MINUTES

To:	Board Members
From:	Business Combinations—Purchase Method Procedures Team (B. Wilson, ext. 275)
Subject:	Minutes of the January 29, 2003 Board Meeting — **Date:** January 31, 2003
cc:	FASB: Bielstein, Smith, Petrone, Bossio, Tamulis, Munro, Manders, B. Wilson, Swift, Polley, Cropsey, Thompson, Gabriele, Sutay, Lapolla, FASB Intranet; IASB: Leisenring, Ryltsova, Kimmitt; CICA: Walsh; AICPA: Hekker; Purchase Method Procedures Working Group Members

Topic: Business Combinations—Purchase Method Procedures: Issues Related to Nonmonetary Consideration Exchanges and Clarification of the Working Principle

Basis for Discussion: Two memorandums dated January 16, 2003 and attached audience handout

Length of Discussion: Starting Time: 9:00 a.m. Concluding Time: 9:45 a.m.

Attendance:

Board members present:	FASB: Herz, Crooch, Foster, Trott, Schieneman, Schipper, and Wulff IASB: Leisenring
Board members absent:	None
Staff in charge of topic:	Bossio
Other staff at Board table:	Bielstein, Tamulis, Manders, and B. Wilson
Outside participants:	Ryltsova (by phone)

Summary for ACTION ALERT:

The Board discussed issues related to nonmonetary consideration exchanged in a business combination. The Board decided that in a business combination in which consideration in the form of a business or other nonmonetary asset is transferred to an entity in exchange for shares issued by that entity, which thereby becomes the first entity's subsidiary, the business combination should be accounted for at fair value. The fair value measurement should be based on the fair value of the nonmonetary consideration paid or the fair value of the business acquired, whichever is more clearly evident of the fair value of the assets acquired and liabilities assumed. However, from the consolidated group's perspective, the business or other nonmonetary asset transferred by the acquiring entity to the acquired entity is not viewed as part of the assets acquired and liabilities assumed. Therefore, the full amount of any gain or loss arising on the transfer to the acquiree of the business or nonmonetary asset should be eliminated in the consolidated financial statements.

The Board also discussed the working principle that applies to this joint project with the IASB. The Board agreed to modify the working principle and its related guidance primarily to clarify its application to business combinations in which the acquirer obtains less than a 100 percent controlling interest in an acquiree.

Matters Discussed and Decisions Reached:

Nonmonetary Consideration Exchanged in a Business Combination

The staff began the discussion by describing a business combination where an entity, B, issues shares to another entity, A, in exchange for a business or other nonmonetary assets of A and as a result of this transaction becomes A's subsidiary (refer to the attachment for an illustration of this example). This is an issue because the business or other nonmonetary asset exchanged is under the control of the acquiree both before and after the business combination. The staff described an example in which Entity A transfers a nonmonetary asset, a building, to Entity B for a 60 percent ownership interest and control of B. The staff provided two alternatives for the Board to consider:

Under the first alternative, the business combination is accounted for at fair value, with the measurement based on either the fair value of the nonmonetary consideration paid or the fair value of the business acquired, depending on which is more clearly evident of the fair value of the transaction. The nonmonetary asset transferred to the acquiree as consideration would be recognized on the date control is obtained and measured at its fair value at that date. As a result, the full amount of any gain or loss arising on the remeasurement of the nonmonetary assets exchanged as consideration for control over the acquiree would be recognized in the consolidated financial statements.

Under the second alternative, the business combination is also accounted for at fair value (as in the first alternative). However, the nonmonetary assets transferred by the acquirer should not be viewed as part of the assets acquired and liabilities assumed of the acquiree. That is because the acquirer controls the nonmonetary asset both before and after the business combination. Therefore, the full amount of any gain or loss arising on the remeasurement of the nonmonetary assets exchanged as consideration is eliminated in the consolidated financial statements.

Ms. Ryltsova reported that the IASB Board voted for the second alternative at their January 22, 2003 meeting. This is because the acquiror controls the business or nonmonetary asset both before and after the business combination. In addition, certain IASB Board members were concerned that the transaction described in the staff's example could be structured in a different way to obtain the same accounting result as in the second alternative.

The Board voted unanimously for the second alternative. Mr. Trott, while in support of the second alternative, was concerned that this decision could appear inconsistent with the decision reached by the Board related to step acquisitions. That is, the Board decided that in a step acquisition, any preacquisition investments held by the acquirer at the acquisition date (the date control is obtained) should be remeasured at their fair value and any unrealized holding gains or losses on those preacquisition investments should be recognized in consolidated net income for the period. However, Mr. Trott was satisfied that the Board was in fact being consistent. This is because in a step acquisition, before an investor obtains control of an investee, the investor only controls its shares in the investee, not the underlying assets of the investee. In this example, the acquirer has control of the nonmonetary assets both before and after the business combination. Ms. Schipper stated that in a step acquisition, gaining control of the investee is the remeasurement event. However, in this example the nonmonetary asset is under the acquirees' control before and after the transaction, and, thus, there is no remeasurement event.

Clarifications to the Working Principle

The staff asked the Board to consider whether the working principle applying to the joint project should be modified (refer to the attachment for the proposed clarifications). The working principle, which was initially agreed to by the Board at its meeting on October 31, 2001, was developed in the context of a business combination in which an acquirer obtains control of a 100 percent interest in an acquiree. Overall, the Board agreed to the proposed clarifications.

Several Board members provided additional suggestions for clarifying the working principle including deleting several unclear and ambiguous words such as, "generally" and "usually." Mr. Trott also suggested clarifying the phrase "absent evidence to the contrary" to note that when there is negative goodwill in a business combination as a result of a transaction that is not an exchange of equal values, that would constitute a circumstance in which there is evidence contrary to the assumption that a business combination is an exchange of equal values.

Follow-up Items:

None

General Announcements:

None

Financial Accounting Standards Board

Board Meeting Handout

January 29, 2003 Norwalk, CT
Business Combinations II—Purchase Method Procedures

At today's meeting, the Board will discuss (1) issues related to nonmonetary consideration exchanged in a business combination, and (2) proposed clarifications to the working principle.

NONMONETARY CONSIDERATION EXCHANGES IN A BUSINESS COMBINATION

The Board will consider the accounting for a business combination in which consideration in the form of a business or other nonmonetary asset is transferred to an entity (Entity B) in exchange for shares issued by that entity which thereby becomes the first entity's (Entity A) subsidiary. In this example, which is referred to as the *Base Case*:

(a) Should A's business or other nonmonetary asset exchanged for an interest in a subsidiary be accounted for (1) at fair value at the date of the transaction, (2) at the previous carrying amount, or (3) some combination of the two?

(b) How should A's gain or loss arising on the transaction be reported?

The Board will also consider two cases for which some argue an economically similar result may be achieved by the acquirer to the one described above (*Base Case*), but with potentially different accounting outcomes. These cases are described below (*Case 1* and *Case 2*).

Entities A and B have the following balance sheets as of December 31, 2002: (Assumptions about carrying amounts and fair values of identifiable net assets of A and B apply to all cases.)

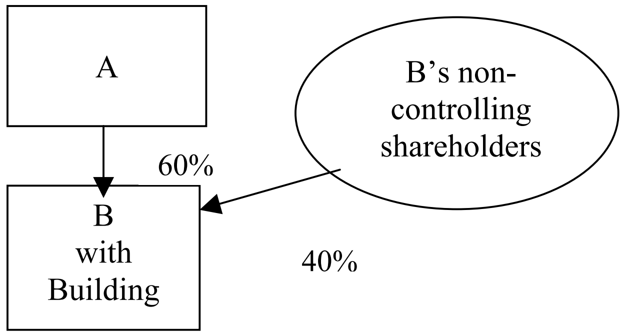
	Carrying Amounts	*Fair Values*
Entity A		
Building	100	600
Other assets and liabilities, net	2,000	2,000
Net Assets	2,100	2,600
Issued Shares	2,100	
Entity B		
Net Assets	200	350
	200	350
Issued Shares	200	

Base Case

The *Base Case* is intended to illustrate the business combination transaction described above.

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.

Facts. On January 1, 2003, B issues shares to A in exchange for A's building. As a result, A now has a 60% ownership interest in, and control of, B.



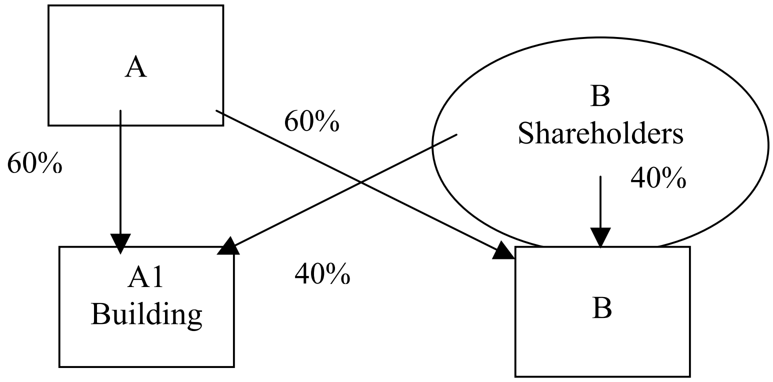
The Board will consider the following two alternatives for accounting for this transaction:

Alternative One: The business combination is accounted for at fair value, with the measurement based on either the fair value of the nonmonetary consideration paid or the fair value of the business acquired, depending on which is determined to be more clearly evident of the fair value of the transaction. Similar to other identifiable acquired assets and assumed liabilities, the nonmonetary asset transferred to the acquiree, as consideration would be recognized on the date control is obtained and measured at its fair value at that date. As a result, the full amount of any profit or loss arising on the transfer to the acquiree of the nonmonetary asset would be recognized in the consolidated financial statements.

Alternative Two: As in Alternative One, the business combination is accounted for at fair value, with the measurement based on either the fair value of the nonmonetary consideration paid or the fair value of the business acquired. However, from the consolidated group's perspective the nonmonetary asset exchanged is viewed as neither part of the consideration paid nor part of the business acquired. Therefore, the full amount of any profit or loss arising on the transfer to the acquiree of the nonmonetary asset is eliminated in the consolidated financial statements.

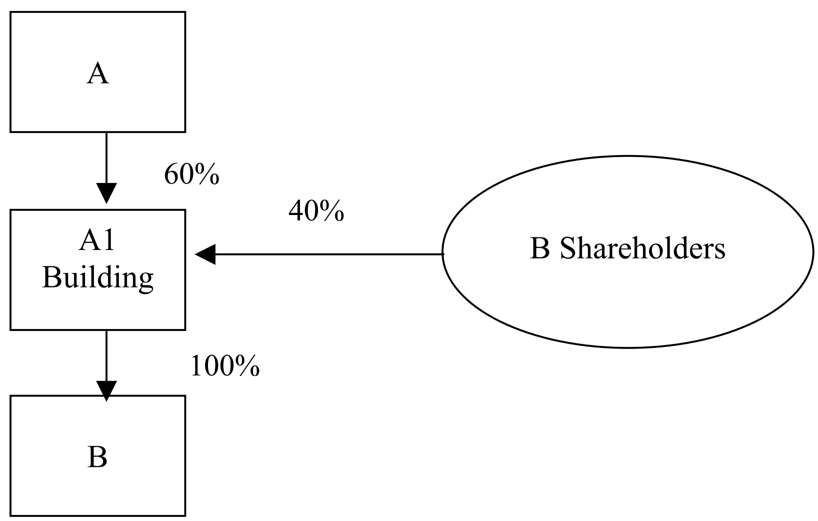
Case 1

Facts. On December 31, 2002, entity A sets up a new subsidiary, A1, and transfers the building to that new wholly-owned subsidiary. On January 1, 2003, shareholders of entity B sell 60% of B's shares to A in exchange for a 40% interest in A's subsidiary A1. As a result, A now has a 60% ownership interest in, and control of, B and maintains control of A1 at the reduced 60% ownership interest.



Case 2

Facts. Entity A owns a building. On December 31, 2002 entity A sets up a new subsidiary A1 and transfers the building to that new wholly-owned subsidiary. On January 1, 2003, A1 issues new shares to shareholders of entity B and in exchange acquires all of the shares of B. As a result, shareholders of B now own a 40% ownership interest in A1. Parent A, through its 60% ownership of A1, has an indirect 60% ownership interest in, and control of, B.



CLARIFICATIONS TO THE WORKING PRINCIPLE

The Board will also consider proposals to clarify the working principle that applies to this joint project with the IASB. The working principle was developed at the beginning of the joint project and agreed to by the Board at the October 31, 2001 meeting.

The working principle was initially developed and considered in the context of an acquisition of a 100 percent interest in an acquiree. However, the Board has also considered matters relating to acquisitions involving noncontrolling (minority) interests, and certain of their decisions raise questions about the clarity of the working principle and the extent to which certain parts of its lower level guidance should be extended.

The Working Principle (changes from the version agreed to by the Board are marked [additions underlined, deletions struck through]):

The accounting for a business combination is based on the assumption that the transaction is an arms-length transaction in which independent and willing parties exchange ~~of~~ equal values[1], and, accordingly, absent evidence to the contrary,[2] the consideration paid by the acquirer usually is representative of the fair value of the interest in the business acquired.[3] ~~; the~~

[4]In an acquisition of a business the total amount to be recognized by the acquirer should be the fair value of the business acquired. In an exchange of equal values,[5] that amount may be measured ~~at either~~ through direct measurement of the fair value of the business acquired or based on[6] the fair value of the consideration paid ~~or the fair value of the net assets acquired~~,[7] whichever is more clearly evident of the fair value of the ~~transaction~~[8] business acquired.

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[1] Addition to make clear and reinforce that the reason underlying the assumption that equal values are exchanged is that independent parties are involved.

[2] The clause *absent evidence to the contrary* is added to provide for the unusual but not rare circumstances in which one of the parties or a third party (e.g., government) is involved and willing to subsidize the business combination. It also helps remind us that some scrutiny is desirable to assure that the assumption of an exchange of equal values is appropriate in the given set of circumstances.

[3] To clarify that the consideration paid is equal to the *interest in* the business acquired—sometimes acquirer only pays for a partial interest in the business acquired.

[4] The paragraph break is for emphasis and to clearly state the objective in the topic sentence.

[5] To clarify that there is some degree of flexibility in measurement based on a judgment about which side of the business combination transaction provides the "best" evidence of the fair value of the business acquired.

[6] To clarify that measure may be "based on" (rather than equal to) consideration paid—when inferred from consideration when less than 100% interest is acquired (the inferring approach could be used only when a control premium is clearly identifiable and measurable with sufficient reliability.

[7] To replace *net assets acquired* (and to reposition the clause) by *business acquired*. Also to avoid confusion since the term *net asset method* is used in the FASB project on Combinations of Non-For-Profit Organizations (NFP) to describe an alternative measurement approach for a business combination involving the acquisition of a not-for-profit organization by another NFP. That method, which is to measure the fair value of recognizable net assets (no goodwill), is viewed as a difference from normal practice for measuring a business combination.

[8] For consistency and clarity.

[9]In an acquisition of all or substantially all of the ownership interest of an acquired business:

- If the consideration paid is cash or other financial[10] assets (or liabilities incurred) of the acquiring entity, the fair value of the consideration paid generally is more clearly evident than the fair value of the business acquired and, thus, usually determines the total amount to be recognized in the financial statements of the acquiring entity.

- If the consideration paid is in the form of marketable[11] equity instruments of the acquirer,[12] the fair value of the equity instruments ~~ordinarily~~ generally is more clearly evident than the fair value of the ~~net assets~~ business acquired and, thus, usually ~~generally will~~ determines the total amount to be recognized in the financial statements by the acquiring entity.

In a business combination, the acquiring entity obtains control over the acquired entity and therefore is responsible for the assets and liabilities of the acquired entity. The ~~identifiable~~[13] acquired assets and assumed liabilities should be recognized on the date control is obtained and measured at their fair values at that date:

- If the ~~total~~ fair value of the acquired business exceeds the sum of the fair values of the recognized identifiable assets acquired and liabilities assumed, that excess amount (which is the *implied fair value* of goodwill) should be recognized as an asset.

- If the ~~total~~ fair value of the ~~acquired business~~ consideration paid is less than the sum of the fair values of the recognized identifiable assets acquired and liabilities assumed, that amount should be recognized as a gain in the income statement (rather than as negative goodwill in the balance sheet). [The staff believes that in these circumstances the exchange, unlike our assumption, is not at equal values.]

[9] To limit the application of the guidance that follows.

[10] Modifier *financial* is to avoid suggesting that all assets (e.g., nonmonetary assets and intangible assets) provide equally strong evidence of fair values.

[11] Modifier *marketable* is to avoid suggesting that all equity instruments of the acquirer provide equally strong evidence of fair values or that they necessarily are more clearly evident than a direct measure of the fair value of the business acquired.

[12] An equity instrument of another entity is among the assets included in the prior bullet.

[13] In principle all acquired assets, including unidentifiable or unrecognizable, ought be recognized.