need to meet the criteria in Statement 141 for separate recognition.

Alternative Two—Interpretation 46(R) should provide separate initial measurement guidance for measuring the assets (other than goodwill), liabilities, and noncontrolling interests of any newly consolidated VIE that is not a business. If the newly consolidated VIE is not a business, the existing guidance in Interpretation 46(R) would continue to apply. Therefore, primary beneficiaries initially would measure the assets, liabilities, and noncontrolling interests of the VIE *at fair value*.

Alternative Three—Interpretation 46(R) should *not* provide separate initial measurement guidance for measuring the identifiable assets, liabilities, and noncontrolling interests of any newly consolidated VIE that is not a business. Therefore, the general concepts related to asset acquisitions, which will be carried forward into proposed Statement 141(R) from paragraphs 3–8 of Statement 141 and paragraph 9 of Statement 142, would apply. Those paragraphs would require that the fair value of the transaction be allocated to each of the assets acquired and liabilities assumed. The individual assets and liabilities, therefore, may not be recorded at fair value and no goodwill (or “negative goodwill”) would be recognized.

If an enterprise becomes the primary beneficiary of a VIE that is not a business, should the difference between (a) the consideration paid, if any, and the reported amount of previously held interests and (b) the net amount of the VIE's recognized assets, liabilities, and noncontrolling interests be recognized as a gain or loss (not an extraordinary gain or loss)?

The Board will discuss whether to require primary beneficiaries to recognize the difference between:

- The consideration paid, if any, and the reported amount of previously held interests and
- The net amount of the VIE's recognized assets, liabilities, and noncontrolling interests

Alternative One—As a gain or loss (but not an extraordinary gain or loss).

Alternative Two—As a pro rata increase to the assets of the VIE or as an extraordinary gain if the difference is *positive*; and as an extraordinary loss if the difference is *negative*.

Should paragraph 20 of Interpretation 46(R) be retained for VIEs that are not businesses?

Paragraph 20 of Interpretation 46(R) requires that the primary beneficiary of a VIE that is not a business initially measure any assets and liabilities it has transferred to the VIE *at, after, or shortly before* the date the enterprise became the primary beneficiary at carryover value (no gain or loss recognition). The Board will discuss whether to retain that guidance (a) only for VIEs that are not businesses or (b) for all VIEs.

Issue 3—Conforming the guidance for common control transactions

Paragraph 19 of Interpretation 46(R) states:

If the primary beneficiary of a variable interest entity is under common control with the variable interest entity, the primary beneficiary shall initially measure the assets, liabilities, and noncontrolling interests of the variable interest entity *at the amounts at which they are carried in the accounts of the enterprise that controls the variable interest entity* (or would be carried if the enterprise issued financial statements prepared in conformity with generally accepted accounting principles). [Emphasis added].

Paragraph D12 of Statement 141, which is part of Appendix D, "Continuing Authoritative Guidance," will be carried forward into paragraph D6 of proposed Statement 141(R). That paragraph states:

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially recognize the assets and liabilities transferred *at their carrying amounts in the accounts of the transferring entity* at the date of transfer. [Emphasis added].

Should the guidance in paragraph 19 of Interpretation 46(R) related to common control transactions be conformed to the guidance in paragraph D6 of proposed Statement 141(R) (formerly paragraph D12 of Statement 141)?

Paragraph 19 of Interpretation 46(R) is broader in scope than paragraph D12 of Statement 141, because paragraph 19 provides measurement guidance for an event (that is, an enterprise becoming the primary beneficiary of an entity) that may not involve a transfer of assets or exchange of shares. In addition, paragraph 19 applies regardless of whether the VIE is a business because it applies to entities under common control outside the scope of proposed Statement 141(R) and to events not covered by paragraph D6 of the proposed Statement. A difference could arise between paragraph 19 of Interpretation 46(R) and paragraph D12 of Statement 141 in certain limited circumstances.¹

The Board will discuss whether to make the following amendment to paragraph 19 of Interpretation 46(R) to conform to paragraph D6 of proposed Statement 141(R):

If the primary beneficiary of a variable interest entity is under common control with the variable interest entity, the primary beneficiary shall initially measure the assets, liabilities, and noncontrolling interests of the variable interest entity at the amounts at which they are carried in the accounts of the entity ~~enterprise that controls the variable interest entity~~ (or would be carried if the entity ~~enterprise~~ issued financial statements prepared in conformity with generally accepted accounting principles).

The Board also will discuss whether a footnote should be added to paragraph D6 of proposed Statement 141(R) to refer to the guidance in Interpretation 46(R).

¹ For example, Entity A owns a controlling interest in two entities, Entity B and Entity PB. Thus, Entity B and Entity PB are under common control by Entity A. Push down accounting has not been applied.

If Entity B **transfers** assets and liabilities to Entity PB, under paragraph D12 of Statement 141, Entity PB would recognize the assets and liabilities at the value in which they were carried on *Entity B's* books.

If Entity PB becomes the primary beneficiary of Entity B, upon initial consolidation Entity PB would recognize the assets and liabilities at the value in which they were carried on *Entity A's (the parent's)* books. Therefore, if push down accounting has not been applied and the assets and liabilities are carried at different values in Entity A's books than in Entity B's books, a difference could arise.



Board Meeting Handout

April 7, 2004

Interpretation of Statement 143

PURPOSE OF TODAY'S DISCUSSION

The purpose of this Board meeting is to discuss and reach a decision as to whether Statement 143 requires an entity to recognize a liability for a legal obligation to perform asset retirement activities when the retirement of the asset is conditional on a future event. If the Board decides that Statement 143 requires an entity to recognize a liability for a legal obligation to perform asset retirement activities when the retirement of the asset is conditional on a future event, the staff also would like to discuss these additional issues:

- The effective date for the proposed Interpretation
- The transition requirements for the proposed Interpretation.

If the Board decides that Statement 143 does not require an entity to recognize a liability for a legal obligation to perform asset retirement activities when the retirement of the asset is conditional on a future event, the staff will defer discussion regarding effective date and transition requirements of the proposed Interpretation until a later Board meeting.

ISSUE 1: DOES STATEMENT 143 REQUIRE AN ENTITY TO RECOGNIZE A LIABILITY FOR A LEGAL OBLIGATION TO PERFORM ASSET RETIREMENT ACTIVITIES WHEN THE RETIREMENT OF THE ASSET IS CONDITIONAL ON A FUTURE EVENT?

The FASB staff will ask the Board to consider the following two views with respect to Issue 1:

View A: Yes. Statement 143 requires an entity to recognize a liability for a legal obligation to perform asset retirement activities when the retirement of the asset is

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

conditional on a future event. The uncertainty with respect to if and when the asset will be retired should be factored into the measurement of the fair value of the liability.

View B: No. Statement 143 does not require an entity to recognize a liability for a legal obligation to perform asset retirement activities when the retirement of the asset is conditional on a future event.

Staff Recommendation: View A

ISSUE 2: EFFECTIVE DATE FOR THE PROPOSED INTERPRETATION

The Staff will ask the Board to consider the following three potential effective date alternatives for the proposed Interpretation to Statement 143 if the Board were to choose View A of Issue 1:

Alternative 1

This Interpretation shall be effective for financial statements issued for fiscal years beginning after December 15, 2004 (January 1, 2005 for calendar year end enterprises). Earlier application is encouraged. Initial application of this Interpretation shall be as of the beginning of an entity's fiscal year. If this Interpretation is adopted prior to the effective date and during an interim period other than the first interim period of a fiscal year, all prior interim periods of that fiscal year shall be restated.

Alternative 2

This Interpretation shall be effective for financial statements issued for fiscal years ending after December 15, 2004 (December 31, 2004 for calendar year end enterprises). Earlier application is encouraged. Initial application of this Interpretation shall be as of the end of an entity's fiscal year. If this Interpretation is adopted prior to the effective date and during an interim period other than the first interim period of a fiscal year, all prior interim periods of that fiscal year shall be restated.

Alternative 3

This Interpretation shall be effective for financial statements issued for fiscal years beginning after December 15, 2005 (January 1, 2006 for calendar year end enterprises). Earlier application is encouraged. Initial application of this Interpretation shall be as of the beginning of an entity's fiscal year. If this Interpretation is adopted prior to the effective date and during an interim period other than the first interim period of a fiscal year, all prior interim periods of that fiscal year shall be restated

Staff Recommendation: Alternative 3

ISSUE 3: TRANSITION REQUIREMENTS FOR THE PROPOSED INTERPRETATION

Measurement of Transition Amounts

The staff believes that if the Board were to choose View A of Issue 1, the requirements for measurement of transition amounts should be consistent with Statement 143, paragraph 25.

Recognition of Transition Amounts

The staff believes that if the Board were to choose View A of Issue 1, the requirements for recognition of transition amounts should be consistent with Statement 143, paragraph 26.