MINUTES

Financial Accounting Standards Board

To: Board Members

From: Business Combinations: Applying the Acquisition Method Team (Rhine, Ext. 296)

Subject: Minutes of the March 21, 2007 Board Meeting **Date:** April 4, 2007

cc: FASB: Bielstein, Smith, MacDonald, Bossio, Tamulis, Posta, Vessels, Willis, Cafini, Delmonico, Rhine, Glotzer, Lapolla, Chookaszian, Polley, Gabriele, Sutay, Carney, Allen, FASB Intranet; IASB: Leisenring, Upton, Hickey, Teixeira, Buschhueter, Quiring, Eastman, Kwiatkowska

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topics: Accounting for contingent consideration in a business combination, valuation allowance disclosures, loss of control of a subsidiary resulting from a nonreciprocal transfer to owners, accounting for bargain purchases, and assembled workforce follow-up

Basis for Discussion: Board Memorandum Nos. 47–51

Length of Discussion: 1:00 to 2:00 p.m.

Attendance:

Board members present: FASB: Herz, Batavick, Crooch, Linsmeier, Seidman, Trott, and Young

Staff in charge of topic: Tamulis and Roberge

Other staff at Board table: Bielstein, Delmonico, Rhine, Tully, and Vessels

IASB participants: Buschhueter, Eastman, Kwiatkowska, Quiring, and Teixeira (by phone)

Summary of Decisions Reached:

The Board continued redeliberations of its June 2005 Exposure Drafts, *Business Combinations*, and *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries.*

1. The Board affirmed the initial and subsequent accounting for contingent consideration that was proposed in the business combinations Exposure Draft. Therefore, an acquirer would:

   a. Measure and recognize contingent consideration at fair value as of the acquisition date.

   b. Classify contingent consideration as either a liability or equity as of the acquisition date.

   c. After initial recognition:

      (1) Not remeasure contingent consideration classified as equity.

      (2) Remeasure to fair value contingent consideration classified as a liability.

      (3) Recognize changes in the fair value of contingent consideration classified as a liability in earnings with one exception. The acquirer may recognize changes in the fair value of contingent consideration classified as a liability in other comprehensive income if the contingent consideration is a hedging instrument and recognition of the changes in other comprehensive income is permitted in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

2. The Board clarified how the measurement period guidance applies to contingent consideration. The measurement period allows the acquirer a period of time to gather information about facts and circumstances that existed at the acquisition date. After the acquisition date, the fair value of contingent consideration classified as a liability will change due to changes in circumstances like meeting specified sales targets, fluctuations in share price, or subsequent events like receiving FDA approval on an in-process research and development (IPR&D) project. Changes in the fair value of contingent consideration classified as a liability due to changes in circumstances since the acquisition date should be recognized in earnings. Changes in the fair value of contingent consideration due to gathering new information about facts and circumstances that existed at the acquisition date, however, would be considered measurement period adjustments and reflected in the purchase price.

3. With respect to disclosures regarding contingent consideration, the Board:

   a. Affirmed that an acquirer should disclose the amount of contingent consideration recognized on the acquisition date

   b. Affirmed that an acquirer should disclose the range of potential payments (undiscounted)

   c. Affirmed that if there is no limitation on the maximum potential amount of future payments, the acquirer should disclose that fact and the basis for determining the amount of the payment

   d. Decided that instead of a rollforward, the acquirer should be required to disclose changes in the amounts recognized for the contingent consideration, changes in the range of outcomes (undiscounted), and the reasons for the changes. That disclosure would be required each period until the contingent consideration is settled.

4. The Board affirmed the decision reached in FASB Statement No. 141, *Business Combinations,* and in the business combinations Exposure Draft that an assembled workforce should not be recognized as an intangible asset separately from goodwill. That is because an at-will workforce cannot be separated from the business. Therefore, it does not meet the separability criterion.

5. The Board decided that if an acquisition is a bargain purchase, the acquirer should calculate the amount of the gain attributable to the acquirer as the excess of (a) the amounts recognized for the identifiable assets acquired and liabilities assumed and (b) the acquisition date fair values of the consideration transferred and the acquisition date fair values of any noncontrolling interest in the acquiree. This decision is a change from the proposals in the business combinations Exposure Draft, which proposed to measure any noncontrolling interest in a bargain purchase at its proportional interest in the amounts recognized for the identifiable assets acquired and liabilities assumed.

6. The Board decided to clarify that the guidance that was proposed in the noncontrolling interests Exposure Draft for calculating the gain or loss when a parent loses control of a subsidiary does not apply to nonreciprocal transfers to owners. Nonreciprocal transfers to owners, such as spin-offs, should continue to be accounted for in accordance with APB Opinion No. 29, *Accounting for Nonmonetary Transactions.*

7. In December 2006, the Board affirmed the proposal in the business combinations Exposure Draft that assets recognized at fair value, including receivables, loans, and finance leases, should be recognized and measured at fair value at the acquisition date. Therefore, an acquirer would be prohibited from recognizing a separate valuation allowance. At this meeting, the Board decided that an acquirer should disclose, by major class of receivables, the receivables' fair value, gross contractual amounts receivable, and the best estimate of cash flows not expected to be collected at the acquisition date.

Objectives of Meeting:

The objective of the meeting was for the Board to reach decisions on the following topics:

1. Accounting for contingent consideration in a business combination
2. Loss of control of a subsidiary resulting from a nonreciprocal transfer to owners
3. Accounting for bargain purchases
4. Assembled workforce follow-up
5. Valuation allowance disclosures.

The objective was met.

Matters Discussed and Decisions Reached:

TOPIC 1: ACCOUNTING FOR CONTINGENT CONSIDERATION IN A BUSINESS COMBINATION

Ms. Tamulis stated that the audience handout includes a summary of the concerns raised in the comment letters about contingent consideration and the staff's responses to those concerns. The concerns include concerns about accounting abuse, cost-benefit, relevance and reliable measurement, application of the measurement period, and the fact that the proposals seem to lead to counterintuitive results.

Ms. Tamulis noted that the more difficult concerns are about reliable measurement, counterintuitive results, and application of the measurement period. Those three concerns are interrelated. Depending on how the Board wants the measurement period guidance to apply to contingent consideration, that decision may indirectly address the concerns about reliable measurement and counterintuitive results. Therefore, the staff presented the measurement period issue first.

Issue 1: Subsequent Adjustments and the Measurement Period

Ms. Tamulis stated that at the education session last week, it became clear that staff and Board members had different interpretations about how the business combination Exposure Draft's measurement period guidance should apply to contingent consideration. Some Board members viewed the measurement period as a way of addressing concerns about reliable measurement and counterintuitive results.

Ms. Tamulis noted that the measurement period guidance in the Exposure Draft was intended to allow an acquirer a period of time to gather information about facts and circumstances that existed at the acquisition date for the purpose of measuring the assets, liabilities, and consideration as of the acquisition date. The business combinations Exposure Draft states that “the measurement period ends as soon as the acquirer receives the necessary information about facts and circumstances that existed as of the acquisition date or learns the information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date” (paragraph 65). When the Boards discussed the measurement period during initial deliberations, one of the objectives was to reign in the practice of adjusting assets and liabilities during the allocation period for what are clearly changes in facts and circumstances that occurred after the acquisition date. The Board understood that that line is often hazy and judgment is sometimes necessary to determine whether a change relates to facts that existed at the acquisition date. Nevertheless, in practice the allocation period is often viewed as a one-year open window for booking almost all adjustments to the purchase price when many of them are clearly due to changes in circumstances.

Ms. Tamulis stated that at the education session some Board members stated that they believe that the Boards originally intended to allow a significant amount of latitude in measuring contingent consideration. They would allow almost all adjustments to the fair value of contingent consideration recognized during the first year after the acquisition date to be recognized as measurement period adjustments. Therefore, they believe that changes in the fair value of contingent consideration due to (a) future performance of the acquiree (such as meeting a sales target), (b) changes in share price, or (c) receiving FDA approval on an IPR&D project during the first year after the acquisition date would be recognized as a measurement period adjustment. Changes in the value of contingent consideration after the measurement period would be recognized in earnings.

The staff noted that this view:

a. Indirectly addresses concerns about reliable measurement because the acquirer would have a one-year period during which to value the contingent consideration. Within a year, an acquirer should be able to develop a reasonable estimate of the contingent consideration's fair value, although the value may not represent the contingent consideration's fair value at the acquisition date.

b. Indirectly addresses concerns about counterintuitive results. Some respondents expressed concern that if an adjustment to contingent consideration was recognized in earnings and not goodwill, then an entity would be required to recognize a loss when it met a defined sales target and a gain when it did not. Allowing changes to contingent consideration to be treated as measurement period adjustments would at least allow those changes to be recognized in goodwill for the first year.

c. Is consistent with the subsequent events guidance in AU Section 560, "Subsequent Events."

d. Is a practical way of addressing concerns about whether a change in the fair value of contingent consideration is a measurement period adjustment.

Ms. Tamulis stated that others believe that the Boards intended that the measurement period would apply very narrowly to measuring contingent consideration. They believe that almost all adjustments to the fair value of contingent consideration after the acquisition date should be recognized in earnings rather than as measurement period adjustments. Those who hold this view understand that the acquirer may need some time to obtain the information to value the contingent consideration at the acquisition date. However, they believe that changes in the fair value of contingent consideration due to (a) future performance of the acquiree (such as meeting a sales target), (b) changes in share price, or (c) receiving FDA approval on an IPR&D project after the acquisition date are all subsequent events that should be recognized in earnings rather than as measurement period adjustments. The staff believes this view is more consistent with how the Boards intended the measurement period to apply to other assets and liabilities. Ms. Tamulis noted that when the IASB discussed this issue, they decided to adopt a narrow view of the measurement period.

Ms. Tamulis emphasized that the measurement period would still apply to contingent consideration. The acquirer would still be given time to collect the information necessary to measure the fair value of contingent consideration at the acquisition date. Ms. Tamulis asked the Board whether subsequent events that take place within the measurement period should also be considered measurement period adjustments.

The Board decided that changes in the fair value of contingent consideration due to changes in circumstances since the acquisition date should be recognized in earnings. (Five agreed; two did not [GJB, LFS].) Examples of such changes in circumstance include (a) future performance of the acquiree (such as meeting a sales target), (b) changes in share price, or (c) receiving FDA approval on an IPR&D project after the acquisition date.

Mr. Trott stated that for practical reasons he would prefer that all changes to contingent consideration be accounted for as measurement period adjustments during the first year after the acquisition date. However, he stated that he would agree with the decision reached by the IASB for the sake of convergence (that is, apply the measurement period guidance narrowly to contingent consideration).

Mr. Linsmeier stated that he believes that permitting all adjustments of contingent consideration to be treated as measurement period adjustments is more than a practical solution but rather has a conceptual basis. Parties to contingent consideration are unable to agree on an acquisition price and, therefore, allow the price to be determined by outcomes subsequent to the acquisition date. Unlike other contingencies, the outcome of this contingency is shared by the acquirer and acquiree, both of whom agree to allow the price of the entity to float. Nevertheless, for the purpose of convergence, Mr. Linsmeier stated that he would agree to apply the measurement period guidance to contingent consideration.

Mr. Herz noted that he believes that contingent consideration is a form of profit sharing and that adjusting the purchase price for changes in the value of contingent consideration is inappropriate. Furthermore, profit sharing arrangements are not limited to contingent consideration but can also arise in other contingencies when stipulations are made. Mr. Herz stated that current accounting in this area seems to be flawed. Currently, an entity is able to simply adjust goodwill when a target is met (with no effect on earnings for the consideration transferred) and does not need to record anything when the target is not met. He continued that while he does not agree with allowing any adjustments to contingent consideration during the measurement period for the reasons outlined, for the sake of convergence, he would agree with applying the measurement period guidance narrowly to contingent consideration. Mr. Young also stated that he would agree with the staff's recommendation on the basis that it is consistent with the IASB's decision.

Mr. Batavick stated that for simplicity he would prefer that all changes to contingent consideration during the measurement period be treated as measurement period adjustments, unless there is reason to believe that the changes clearly relate to events that occur subsequent to the acquisition date. That is because it is often unclear what changes are caused by subsequent events and what changes reflect additional clarity about the acquisition date fair value.

Ms. Seidman noted that one of the most significant concerns expressed by constituents about fair value measurement relates to measuring contingent consideration at fair value. Therefore, to ease the burden of measuring contingent consideration, she agrees with Mr. Batavick that all adjustments to contingent consideration within the measurement period should be treated as measurement period adjustments. Ms. Seidman noted that she would be willing to consider providing relief in another form, such as requiring that adjustments to contingent consideration that are linked to performance be treated differently from other adjustments.

Issue 2: Recognition and Measurement

Ms. Tamulis stated that the staff continues to recommend that the Board affirm the initial and subsequent accounting for contingent consideration that was proposed in the business combinations Exposure Draft.

The Board agreed with the staff's recommendation and decided that an acquirer should:

a. Measure and recognize contingent consideration at fair value as of the acquisition date.
b. Classify contingent consideration as either a liability or equity as of the acquisition date.

c. After initial recognition:

(1) Not remeasure contingent consideration classified as equity.

(2) Remeasure to fair value contingent consideration classified as a liability.

(3) Recognize changes in the fair value of contingent consideration classified as a liability in earnings with one exception. The acquirer may recognize changes in the fair value of contingent consideration classified as a liability in other comprehensive income if the contingent consideration is a hedging instrument and recognition of the changes in other comprehensive income is permitted in accordance with Statement 133. (All agreed.)

Mr. Herz noted that while this was not his preferred model, he would agree with the proposed guidance on the basis of convergence.

Issue 3: Disclosures

Ms. Tamulis stated that respondents did not comment on the proposed disclosures for contingent consideration. The Board discussed contingency disclosures last month. Since the staff views contingent consideration as a type of contingency, the staff believes the disclosures should be similar.

The Board agreed with the staff's recommendation as follows:

a. The Board affirmed that an acquirer disclose the amount of contingent consideration recognized on the acquisition date

b. The Board affirmed that an acquirer disclose the range of potential payments (undiscounted)

c. The Board affirmed that if there is no limitation on the maximum potential amount of future payments, the acquirer disclose that fact and the basis for determining the amount of the payment

d. The Board decided that instead of a rollforward, an acquirer be required to disclose changes in the amounts recognized for the contingent consideration, changes in the range of outcomes (undiscounted), and the reasons for the changes. That disclosure would be required each period until the contingent consideration is settled. (All agreed.)

TOPIC 2: LOSS OF CONTROL OF A SUBSIDIARY RESULTING FROM A NONRECIPROCAL TRANSFER TO OWNERS

Ms. Tamulis noted that the noncontrolling interests Exposure Draft proposes guidance for calculating the gain or loss if a parent loses control of a subsidiary, which was affirmed by the Boards in redeliberations. A few respondents questioned whether that guidance would be applicable to nonreciprocal transfers to owners (for example, the distribution of a business to owners in a spin-off). The guidance for nonreciprocal transfers to owners is in Opinion 29. The staff believes that the Board did not intend to change the guidance in Opinion 29 as part of the business combinations project. Ms. Tamulis asked the Board whether it wanted to clarify in the final noncontrolling interests Statement that the guidance for calculating the gain or loss when control of a subsidiary is lost does not apply to nonreciprocal transfers to owners.

The Board decided to clarify that the guidance that was proposed in the noncontrolling interests Exposure Draft for calculating the gain or loss when a parent loses control of a subsidiary does not apply to nonreciprocal transfers to owners. Nonreciprocal transfers to owners, such as spin-offs, should continue to be accounted for in accordance with Opinion 29. (Six agreed; one did not [RHH].)

Mr. Herz stated that while he is not in favor of revaluing a retained interest when control is lost, he believes that the guidance for loss of control should consistently be applied regardless of how control is lost. Therefore, if an entity loses control through a nonreciprocal transfer to owners, it should be required to revalue its retained interest at fair value. Ms. Seidman explained that while this project considers loss of control to be a significant event that warrants remeasurement, Opinion 29 does not.

TOPIC 3: ACCOUNTING FOR BARGAIN PURCHASES

Ms. Tamulis stated that the business combinations Exposure Draft proposes that in a bargain purchase no goodwill would be recognized and the noncontrolling interest would be recognized as its proportional interest in the net identifiable assets of the acquiree. However, the Board decided in redeliberations that instead of focusing on the fair value of the acquiree, it would focus on measuring the fair value of the acquirer’s interest and the fair value of the noncontrolling interest. That led to the conclusion that goodwill would be calculated as the excess of:

a. The fair value of the acquirer's interest (usually, the fair value of the consideration transferred) plus the fair value of the noncontrolling interest over
b. The recognized amounts of the identifiable net assets acquired.

Ms. Tamulis stated that the change in focus leads to the question about how to measure the noncontrolling interest and goodwill if the acquisition is a bargain purchase. The staff identified three alternatives as detailed in the audience handout:

a. **Alternative 1:** Measure the noncontrolling interest at fair value and calculate goodwill or a bargain purchase gain as the final residual.
b. **Alternative 2:** Measure the noncontrolling interest as its proportional interest in the identifiable net assets. No goodwill would be recognized.
c. **Alternative 3:** Measure the noncontrolling interest at fair value and recognize goodwill attributable to the noncontrolling interest (calculated as the difference between the fair value of the noncontrolling interest and the noncontrolling interest's proportional interest in the identifiable net assets).

The Board decided that if an acquisition is a bargain purchase, the acquirer should calculate the amount of the gain attributable to the acquirer as the excess of (a) the amounts recognized for the identifiable assets acquired and liabilities assumed and (b) the acquisition date fair values of the consideration transferred and the acquisition date fair values of any noncontrolling interest in the acquiree (Alternative One). (All agreed.)

Ms. Tamulis noted that the IASB decided to allow an exception to measuring the noncontrolling interest at fair value. It decided that the noncontrolling interests should be measured at fair value unless doing so would impose undue cost and effort on the acquirer. Ms. Tamulis stated that the IASB agrees, in concept, with Alternative One for measuring the gain if the acquisition is a bargain purchase. However, if the entity took the undue cost and effort exception, the default would be Alternative Two. Therefore, the IASB believes that the bargain purchase guidance should be worded to state that the acquirer should calculate the amount of the gain attributable to the acquirer as the excess of (a) the amounts recognized for the identifiable assets acquired and liabilities assumed and (b) the acquisition date fair values of the consideration transferred and **the amount recognized for any noncontrolling interest in the acquiree.**

TOPIC 4: ASSEMBLED WORKFORCE FOLLOW-UP.

Ms. Tamulis stated that at their separate October 2006 meetings, the Boards were asked to reconsider whether an assembled workforce is a separable intangible asset that should be recognized separately from goodwill. The IASB voted (7-5) to require recognition of an assembled workforce if it was separable. The FASB voted (5-2) to affirm the existing provision in Statement 141 that prohibits the recognition of an assembled workforce on the basis that it is never separable or very rarely separable. Therefore, the Boards have not reached a converged decision. At its most recent Board meeting the IASB reversed its previous decision and decided to preclude the separate recognition of an assembled workforce on the basis that it is not separable, which is consistent with the FASB's original decision.

The Board affirmed its decision that an assembled workforce cannot be recognized separately from goodwill because an at-will workforce cannot be separated from the business and, therefore, does not meet the separability criterion. (All agreed.)

TOPIC 5: VALUATION ALLOWANCES

Mr. Roberge stated that in December 2006, the Board affirmed that an acquirer measure acquired receivables, loans, and finance leases (financing receivables) at their acquisition date fair values. As such, an acquirer would be prohibited from recognizing a separate valuation allowance. At that meeting, the Board directed the staff to evaluate types of disclosures that should be provided, if any, to communicate information about the credit quality of acquired receivables.

Mr. Roberge noted that at the January 30, 2007 Board meeting, the Board added a project to its agenda to improve disclosures related to the allowance for credit losses associated with financing receivables. In light of that decision, Mr. Roberge asked the Board whether the Board wished to provide disclosure guidance in the final business combinations Statement about credit considerations factored into the valuation of receivables or to develop and provide that guidance as part of the project on disclosure requirements. Mr. Roberge continued that if the Board wants to provide a disclosure requirement as part of the business combinations project, the staff believes the following disclosure would be appropriate:

> For receivables acquired not subject to the requirements of AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, the acquirer shall disclose the receivables' fair value, gross contractual amounts receivable, and the best estimate of cash flows not expected to be collected at the acquisition date. The disclosures shall be provided by major class of receivable, such as loans, direct finance leases in accordance with FASB Statement No. 113, *Accounting for Leases*, and any other material class of receivables.

The Board decided that an acquirer should disclose, by major class of receivable, the receivables' fair value, gross contractual amounts receivable, and the best estimate of cash flows not expected to be collected at the acquisition date. (All agreed.)

Mr. Trott stated that he hopes a final document for loan allowances, which is expected to provide more comprehensive disclosures, will be applied before the effective date of the business combinations Statement. Mr. Batavick agreed that the proposed disclosure would be an effective placeholder until the issuance of a final document for loan allowances. He noted that the disclosure would only provide information about the receivables at the date of acquisition but would not reflect changes in subsequent periods.

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

None.

<u>General Announcements:</u>

None.