Financial Accounting Standards Board

To: Board Members

From: Inzano (x364) and Schonefeld (x442)

Subject: Minutes of the February 25, 2009 Board Meeting: Redeliberation of Accounting for Assets and Liabilities Arising from Contingencies in a Business Combination

Date: March 18, 2009

cc: FASB: Golden, Bielstein, Proestakes, Stoklosa, Inzano, Elsbree, Vernuccio, Lott, Posta, Glotzer, C. Smith, Mechanick, Bossio, Willis (consultant), Chookaszian, Gabriele, Allen, Klimek, FASB Intranet; IASB: Leisenring, Brown

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, Interpretation, or FASB Staff Position.

Topic:	Redeliberation of Accounting for Assets and Liabilities Arising from Contingencies in a Business Combination
Basis for Discussion:	Board Memorandum No. 6
Length of Discussion:	11:30 a.m. to 12:45 p.m.
Attendance:	
Board members present:	Herz, Linsmeier, Seidman, Siegel, and L. Smith
Board members absent:	None
Other participants:	None
Staff in charge of topic:	Inzano, Elsbree, and Schonefeld
Other staff at Board table:	Golden, Proestakes, and Leisenring

Summary of Decisions Reached

Accounting for assets and liabilities assumed in a business combination that arise from contingencies. The Board redeliberated significant issues raised in comments received on proposed FSP FAS 141(R)-a, *Accounting for Assets and Liabilities Assumed in a Business Combination That Arise from Contingencies.*

The Board decided to amend the guidance in FASB Statement No. 141 (revised 2007), *Business Combinations*, to require that assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value if fair value can be reasonably estimated. If fair value of such an asset or liability cannot be reasonably estimated, the asset or liability would be recognized in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. Additionally, the Board decided to remove the subsequent accounting guidance for assets and liabilities arising from contingencies from Statement 141(R). The Board decided that the guidance in FASB Statement No. 141, *Business Combinations*, should essentially be carried forward without significant revision. However, the Board decided that the word *determined* in Statement 141 should be replaced with *reasonably estimated.*

The Board also discussed issues about disclosures, contingent consideration, and extending the guidance in the FSP to other areas in a business combination and decided the following:

1. The Board decided to amend the disclosure requirements in Statement 141(R) to eliminate the requirement to disclose an estimate of the range of outcomes of recognized contingencies at the acquisition date. For unrecognized contingencies, the Board decided to require that entities include only the disclosures required by FASB Statement No. 5, *Accounting for Contingencies,* and that those disclosures be included in the business combination footnote.
2. The Board decided that contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination should be treated as contingent consideration of the acquirer and should be initially and subsequently measured at fair value in accordance with Statement 141(R).
3. The Board affirmed its decision that contingent consideration be excluded from the scope of the final FSP.

The Board directed the staff to proceed to a draft of a final FSP for vote by written ballot.

Objectives of Meeting:

The purpose of this meeting was for the Board to redeliberate the proposed FASB Staff Position (FSP) FAS 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies,* based on significant comments and issues raised by respondents in their comment letters and decide whether to proceed to drafting a final FSP.

Matters Discussed and Decisions Reached:

Overview

1. Ms. Inzano stated that the comment period on the proposed FSP ended on January 15, 2009, and that 18 comment letters were received. She stated that although the majority of the respondents expressed support for addressing implementation issues in Statement 141(R), there were some diverse views on several key provisions. She also stated that a few respondents opposed the issuance of the FSP.

Issue 1: Measurement Basis for Initial Recognition and Measurement of Assets and Liabilities Arising From Contingencies

2. Ms. Inzano stated that several respondents had concerns that the proposed FSP adds complexity to the accounting for assets and liabilities arising from contingencies in a business combination. She stated that there were two main issues addressed by respondents, which were (a) that the FSP requires different accounting initially and subsequently and (b) that it requires different accounting for assets and liabilities acquired in a business combination than those outside a business combination. She stated that some respondents recommended that the guidance in Statement 141 be retained without revision, while others recommended that all assets and liabilities arising from contingencies in a business combination be accounted for in accordance with FASB Statement No. 5, *Accounting for Contingencies*. Other respondents believe that the initial recognition and measurement guidance in Statement 141(R) should be retained or should be revised to require that all assets and liabilities arising from contingencies in a business combination be recognized at fair value.

3. Ms. Inzano stated that the staff believes there are several alternatives that may reduce the complexity in accounting for assets and liabilities arising from contingencies in a business combination from the guidance in the proposed FSP. These alternatives include (a) carry forward the guidance in Statement 141 without revision (that is, without additional guidance for assessing whether the fair value of an asset or liability arising from a contingency can be reasonably

determined and without subsequent accounting guidance), (b) require that all assets and liabilities arising form contingencies in a business combination be accounted for in accordance with Statement 5, or (c) require that assets and liabilities arising from contingencies in a business combination be subsequently measured on the same basis as they are originally measured. Ms. Inzano noted that (c) above is the alternative view set forth in the proposed FSP, and while it would reduce complexity between the initial and subsequent measurement, it would not address the complexity between contingencies inside and outside of a business combination, and also would not address the complexity between different types of contingencies within a business combination (that is, those measured at fair value and those that are not).

4. Ms. Inzano noted that the accounting for assets and liabilities arising from contingencies in the proposed FSP was intended to be similar to the accounting under Statement 141. However, the proposed FSP includes additional guidance that was intended to help users. Ms. Inzano stated that the comments that were received seemed to indicate that the extra guidance for assessing whether fair value can be reasonably determined added to complexity.

5. **Staff Recommendation:** The staff's recommendation was that the guidance in Statement 141 be carried forward without revision. However, the staff recommended that the guidance specific to warranties not be carried forward from Statement 141 (that is, warranties would be subject to the same guidance of as all other contingencies and not the specific guidance related to liabilities and accruals, including warranties, in Statement 141).

6. **Board Vote:** The Board voted to effectively carry forward the guidance from Statement 141 without significant revision, including not providing subsequent accounting guidance, except that the word *determined* in Statement 141 should be replaced with *reasonably estimated.* **Three Board members agreed. Ms. Seidman did not object to the majority view. Mr. Linsmeier dissented.**

7. **Board Comments:** Mr. Leisenring noted that few assets and liabilities have fair values that can be determined. He stated that their fair values may be estimable

but not determinable. Ms. Seidman noted that practice does fair value some items.

8. Mr. Siegel noted that the staff's recommendation is inconsistent with the approach taken in Statement 141(R) that ties back to Statement 157.

9. Mr. Linsmeier noted that he does not support the staff's recommendation. He said that in order to determine whether the fair value is determinable, you need to know what "determinable" means. He said that if something is in the fair value category, he does not think staying silent on day two represents good standard-setting. Mr. Linsmeier stated that he would feel better if the word "determinable" were changed to "estimable," but he still would not support the staff's recommendation because of the lack of day two guidance.

10. Mr. Golden stated that he thinks the word "estimable" would cause all contingencies to be reported at fair value because almost everything can be estimated. Mr. L. Smith stated that he disagrees with Mr. Golden because he does not think you can estimate a lot of contingencies because many lack information available to preparers and auditors. Mr. Golden contended that theoretically the acquirer placed an estimate on the fair value when assessing whether to acquire the entity.

11. Mr. L. Smith noted that the staff recommended changing Statement 141 to exclude guidance for warranties and asked whether the staff believes that the fair values for warranties could be "determined." Ms. Inzano stated that she thought they generally could be determined.

12. Mr. Herz noted that he did not think anything could be resolved on this issue until the bigger issues of recognition and measurement and disclosure related to contingencies are solved more broadly. He said he therefore supports the staff's recommendation.

13. Ms. Seidman pointed out that when drafting Statement 141(R), the Board tried to distinguish between those items that can be fair valued and those that cannot, which is why the Board tried to distinguish between contractual and

noncontractual contingencies. She stated that problems arose when constituents began asking about distinguishing between contractual and noncontractual contingencies, and she is starting to think that it might be a better approach to just clarify that lawsuits are not contractual. She stated that another issue is the precise language used with the "higher of" notion, which does not allow relief for running off contingencies over time. She said that we could clarify that the Board did not mean for preparers to keep those contingencies there in perpetuity and that they should use their normal revenue recognition procedures and run it off over time. Mr. Golden stated that he could agree with Ms. Seidman's proposal but that noncontractual liabilities would need to follow Statement 141 because current requirements for noncontractual liabilities in Statement 141(R) do not reconcile with the treaty between the American Bar Association and the American Institute of Certified Public Accountants.

14. Mr. Herz stated that the Board may not like how practice has dealt with the contingencies, but that the Board needs to move on and come to a decision. Ms. Seidman questioned the ability to move on at this point because constituents are asking questions about day two accounting, and they are now aware of the subsequent reporting alternatives that were considered by the Board.

15. Mr. Golden suggested going to something that we know works. Mr. Herz clarified that Statement 141 does not work from an information standpoint, but that practice has established application of the statement. Further, he stated that the Board has tried multiple times to find an alternative and that each alternative poses problems.

16. Mr. L. Smith stated that he agrees with Mr. Herz when it comes to litigation-type contingencies. He stated that he believes that warranties have fair values that can be estimated, but he is not sure if their fair values can be determined.

17. Mr. Siegel stated that investors have been clear that they want fair value for day one and day two accounting for contingencies. He stated that he has trouble reconciling different treatment between acquired contingencies and organic contingencies. Mr. Golden stated that he agrees. Mr. Linsmeier stated that the

only way acquired and organic contingencies could be treated the same would be to go to Statement 5 for day one and day two accounting because using the notion of "higher of" or "lower of" is not the same as doing Statement 5 on day two.

18. Mr. Proestakes noted that litigation could look like warranties with the law of large numbers, such as in a class action lawsuit with a lot of settlements. In this situation, he stated that a fair value estimate could likely be attained.

19. Mr. Linsmeier noted that this project was undertaken in the first place, in part, due to a number of comments asking for guidance on day two accounting. He stated that not addressing these comments would not make sense. Mr. Golden stated that going back to the Statement 141 model for contingencies addresses the day two problem because people are applying that standard today and should know how to account for day two.

20. Mr. Leisenring asked whether the staff's recommendation also applies to contingent assets and whether a change will result in further divergence from IFRS. Ms. Inzano stated that assets are included in this project because the staff wanted to address all contingencies without splitting it into pieces by having separate asset guidance. She stated that there are also contractual-versus-noncontractual issues that need to be addressed with respect to assets. She noted that the staff recommends reverting to Statement 141 to deal with assets as well as liabilities. Ms. Inzano also noted that contingent assets are not currently recognized under IFRS.

21. Mr. Siegel stated that he agrees with the staff recommendation, except he recommends that contingencies should be recognized at fair valued if the fair value is "reasonably estimable" rather than if the fair value can be "determined."

22. Mr. Linsmeier stated that very few contingencies are being valued at fair value and that preparers are applying Statement 5. He stated that preparers may not know how to apply day two accounting because they have not been recording these contingencies at fair value. Mr. L. Smith stated that practice has been discounting some contingencies. Mr. Herz stated that obligations that include a large number of similar items may not be technically at fair value because they do

not have a profit element included but that liabilities have been recorded in practice.

23. Ms. Inzano noted that many of the liabilities for which fair value could be reasonably estimated would be those that have large numbers where the liability would be reduced as activity occurs. She said that the “higher of” notion appears to apply more to one-time phenomena, such as litigation contingencies, where estimates will change based on new information and not liabilities that will be reduced as activity occurs.

24. Mr. Golden recommended that examples be included in the FSP to illustrate the meaning of the term “reasonably estimable” and how it applies to warranties and litigation contingencies. Mr. L. Smith and Mr. Herz stated that they would agree with the staff’s recommendation of carrying forward the guidance in Statement 141 if the guidance was revised to require that contingencies be recognized at fair valued if the fair value is “reasonably estimable” rather than if the fair value can be “determined” and if examples of situations in which fair value can or cannot be reasonably estimated are included.

25. Mr. Linsmeier questioned whether fair value would be permitted for day two for contingencies reported at fair value on day one. Mr. Herz stated that it depends on what the ongoing accounting for the item is. Mr. Linsmeier expressed concern that companies will recognize a day two gain for the profit element included in the fair value of a warranty liability if they switch to applying Statement 5 to the liability on day two. Mr. Elsbree indicated that he believes companies will likely come up with a method for amortizing the profit element, similar to the treatment of inventory, and will not recognize an immediate gain. Mr. L. Smith stated that changes from fair value to Statement 5 will likely be in situations in which the company significantly underestimates a liability and has to record an additional liability under Statement 5. Mr. Leisenring stated that warranties should not be considered contingencies and should not be accounted for under Statement 5. However, it was noted that Statement 5 specifically includes warranties as an example of a contingency.

26. Mr. Linsmeier stated that he did not like the "higher of" and "lower of" notion, but he thought the proposed FSP did a good job talking about how to do runoff. He does not like abandoning what was done to demonstrate runoff. He stated that he thinks there will be questions about what reasonably estimable means and how to do day two accounting. Mr. Elsbree stated that he thinks preparers will understand that the intent of the Board was not to allow a day two gain and that that will not be allowed in practice.

Issue 2: Disclosure

27. Ms. Inzano stated that a number of respondents had concerns about disclosures required in the proposed FSP. The majority of those respondents recommended that the FSP simply refer to the disclosures required by Statement 5 until the Board completes its project to reconsider the disclosure requirements for all contingencies.

28. Ms. Inzano stated that the staff does not believe that the comment letters received raised any new information with respect to this issue. However, she said the staff recommends that the Board reconsider the disclosure requirements in the proposed FSP. Ms. Inzano stated that if the Board decides to reconsider the disclosure requirements in the FSP, the staff believes the Board should consider (a) only requiring disclosures required under Statement 5 until the contingency disclosure project is complete, (b) requiring disclosures required under Statement 5 plus additional disclosures, such as the valuation technique and inputs used to develop fair value for assets and liabilities recognized at fair value at the acquisition-date (similar to the requirements in Statement 157), or (c) including a prejudicial exception for litigation-related contingencies.

29. **Staff Recommendation:** The staff recommended alternative (a), which requires Statement 5 disclosures.

30. **Board Vote:** The Board decided to amend the disclosure requirements in Statement 141(R) to eliminate the requirement to disclose an estimate of the range of outcomes of recognized contingencies at the acquisition date. For unrecognized contingencies, the Board decided to require that entities include only the

disclosures required by Statement 5 and that those disclosures be included in the business combination footnote. **Four Board members agreed. Mr. Linsmeier did not.**

31. **Board Comments:** Ms. Seidman stated that she previously thought that Statement 141R included requirements to disclose assumptions used to determine fair value estimates for everything booked on day one, but she was mistaken with that thought. She thinks it is odd to require disclosure of assumptions used to determine fair value for only this one item (contingencies) in a business combination.

32. Mr. Linsmeier stated that if an entity uses fair value on day one, disclosures for nonrecurring fair value measurements would be required. Ms. Inzano stated that Statement 157 only requires disclosures for assets and liabilities measured at fair value on a nonrecurring basis in periods subsequent to initial recognition. She said that, for example, if the entity subsequently recognizes an impairment of the asset, fair value disclosures are required. Mr. Golden stated that fair value disclosures were not required under Statement 141(R) because of the magnitude of the disclosures that would be required.

33. Mr. Herz suggested disclosure of the amount recognized on the acquisition date, separated between contingencies recognized at fair value and contingencies recognized in accordance with Statement 5.

34. Ms. Seidman asked if moving to Statement 5 would replace what is currently in Statement 141(R), which states that for assets and liabilities arising from contingencies, disclose the amounts recognized or an explanation why nothing was recognized, the nature of recognized and unrecognized contingencies, and an estimate of the range of outcomes, discounted for contingencies recognized and unrecognized; or, if there’s a range, why you cannot find a fair value. Mr. Golden pointed out that the range of outcomes is most problematic. Mr. L. Smith pointed out that if the Statement 5 disclosures were required, to the extent there was a reasonable, possible chance of negative effects, you would have to disclose what that range of possibilities was or state that an estimate cannot be made.

35. Ms. Seidman said there should be a discussion of the amounts recognized or an explanation of what was not recognized and the nature of the contingencies. Mr. Elsbree pointed out that the concern with Ms. Seidman's proposal would be that there is no threshold for recognition, such as "remote," and companies would be required to disclose frivolous contingencies that are not meaningful.

36. Mr. Golden suggested that the Board require disclosure of the nature and amount of a recognized contingency on day one, and on day two, require the disclosures in Statement 5. Ms. Seidman said she would not separate between what is at fair value and what is not at fair value in the disclosures. Mr. L. Smith stated that what is unrecognized is just as important as what is recognized. Mr. Golden stated that in theory, the unrecognized contingencies would be required to be disclosed under Statement 5. Mr. L. Smith stated that it should be clear that the Statement 5 disclosures should be required in the period the business combination is completed.

37. Mr. L. Smith stated that in Statement 5, for loss contingencies that have been recognized because they are probable and estimable, paragraph 9 states that disclosure of the amount recognized may be necessary to ensure financial statements are not misleading. Ms. Seidman clarified that for subsequent periods, that provision would apply.

38. Mr. Siegel noted that he would like to see any disclosures of contingencies initially included in the business combination footnote rather than included with all other contingencies so that the business combination could be better evaluated.

Issue 3: Contingent Consideration of an Acquiree

39. Ms. Inzano stated that the scope that was originally discussed for this FSP was that it would include anything that meets the definition of a contingency in Statement 5, except items that have specific guidance elsewhere in Statement 141(R), such as contingent consideration, income taxes, and indemnifications.

40. Ms. Inzano noted that several respondents commented on paragraph 6(b) of the proposed FSP, which states that contingent consideration arrangements include an

acquiree's contingent consideration agreement assumed by the acquirer in a business combination. She stated that the issue was whether the contingent consideration guidance should be applied to the contingent consideration of an acquiree. She said respondents commented that an acquiree's contingent consideration arrangement does not meet the definition of contingent consideration in paragraph 3 of Statement 141(R) because it is not an obligation to the former owners of the acquiree.

41. **Staff Recommendation:** The staff recommended that paragraph 6(b) of the proposed FSP be revised to remove the statement that contingent consideration arrangements include an acquiree's contingent consideration agreement assumed by the acquirer in a business combination and that these types of arrangements be subject to the guidance in this FSP

42. **Board Vote:** The Board voted to require that contingent consideration agreements that an acquiree entered into in a prior acquisition should be accounted for as contingent consideration of the acquirer. **All Board members agreed.**

43. **Board Comments:** Ms. Inzano stated that the staff's intention was not to change the definition of contingent consideration. She noted that Statement 141(R) generally requires a complete reassessment of all assets and liabilities acquired or assumed in business combinations and does not result in a carryover of the previous accounting of the acquiree (for example, goodwill of the acquire is not carried over). Once the acquisition takes place, the contingent consideration of the acquiree becomes an obligation of the acquirer, similar to milestone payments. The staff recommends taking out the phrase "including contingent consideration of the acquiree" from paragraph 6(b), which would mean these arrangements would be accounted for in accordance with the FSP.

44. Mr. Herz stated that he does not agree with the staff's recommendation. He stated the contingent consideration is reported at fair value on the acquiree's books, and it should continue to be reported that way for subsequent acquisitions.

45. Ms. Seidman stated that she finds it odd to require companies to fair value contingent consideration at the time of the acquisition, when it is most difficult to fair value it, and then to measure it at something other than fair value when the fair value can determined much more easily.

46. Mr. Herz said he would agree with putting in a stipulation that would allow an entity to continue to apply the accounting for the arrangement under Statement 141 when the original transaction that gave rise to the contingent consideration occurred before the effective date of Statement 141(R). If the original arrangement was accounted for under Statement 141(R), entities would be required to continue to account for it as contingent consideration. Mr. L. Smith stated that he agrees.

47. Mr. Golden questioned whether an exception was necessary for arrangements entered into prior to the effective date of Statement 141(R) because if the Board believes it is contingent consideration of the acquirer, Statement 141(R) tells you how to account for it. Mr. Herz said he would agree with Mr. Golden's proposal. Ms. Seidman, Mr. L. Smith, Mr. Linsmeier, and Mr. Siegel also expressed agreement with Mr. Golden's proposal that no exception be provided for arrangements entered into prior to the effective date of Statement 141(R).

Issue 4: Extending Guidance To Other Areas In A Business Combination

48. Ms. Inzano asked whether the Board wanted to consider whether applying the approach in the proposed FSP to other areas in a business combination, such as accounting for contingent consideration, would improve financial reporting.

49. **Staff Recommendation:** The Staff recommended not extending the guidance to contingent consideration.

50. **Board Vote:** The Board voted to support the staff's recommendation. **All Board members agreed.**

51. **Board Comments:** Mr. Golden stated that not extending the guidance to contingent consideration could cause problems for contingent consideration based on legal activities. If the reason for the FSP is because you can't value litigation-related contingencies, it does not make sense that you can fair value contingent consideration that is based on legal activities.

Issue 5: Does The Board Approve of Proceeding To a Final FSP?

52. **Staff Recommendation:** The staff recommended proceeding to a final FSP.

53. **Board Vote:** The Board voted to proceed to a final FSP. **Four Board members agreed. Mr. Linsmeier dissented.**