MINUTES

Financial Accounting Standards Board

To: Board Members

From: Business Combinations—Purchase Method Procedures Team (Rohrkemper, ext. 284)

Subject: Business Combinations Minutes of the April 7, 2004 Board Meeting **Date:** April 14, 2004

cc: FASB: Bielstein, Smith, Leisenring, Petrone, Bossio, Lott, Tamulis, Munro, Pinson, Manders, Rohrkemper, Hamilton, Swift, Polley, Cropsey, McIntosh, Thompson, Gabriele, Sutay, Thompson, Lapolla, McKenna, Zeyher, Budak; FASB Intranet; IASB: Clark, Leisenring, Ryltsova, Kimmitt, Crook; CICA: Walsh; AICPA: Hekker; Purchase Method Procedures Resource Group Members and Observers

Topic: Issues pertaining to the interrelation of the Board's project on business combinations with (a) its project on equity-based compensation and (b) FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*.

Basis for Discussion: Equity-Based Compensation Board Memorandum No. 62 dated March 26, 2004 and Business Combinations Board Memorandum dated March 25, 2004

Length of Discussion: 9:00 a.m. to 11:20 a.m.

Attendance:

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

Summary of Decisions Reached

The Board discussed two sets of issues pertaining to the interrelation of its project on business combinations with (a) its project on equity-based compensation and (b) FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*.

Equity-Based Compensation Issues

The Board discussed whether the fair value of *replaced equity-based awards*—that is, outstanding awards issued by the acquiree, such as employee stock options, that are replaced by the acquirer as part of a business combination—should be considered part of the consideration paid in such a combination or whether the fair value of the replacement awards should be treated as a separate compensation arrangement of the acquirer. The Board also discussed how, if at all, any portion treated as consideration paid for the acquired business should be measured.

The Board reached the following tentative decisions with respect to the replacement of equity-based awards in a business combination:

a. To be considered part of the consideration paid in a business combination, an acquirer must have an obligation as part of the business combination to replace outstanding equity-based awards issued by the acquiree. If there is no obligation, then the replacement awards issued by the acquirer would be treated as a separate compensation arrangement of the acquirer.

b. If the acquirer has an obligation, the Board would reject approaches that require the acquirer to allocate the entire fair value of the replacement award either to the consideration paid in the business combination (purchase price) or to compensation cost. In determining the amount that would be allocated to purchase price, the Board decided that a number of factors would be taken into consideration including the percentage of requisite service that had been rendered at the date of the acquisition.

The fair value of the acquirer-issued replacement award would be compared to the fair value of the replaced equity-based awards of the acquiree. To the extent that the fair value of the acquirer-issued replacement award exceeds the fair value of any replaced equity-based awards of the acquiree, that excess would be compensation cost of the acquirer.

To the extent that service is explicitly required subsequent to the consummation date of the acquisition in order to vest in the acquirer-issued replacement awards, a portion of the fair value of the acquirer-issued replacement award would be recognized as compensation cost over the requisite service period.

c. There would be no subsequent adjustments to the amount considered as part of the consideration paid stemming from an acquirer-issued replacement awards issued as part of a business combination. Accordingly, any events subsequent to the business combination affecting that equity-based awards issued as part of a business combination should be accounted for in accordance with FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as amended by the proposed Statement on share-based payment.

Interpretation 46(R) Issues

The Board also discussed whether and how to conform the initial measurement guidance in paragraphs 18–21 of Interpretation 46(R) and the measurement guidance in the proposed Statement on business combinations.

The Board reached the following tentative decisions:

a. When an enterprise becomes the primary beneficiary of a variable interest entity that meets the definition of a business, the enterprise would be required to apply the measurement, recognition and disclosure requirements in the proposed Statement on business comibinations.

b. When an enterprise becomes the primary beneficiary of a variable interest entity that does *not* meet the definition of a business, the enterprise would be required to apply the recognition and measurement guidance in the proposed Statement on business combinations for the assets (other than goodwill) and liabilities of the newly consolidated variable interest entity unless those assets and liabilities were transferred by the enterprise at, after or shortly before the date of initial consolidation. If a variable interest entity is not a business, no goodwill would be recognized; any difference between (1) the consideration paid, if any, and the reported amount of any previously held interests and (2) the net amount of the variable interest entity's recognized assets, liabilities, and noncontrolling interests would be recorded as a gain or loss and separately disclosed in notes to the consolidated financial statements.

c. The requirement in paragraph 19 of Interpretation 46(R) for enterprises and variable interest entities that are under common control will be retained.

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

The meeting took place in two parts in which the Board discussed business combination issues related to (a) equity-based compensation and (b) Interpretation 46(R).

The objective of the discussion on equity-based compensation was to address known practice issues related to the replacement of equity-based awards of the acquiree with equity-based awards of the acquirer.

The objecteive of the discussion on Interpretation 46(R) was to address the conformation of the initial measurement guidance in paragraphs 18–21 of that Interpretation and the measurement guidance in the proposed Statement on business combinations.

Matters Discussed and Decisions Reached:

Part I: The Replacement of Equity-Based Awards of the Acquiree with Awards of the Acquirer

The staff pointed out that in a business combination in which the acquiree has equity-based awards outstanding, the acquirer may choose or be obligated (by law or otherwise) to replace some or all of those awards with acquirer-issued awards, which may be in the form of cash awards, equity-based liability awards, or equity-based equity awards. At issue during the first part of the meeting was how these replacement awards should be accounted for.

Ms. Zeyher invited the Board to first discuss the staff's suggested refinements to the scope of the issue—that is, whether only acquirer-issued awards with certain characteristics should be considered replacement awards. The staff recommended that the scope of the issue be limited to awards that (a) are issued concurrent with a business combination, (b) are required to be issued as part of the combination, and (c) are similar to the awards being replaced.

Ms. Schipper disagreed with the staff recommendation that nonconcurrent, disimliar replacement awards be excluded from the scope of the Board's decision. In her view, the notions of concurrence and, in particular, of similarity are difficult to define and she anticipated that many constituents would likely encounter application problems without such definitions. Messrs. Trott and Cassel agreed. Mr. Trott suggested that these scope questions be deferred until after the Board meets with the International Accounting Standards Board to revisit their decision on which assets and liabilities should be considered part of the combination. He noted that the Boards' ultimate view of what is part of the combination may be sufficient in limiting the scope of the decision on replacement awards without reliance on the notions of concurrence or similarity.

Ms. Schipper also noted that the staff's scope questions need not be addressed if the Board decides to account for *all* replacement shares as compensation expense under Statement 123—that is, to treat none of the replacement shares as part of the consideration paid in the combination. She pointed out that this alternative would be the least complicated of the staff's proposals because it does not require an acquirer to differentiate awards that are consideration paid for the acquired business from awards that are compensation costs.

Mr. Trott emphasized that Ms. Schipper's proposed alternative only applies to *replacement* awards. Replacement awards refer to the awards issued by the acquirer to replace acquiree awards outstanding at the date of the acquisition; they do not include awards exchanged solely as consideration to acquire the business. To illustrate, Mr. Trott offered the following as an example. Consider an acquisition of a business with no equity-based awards outstanding. If the consideration paid to the owners, who are all employees, in exchange for that business is entirely composed of equity-based awards of the acquirer (employee stock options, for example), then *none* of those awards would be replacement awards because there were no outstanding awards for them to replace. Instead, all of those newly issued awards should be treated as considereation paid for the acquired business.

Mr. Trott agreed with Ms. Schipper that the simplest answer would be to deem all replacement awards compensation costs subject to Statement 123. However, he pointed out that the staff's conceptual basis for treating at least *some* replacement awards as a consideration paid is that some award holders are, economically, situated very similarly to shareholders and for these holders, the replacement awards are a way to "buy out" their equity-like interest. Both Mr. Trott and Ms. Schipper agreed with this basis, however neither believed that the staff's proposed criteria for limiting the scope of the decision, particularly the criterion relying on the notion of similarity, would be sufficiently detailed to be operable.

Mr. Cassel also asked the Board to consider employee stock appreciation rights of the acquiree that are not vested and are due to be settled in cash. He emphasized the possibility that these awards, which are not acquiree equity interests, might instead be considered liabilities assumed in a business combination if replaced. Mr. Trott responded that, separate from the consideration of whether share-based payment arrangements are equity interests in the acquiree—which the Board agreed should be treated as part of the purchase price to the extent that they are replaced by the acquirer—an acquirer should consider whether it is obligated to replace those arrangements. If the acquirer is not obligated to replace the outstanding equity-based awards of the acquiree, then the replacement awards issued by the acquirer should be treated as a separate compensation arrangement of the acquirer. Only if the acquirer is obligated should the awards that are determined to be equity interests of the acquiree be considered part of consideration paid.

Mr. Herz also agreed that replacement awards should be treated like consideration paid to the extent that the awards they are replacing are equity interests in the acquired business. He suggested that to the extent that the fair value of replacement shares issued in a business combination are greater than the fair value of the outstanding awards being replaced, the excess fair value of those replacement awards would be compensation cost of the acquirer. No Board members objected.

Mr. Trott noted that many equity-based award packages have accelerated vesting clauses under which outstanding, unvested awards become instantaneously vested—that is, without completion of the required service period—in the event that the business is aquired in a business combination. However, while such clauses are common, it is inevitable that some award packages exist that do not offer accelerated vesting.

Ms. Schipper agreed and urged the Board to choose a method for determining what portion of unvested acquiree awards should be considered equity interests in the acquiree and therefore considered part of the consideration paid when replaced in a combination. She pointed out that FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, provides a reasonable method for allocating between compensation cost and purchase price (consideration paid) whereby the portion allocated to compensation cost is calculated as the ratio of the remaining future service period divided by the total service period (the service period prior to the consummation date plus the remaining future service period).

Mr. Herz asked the Board whether it would be opposed to using the allocation method described in Interpretation 44 in circumstances in which the acquiree's unvested awards are replaced by unvested awards of the acquirer. No Board members objected, but Mr. Trott clarified that under such a circumstance (and any other circumstance), the Board's final decision with regard to what is part of the combination might preclude some transactions from being accounted for as part of the business combination, particularly those that are potentially abusive—for example, stock options granted by the acquiree in contemplation of the business combination in order to shift acquirer compensation cost into the consideration paid.

Mr. Cassel noted that the Board discussed a relevant example at its April 1, 2004 education session, the outcome of which required clarification in light of the Board's decision to allocate based on the remaining required service period. In this example, the replaced awards are vested, deep out-of-the-money employee stock options—vested options with a large, negative intrinsic values—such that, while there is no explicit service period required, a derived service period[1] for those options can be inferred from the fact that their holders must remain employed with the acquiree for an unspecified, but derivable period of time before they can exercise their vested options and earn an award. Mr. Cassel asked the Board, if such awards are replaced with equivalent-valued, fully vested, deep out-of-the-money awards of the *acquirer*, whether the vested status of the awards would cause the acquirer to consider them equity interests (and

[1] Derived service periods are described in paragraph B38 of the proposed Statement on share-based payment as follows: "Derived service periods are relevant only for awards with market conditions that affect exercisability (or exercise price) or the ability to retain the award. Derived service periods are implied by, or can be derived from, certain valuation techniques used to estimate fair value. For example, the derived service period for a share award that can be retained by the employee only if the share price increases by 25 percent at any time during a 5-year period can be derived from the valuation technique used to estimate fair value."

therefore part of the purchase price) or whether the derived service periods would necessitate treatment in-line with unvested awards (and therefore considerd part compensation expense).

Mr. Trott responded that the vested status of the outstanding awards described in Mr. Cassel's example demonstrates that there is an equity interest held by the employees with the awards. He stated that the issue of whether that interest is acquired in a business combination is a separate question. If the equity interest is aquired, even though it is deep out-of-the-money and therefore has a derived service period, it should be considered part of the purchase price.

Ms. Schipper clarified that whether part of the fair value of the replaced awards in this example should be considered compensation cost is dependent on the features of the awards that they are being replaced with. If the replacement awards are vested, but have a derived service period, the issue to be addressed is whether part of those awards should be considered compensation cost. If one were to follow the guidance in Interpretaion No. 44 to allocate between purchase price and compensation cost, *all* of the replacement awards would be considered purchase price because the options in the example are vested and the newly required service period is zero.

Mr. Crooch expressed the preference that all fully vested replacement awards be considered part of consideration paid regardless of whether there is a derived service period. In his view, the character of the replacement awards should not matter. He pointed out that if cash was given as a replacement for the vested awards of the acquirer, all of the Board members would agree that it be treated as purchase price. Why not then treat any vested award of the same fair value as that cash payment as purchase price as well? Ms. Seidman agreed.

Mr. Cassel pointed out that if that cash payment was contingent on several more years of service, it would be difficult to justify considering it purchase price and not compensation cost. But the question still remains: where do you draw the line and how do you allocate between purchase price and compensation cost?

Mr. Herz suggested an approach similar to the Interpretation No. 44 allocation method, but with some modifications. First, instead of using intrinsic value, Mr. Herz suggested using the fair value of the replaced awards as the base for the calculation—that is, the amount to be allocated. As a second modification, he suggested creating a total combined service period running from the original grant date from the acquiree's perspective to the end of the service period (derived or required) for the combined entity, and allocating the fair value of the replaced awards to purchase price on the basis of the total combined service already provided as of the acquisition date.

Mr. Schieneman suggested that the Board adopt a less complicated approach. He suggested that the Board focus on whether the acquiree's replaced awards are equity interests in the acquiree. To the extent that replaced awards are equity interests, their fair value should be allocated to purchase price. Mr. Schieneman proposed that only vested awards be considered equity interests in the acquiree.

Mr. Trott agreed with Mr. Schieneman's general approach, but disagreed that only vested awards are equity interests. He suggested instead that the earned portion of unvested awards (by whatever method of allocation the Board later decides is reasonable) also be included in the replaced awards that are deemed to be equity interests. He stated that an allocation method similar to the one described in Interpretation No. 44 seemed reasonable because unvested awards that are very close to vesting (for example, a one-year cliff-vesting option one week prior to vesting) are more like equity interests than unvested awards that are far from vesting (for example, a one-year cliff-vesting option one week after the grant date).

The Board decided that the fair value of the awards that the acquirer is obligated to issue in replacement of the equity-based awards of the acquiree (replacement awards and replaced awards, respectively) should be considered part of the purchase price. The Board did not decide how to determine a method for determining what portion of the outstanding acquiree awards are deemed equity interests in the acquiree. However, The Board agreed that the fair value of any acquirer-issued awards should be considered compensation cost to the extent that it exceeds the fair value of the replaced awards.

Mr. Trott noted that at both the FASB's April 14, 2004, and the April 22, 2004 joint meeting with the IASB, the FASB will discuss issues pertaining to which assets and liabilities are part of a business combination. Those discussions will impact the decision on replacement awards insofar as both Boards decide whether a transaction giving rise to replacement awards is within the business combination accounting. He also pointed out that the agreed-upon method would not always result in a perfect representation of the economics of every transaction, but to devise a method that would pinpoint the exact amounts of purchase price and compensation cost would introduce unnecessary overcomplication.

The staff recommended that there should be no subsequent adjustments to the amount considered part of the consideration paid stemming from replacement awards issued as part of a business combination. Accordingly, any events subsequent to the business combination affecting equity-based awards issued as part of a business combination should be accounted for in accordance with Statement No. 123, as amended by the proposed Statement on share-based payment. Ms. Schipper agreed with the staff's recommended treatment of subsequent adjustments. All Board members agreed.

Mr. Leisenring questioned why this issue was brought to the Board as a FASB-only issue when both the purchase method procedures and equity-based compensation projects are being conducted as joint projects. Mr. Trott agreed and suggested that the staff introduce the issue and the Board's decision to the IASB.

Whether and How to Conform the Initial Measurement Guidance in Paragraphs 18–21 of Interpretation 46(R) and the Measurement Guidance in the Proposed Statement on Business Combinations

The staff provided an overview of the three main issues.

The first issue concerns what measurement guidance should be used to initially measure the assets and liabilities of a newly consolidated variable interest entity (VIE) that also meets the definition of a business.

The second issue primarily relates to what measurement guidance should be used to initially measure the assets and liabilities of a newly consolidated VIE that does not meet the definition of a business.

The third issue relates to potential other conforming changes to Interpretation 46(R) and the proposed Statement on business combinations related to guidance for common control transactions.

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

Issue 1 consists of three questions:

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

b. Should the guidance in paragraph 20 of Interpretation 46(R) be incorporated into the proposed Statement on business combinations?

c. Is the phrase *previously acquired noncontrolling investments* in the proposed Statement on business combinations intended to be limited to equity investments?

Under the proposed Statement on business combinations, a business combination would be defined as a transaction or other event in which an acquiring entity obtains control over one or more businesses. The proposed Statement does not differentiate between obtaining control of a business that is or is not a VIE. If a primary beneficiary obtains control of a VIE that is a business, according to the proposed Statement on business combinations that event would be a business combination. Since the initial measurement guidance that will be included in the proposed Statement on business combinations differs from that of Interpretation 46(R), the first issue is primarily related to whether primary beneficiaries who obtain control of VIEs that are businesses should apply the requirements of the proposed Statement on business combinations or the existing requirements of Interpretation 46(R) for initial measurement of the VIEs assets and liabilities.

Should Primary Beneficiaries Who Obtain Control of VIEs That Are Businesses Apply the Requirements of the Proposed Statement on Business Combinations or the Existing Requirements of Interpretation 46(R) (or a Combination of Both)?

The staff presented 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 the proposed Statement on business combinations should apply.

Alternative Two–Include a scope exception in the proposed Statement for business combinations in which control of a business is obtained and that business also is a VIE. Continue to provide initial measurement guidance in Interpretation 46(R) that requires that primary beneficiaries recognize the assets, liabilities, and noncontrolling interests of the VIE upon initial consolidation at fair value.

The staff summarized the significant implications of Alternative One:

a. 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. This also would result in the recognition of the full amount of goodwill.

b. The same scope exceptions to the fair value measurement principle in 141(R) also would apply, (for example, operating leases, deferred tax assets and liabilities, and liabilities for employee benefits). Therefore, 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 the proposed Statement on business combinations.

The staff recommended Alternative One because it believes that obtaining control of a business should be accounted for the same regardless of whether the business is a VIE.

Mr. Herz asked whether this recommendation would be included in the Exposure Draft for the proposed Statement on business combinations. Ms. Tamulis responded that Alternative One would be included among its consequential amendments, specifically amending Interpretation 46(R) to require that primary beneficiaries of newly consolidated VIEs that are businesses apply the measurement, recognition, and disclosure guidance of the proposed Statement on business combinations.

The Board unanimously agreed with the staff's recommendation.

Should the Guidance in Paragraph 20 of Interpretation 46(R) Be Incorporated into the Proposed Statement on Business Combinations?

The staff stated paragraph 20 of Interpretation 46(R) requires that the primary beneficiary of a VIE initially measure any assets and liabilities transferred to the 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.* Therefore, no gain or loss would be recognized because of such transfers.

The staff stated it believes that transfers *after* the acquisition date would be sufficiently addressed by the common control guidance in the proposed Statement on business combinations, which would be carried forward from paragraph D12 of FASB Statement No. 141, *Business Combinations*.. Under that guidance, no gain or loss would be recognized and that is consistent with Interpretation 46(R).

The staff stated it believes that if an acquirer transfers assets or liabilities *at* the acquisition date, then the presumption would be that those assets and liabilities are part of the consideration exchanged. If the acquirer transfers assets and liabilities at the acquisition date as part of the combination and those assets and liabilities remain within the consolidated entity, the proposed Statement on business combinations would require that no gain or loss be recognized on the remeasurement of those assets and liabilities to fair value. Therefore, the staff stated that it believes the same accounting would result under the proposed Statement on business combinations and Interpretation 46(R). The staff recommended against requiring outright that transfers of assets at the acquisition date be recognized at a carryover basis if they remain in the consolidated entity because legitimate reasons may exist for recognizing those assets or liabilities outside of the business combination accounting.

The staff stated it believes that the facts and circumstances surrounding a transfer of assets and liabilities *shortly before* the acquisition date should be evaluated. It may be unclear whether a transfer of assets or liabilities shortly before the acquisition date is part of the business combination or a separate transaction. If the transfer is unrelated to the business combination, then other relevant GAAP should apply. If the transfer is completed *shortly before* the business combination, then it is possible that the transfer was entered into in contemplation of the business combination and perhaps should be accounted for as part of the consideration exchanged. The staff stated that if the transfer is part of the business combination and the assets remain within the consolidated entity, then the proposed Statement on business combinations would apply and no gain or loss would be recognized in the consolidated financial statements. However, the staff recommended clarifying the proposed Statement on business combinations to require consideration of the facts and circumstances surrounding a transfer of assets or liabilities *shortly before* the acquisition date to determine whether the transfer is part of the consideration exchanged in the business combination.

The Board unanimously agreed with the staff's recommendation.

Is the Phrase* Previously Acquired Noncontrolling Investments *in the Proposed Statement on Business Combinations Intended* to *Be Limited to Equity Investments?

In the business combinations project, the Board decided that if a business combination results 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 staff stated that the phrase *previously acquired noncontrolling investment* is unclear and could be interpreted differently. The staff clarified it is not clear whether the phrase was intended to be limited to previously acquired *equity* investments or *all* previously acquired investments (such as investment in debt securities of the acquiree). The staff believes it was intended to be limited to equity investments, but asked the Board whether its intent was such that the phrase would be applied only for equity investments.

The Board clarified that previously acquired noncontrolling investments are limited to previously acquired noncontrolling equity investments.

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

Issue 2 consists of three questions:

a. 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?

b. If an enterprise becomes the primary beneficiary of a VIE that is not a business, should the difference between (1) the consideration paid, if any, and the reported amount of previously held interests and (2) 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)?

c. 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 staff stated that it considered three alternatives for measuring the assets (other than goodwill) and liabilities of a VIE that is NOT a business.

Alternative One–Primary beneficiaries should use the guidance in the proposed Statement on business combinations 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 FASB Statement No. 142, *Goodwill and Other Intangible Assets*, 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 the proposed Statement on business combinations 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.

The staff stated that Alternative Three would be consistent with the way other asset acquisitions are accounted for, but inconsistent with the Board's decision in Interpretation 46(R). As noted in paragraphs D50–D52 of Interpretation 46(R), the Board decided to require that if a VIE is not a business, then the unidentified "difference" would be recorded as an extraordinary loss since it would not be appropriate to allocate a loss to increase newly acquired assets, especially since so many of those assets are financial assets. Therefore, the staff believes that there is sufficient reason to have different accounting for acquisitions of assets and acquisitions of assets that are also VIEs.

The staff stated that it has mixed views on whether to recommend Alternative One or Alternative Two.

The staff members who recommend Alternative One believe it is the least problematic alternative. The exceptions to the fair value measurement requirement in the proposed Statement on business combinations were made for pragmatic reasons. It would seem inconsistent to require that all assets and liabilities of a newly consolidated VIE that is not a business be measured at fair value and not to require that in the proposed Statement on business combinations. However the staff members do acknowledge that it may be difficult to explain why the guidance in the proposed Statementon business combinations does not apply to measuring the identifiable assets and liabilities of an entity that is not a business unless that entity also is a VIE.

The staff members who recommend Alternative Two believe that Alternative One is inconsistent with the scope of the proposed Statement on business combinations because Alternative One would not be a conforming change; rather, it would be a change that is outside the scope of the business combinations project since that project is limited to acquisitions of businesses.

Mr. Trott stated that he prefers Alternative Two or that the Board consider whether there should be a distinction between the accounting for acquisitions of businesses and the accounting for acquisitions of groups of assets.

Ms. Seidman stated that Alternative Two would result in different measurement requirements for similar transactions and allow divergent guidance to exist on consolidations depending on whether an acquisition is a business or not. She stated that she supported Alternative One.

Ms. Schipper stated that under Alternative One, the assets and liabilities of a VIE that is not a business would be measured the same as if under the proposed Statement on business combinations except that there would be no recognition of goodwill, and thus the VIE would not be recognized at fair value.

Four Board members voted in favor of Alternative One (GB, BH, LS, and KS). Three Board Members voted in favor of Alternative 2 (ET, MC, and GS). No Board members objected to Alternative One.

Several Board members requested that the Board reconsider its decision not to open the scope of the proposed Statement on businesss combinations for accounting for acquisitions of groups of assets. However, the Board voted against opening the scope of the project.

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 staff introduced the following alternatives:

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*.

The staff recommended against recognizing the positive difference as a pro rata increase to the assets for the same reasons outlined in the basis of Interpretation 46(R); that is, so many assets are financial assets, it does not make sense to prorate increase the fair value of financial assets.

The staff stated that in terms of whether the gain or loss should be recognized as extraordinary, the classification of the loss as extraordinary under Interpretation 46(R) was consistent with the classification of negative goodwill as an extraordinary gain under Statement 141. The proposed Statement on business combinations would not classify that gain as extraordinary and therefore, for consistency, the staff recommended that the gain or loss not be classified as extraordinary. Therefore, the staff recommended Alternative One.

Mr. Herz stated he would prefer that these types of gains and losses be accounted for as extraordinary gains and losses. He further stated that at minimum he would like to see these types of gains and losses recorded as a separate line item in the income statement. The staff stated that as an alternative to requiring extraordinary classification, the Board could decide to require separate disclosure of those gains or losses. He stated that only requiring additional disclosure would be inadequate in his view.

Ms. Schipper stated that she agreed with the staff's recommendation with the modification that the the gain or loss be required to be separately disclosed.

Mr. Herz asked if any Board members objected to the staff's recommendation with the requirement that those gain or losses be separately disclosed. No Board members objected.

Should Paragraph 20 of Interpretation 46(R) Be Retained for VIEs That Are Not Businesses?

The staff stated that paragraph 20 of Interpretation 46(R) requires that the primary beneficiary of a VIE 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 staff recommended that if the Board chooses to retain that guidance, that it only be retained for VIEs that are not businesses.

The Board unanimously agreed to retain paragraph 20 of Interpretation 46(R) only for VIEs that are not businesses.

Issue 3–Conforming the Guidance for Common Control Transactions

The staff stated that the last issue relates to conforming the guidance for common control transactions.

The staff stated that paragraph 19 of Interpretation 46(R) requires that if the primary beneficiary of a VIE is under common control with the VIE, the primary beneficiary should initially measure the assets, liabilities, and noncontrolling interests of the VIE *at the amounts at which they are carried in the accounts of the enterprise that controls the VIE*.

The staff further stated that paragraph D12 of Statement 141, which will be carried forward into the proposed Statementon business combinations, requires that 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 should initially recognize the assets and liabilities transferred *at their carrying amounts in the accounts of the* <u>*transferring*</u> *entity* at the date of transfer.

The staff stated that paragraph 19 of Interpretation 46(R) is broader in scope than the guidance in the proposed Statementon business combinations, because paragraph 19 provides measurement guidance for an event that is not limited to a transfer of assets or exchange of shares and paragraph 19 applies regardless of whether the VIE is a business.

The staff also provided an example to illustrate when a difference could arise between the guidance in paragraph D12 and paragraph 19:

> 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.

The staff stated that since common control is outside the scope of the purchase method procedures project, the staff would prefer not to amend the common control guidance in Statement 141 substantively. However, there are mixed views among the staff about whether an amendment to paragraph 19 should be made to conform to the proposed Statement on business combinations. The staff stated that since common control is outside the scope of the proposed Statement on business combinations, any amendment to paragraph 19 of Interpretation 46(R) may appear inconsistent with the scope of the project. However, if the Board chooses not to amend that paragraph, differences could arise. The staff stated that some of its members believe that the Board should focus on project scope and some on consistent guidance.

Mr. Crooch stated that if consolidation of a VIE by a commonly controlled enterprise occurs, the parent's (controlling entity's) basis should be used. Therefore, he believes paragraph 19 of Interpretation 46(R) should not be amended.

The Board unanimously decided not to amend paragraph 19 of Interpretation 46(R).