



Financial Accounting Standards Board

Board Meeting Handout Conceptual Framework

February 28, 2007

At today's meeting, the Board will discuss the comment analysis on the Discussion Paper (DP), *Preliminary Views on an improved Conceptual framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*. The meeting is for informational purposes; the staff plans to begin redeliberations on Chapters 1 and 2 of the framework in April 2007.

SUMMARY

The FASB and IASB received 179 comment letters. In addition to commenting on the objective of financial reporting and the qualitative characteristics, constituents commented on several issues discussed in the preface of the DP. Those issues include:

1. Objectives of the project. Generally, respondents supported the Boards' plans to update and converge the frameworks without a comprehensive reconsideration. However, a minority indicated that the Boards should complete a more comprehensive reconsideration of the framework.
2. Authoritative status of the framework. A substantial number of respondents were concerned about the Boards' decision to deliberate the authoritative status of the framework in Phase F of the conceptual framework project. Those respondents recommended that the Boards consider accelerating Phase F to make the authoritative status of the framework clear as the Boards deliberate its content.
3. Phase G, *Not-for-profit and other business entities in the public sector*. A number of respondents expressed disappointment that the DP is limited to business entities.
4. Length of document. Some respondents criticized the length of the DP.
5. Finalization. Some respondents indicated that they would prefer the Boards publish a single exposure draft after all phases of the project are deliberated.

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OBJECTIVE OF FINANCIAL REPORTING

Respondents commented on three specific areas within Chapter 1 of the DP: Objective, Users, and Scope.

Objective

14% of respondents who commented specifically on the objective agreed that decision-usefulness is the only objective of financial reporting. Those who agreed commented that (1) the objectives of financial reporting should not be confused with corporate governance issues, and (2) making a distinction between the stewardship and decision-usefulness objective would risk separating the company's performance from that of the company's managers when they are not able to be separated.

86% of respondents disagreed with the Boards' decision regarding the objective of financial reporting. The majority of these respondents noted that to satisfy information needs of the entity's users, the objectives of financial reporting should include both stewardship/accountability and decision-usefulness. Additionally, some respondents disagreed with how stewardship is described in the DP. Finally, some respondents agreed with the objective of financial reporting and the relevance of information about future cash flows to that objective, but were concerned that the DP did not examine other types of information that may be useful to investors.

Users

Most respondents agreed that the Boards identified the relevant potential users of financial reporting in the DP. However, some respondents proposed that management or governments and regulatory bodies should be included as potential users. Others thought that the Boards focused too heavily on analysts and other sophisticated financial statement users rather than on investors, creditors, and potential investors and creditors.

A majority of respondents also agreed that the Boards should focus on a primary user group. However, some constituents disagreed with the Boards' definition of the primary user group. Of

those who disagreed with the Boards' focus on current and potential investors and creditors, some preferred to focus only on existing ordinary common shareholders.

Scope

About 16% of respondents expressed support for the Boards' decision to address the objective of financial reporting broadly. Many of these constituents also agreed with the DP that financial statements are still central to the financial reporting process and should remain the focus of the Boards' standard-setting activities. Some respondents objected to the fact that the Boards have proposed an objective of financial reporting rather than a more limited objective of financial statements, particularly because the Boards have not yet defined what constitutes financial reporting.

Nearly all respondents who commented on the entity perspective proposed in the DP stated that the issue should not be prejudged until it has been deliberated fully. Many said that the issue of entity vs. proprietary approach should be considered as part of Phase D, *Reporting Entity*, which concerns the definition and boundaries of the reporting entity. Some respondents indicated that they preferred the proprietary approach over the entity perspective.

QUALITATIVE CHARACTERISTICS

The DP includes qualitative characteristics of relevance, faithful representation, comparability, and understandability, and constraints of materiality and cost-benefit considerations. Some respondents argued that the qualitative characteristics seem suitable for financial **statements** but not financial **reporting**, and thus do not fit with the objective of financial **reporting**. A few respondents suggested additional qualitative characteristics. These qualitative characteristics include:

1. True and fair view
2. Prudence or conservatism
3. Substance over form

Many respondents objected that the DP includes references to measurement attributes such as fair value and historical cost. These constituents argued that discussions of measurement should be reserved for the measurement phase of the project.

Relevance

20% of respondents commented favorably on the Boards' inclusion of relevance (including predictive value, confirmatory value, and timeliness) as a qualitative characteristic; 16% commented unfavorably. Some respondents stated that the proposed phrase "capable of making a difference" is vague and may inappropriately broaden the definition of relevance to include information that "may possibly" make a difference. Respondents suggested changing the phrase to "actually making a difference" or "would make a difference if provided," instead of "capable of making a difference."

Some respondents wrote that timeliness should not be a component of relevance, but rather should be included in the chapter as a constraint. Constituents explained that materiality and timeliness affect many of the qualitative characteristics in the same manner, and as such, both materiality and timeliness should be either components of relevance or constraints.

Faithful Representation

5% of respondents commented favorably on the Boards' inclusion of faithful representation (including verifiability, neutrality, and completeness) as a qualitative characteristic; 73% commented unfavorably. Constituents gave the following reasons for disagreeing with the Boards' description of faithful representation:

1. Reliability is understood.
2. Reliability is a broader term than faithful representation, as faithful representation is one component of reliability in the current framework.
3. Reliability should be clarified, not replaced, if it is misunderstood.
4. The description of faithful representation needs to include a notion of 'reliability of measurement'.

Additionally, some constituents noted that the term *real-world economic phenomena* is difficult to translate and suggested the term be clarified.

Many respondents noted that verifiability should include the notion of judgment and the need for reliable evidence. They wrote that verifiability, along with faithful representation, does not encompass the full meaning of reliability. Several constituents wrote that indirect verification should not only require that the chosen recognition or measurement method is applied without material error or bias but also that the chosen method be one that knowledgeable and independent observers would agree is reasonable and appropriate in the circumstances. Additionally, some constituents suggested that verifiability should not be a component of faithful representation. Those constituents argue that certain useful information presented in financial reports can faithfully represent what it purports to represent while nonetheless being unverifiable.

Comparability and Understandability

8% of constituents commented favorably on the Boards' inclusion of comparability (including consistency) as a qualitative characteristic; 10% commented unfavorably. Some of those who commented unfavorably noted that it is important to reflect reality, and that the effort to enforce consistency can lead to a lack of faithful representation.

15% of respondents commented favorably on the Boards' inclusion of understandability as a qualitative characteristic; 10% commented unfavorably. Among those who commented unfavorably, some argued that the discussion on understandability must place more emphasis on the need for making financial reports as a whole as clear as possible. Those constituents stated that understandability should require making financial statements understandable for the common user and, accordingly, the Boards should place less emphasis on sophisticated users when assessing understandability.

Sequential Order of Qualitative Characteristics

4% of respondents commented favorably on the sequential order of the qualitative characteristics; 21% commented unfavorably. Notwithstanding a clear statement in the DP that

faithful representation is not secondary to relevance, many respondents noted that the sequential ordering appears to make relevance the most important qualitative characteristic.

Materiality

9% of respondents commented favorably on the Boards' inclusion of materiality as a constraint on financial reporting; 16% commented unfavorably. Of those who commented unfavorably, some argued that materiality should be a qualitative characteristic rather than a constraint.

PLANS FOR REDELIBERATIONS

The staff plans to address Chapter 2 and matters outside the scope of the DP at the April 2007 meetings. Redeliberations for Chapter 1 will commence at the Boards' June 2007 meetings. Other issues raised by constituents not specifically dealt with in Chapters 1 and 2 (that is, the authoritative status of the framework), will be discussed at the Boards' joint meeting in April 2007.

The staff recommends the Boards agree not to hold a roundtable to discuss issues related to stewardship. Rather, the staff recommends the Boards consider other forms of meetings to discuss the stewardship issue.



**Business Combinations: Applying the Acquisition Method
Board Meeting Handout**

February 28, 2007

OVERVIEW

The purpose of this Board meeting is to discuss the following topics as a part of the redeliberations of the FASB’s June 2005 Exposure Draft, *Business Combinations*:

- Topic 1:** Accounting for contingencies in a business combination
- Topic 2:** Assets acquired in a business combination that are subject to an operating lease to which the acquirer is the lessor
- Topic 3:** Attribution of income or losses and other comprehensive income to controlling and noncontrolling interests
- Topic 4:** Guidance for when multiple arrangements should be accounted for as a single arrangement
- Topic 5:** Transition provisions for the final business combinations and noncontrolling interests Statements

TOPIC 1: ACCOUNTING FOR CONTINGENCIES

Issue 1: Initial measurement and recognition

Following the December 19, 2006 Board meeting, the staff met informally with Board members to discuss their views on the measurement and recognition of contingencies acquired or assumed in a business combination. At this Board meeting, the staff will present the two alternatives for which Board members expressed support.

Alt.	Initial Recognition	Provide Additional Recognition Guidance? (Yes/No)	Measurement
1	Recognize contingencies that meet the definitions of assets or liabilities.	<p>Yes</p> <ul style="list-style-type: none"> • Require recognition of all contractual contingencies. • Require recognition of non-contractual contingencies when it is more likely than not that the contingency meets the element definition. 	<p>Fair value</p> <p>Those who support this alternative believe that guidance is needed in evaluating whether the element definition is met. If it is more likely than not that the element definition is met, then fair value can be reasonably estimated. Therefore, no exception would be allowed on the basis that a contingency could not be reasonably estimated.</p>

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2	Recognize contingencies that meet the definitions of assets or liabilities.	Yes <ul style="list-style-type: none"> • Require recognition of all contractual contingencies. • Require recognition of non-contractual contingencies that can be reasonably estimated. 	Fair value Those who support this alternative believe that non-contractual contingencies that meet the element definition should only be recognized if they can be reasonably estimated. Those who support this alternative would provide guidance similar to FASB Interpretation No. 47, <i>Accounting for Conditional Asset Retirement Obligations</i> , which would limit the instances of non-recognition.
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Alternatives 1 and 2 are similar in the following respects:

- a. Both would require initial recognition of **contractual contingencies at fair value**.
- b. Both would address issues raised by constituent about **element uncertainty** and **measurement reliability**; however, they would address them in slightly different ways.
- c. Both would require all recognized contingencies to be initially measured at **fair value**.

Alternatives 1 and 2, however, would provide different guidance for recognizing non-contractual contingencies.

Alternative 1: Non-Contractual Contingencies

Alternative 1 proposes a recognition threshold of **more likely than not** as the way of addressing **element uncertainty**, that is, whether a contingency meets the asset or liability element definition. Proponents of this alternative believe that the recognition threshold also indirectly addresses the concerns about the reliability of the fair value measurement. That is because the difficulty posed for measuring contingencies is thought to be for those that contain element uncertainty. Thus, they see no need to allow an exception to recognition on the basis that the contingency cannot be reasonably estimated. Proponents of Alternative 1 want to remedy the non-recognition of contingencies that occurs under present practice, which they believe is caused by a view that the Statement 141 and Statement 5 requirement that a contingency must be **reasonably estimable** is a very high hurdle—certainly higher than the Board intends.

Proponents of this view note that the approach is similar to the approach taken for intangible assets—that is, the contractual/legal and separability criteria are recognition criteria developed as a means for addressing concerns about measurement reliability.

Alternative 2: Non-Contractual Contingencies

Proponents of Alternative 2 are primarily concerned with the reliability of fair value measurements of non-contractual contingencies. They believe that many non-contractual contingencies (primarily litigation) cannot be reasonably estimated even if it is **more likely than not** that those contingencies meet the elements definition. They would, therefore, include **fair value can be reasonably estimated** as a threshold for recognition. Like proponents of Alternative 1, they believe that many of the difficulties in measuring contingencies are those for which there is element uncertainty. Therefore, the **reasonable estimation** criterion would indirectly address constituents' concerns about element uncertainty. Proponents of this alternative would allow delayed recognition of a non-contractual contingency if the acquirer cannot reasonably estimate it at the acquisition date (presumably, if the fair value can be estimated during the measurement period, it would be recognized through an adjustment to goodwill and, possibly, recasting of prior-period financial statements). Contingencies initially recognized after the measurement period would result in a corresponding charge to income.

Proponents of Alternative 2 share the concerns expressed by those who support Alternative 1. That is, they are concerned about the non-recognition of contingencies in present practice. Rather than remove the reasonable estimation criterion, however, Alternative 2 would address that issue by providing guidance similar to Interpretation 47.

Question 1a: Does the Board prefer Alternative 1 or Alternative 2?

Issue 2: Subsequent Accounting for Contingencies

The majority of Board members seemed to support recognizing **changes in the fair value of contingencies in income** (except for measurement period adjustments) rather than in goodwill or other comprehensive income.

The majority of Board members preferred that, after the acquisition date, contingencies be accounted for in accordance with any other applicable GAAP (for example, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, or No. 142, *Goodwill and Other Intangible Assets*, and so on) unless the other applicable GAAP would be FASB Statement No. 5, *Accounting for Contingencies*. If the other applicable GAAP would be Statement 5, then those contingencies would be measured at **fair value at each reporting period**. For those contingencies that would otherwise be subject to Statement 5, there seemed to be little support for creating a measurement basis other than fair value.

One Board member previously suggested that the acquirer should report the following for reporting periods after the acquisition until the contingency is settled:

- a. For liabilities—the higher of the acquisition date fair value of the contingency or the best estimate.
- b. For assets—the lower of the acquisition date fair value of the contingency or the best estimate.

That suggestion was made on the basis of cost-benefit. It would eliminate subsequent fair value measurements that are difficult to make for recognized contingencies that result from a business combination. However, that approach might result in a liability being reported at more than its fair value or an asset being reported at lower than its fair value.

Question 1b: Does the Board wish to affirm that an acquirer should recognize changes in the fair value of a contingency in income rather than as adjustments to goodwill or in other comprehensive income?

Question 1c: Does the Board wish to affirm that for contingencies that would otherwise be subject to Statement 5, an acquirer should measure those contingencies at fair value at each reporting period after the acquisition date?

Issue 3: Contingency Disclosures

At the February 21, 2007 education session, a few Board members suggested modifying the disclosures that were proposed by the staff. One Board member suggested eliminating the proposal in the business combinations Exposure Draft to present a detailed rollforward of

contingencies and simply requiring disclosure of any significant changes in the amount recognized.

For contingencies acquired or assumed in the business combination that meet the definition of an asset or a liability (recognized or unrecognized), the acquirer shall disclose the nature of the contingency, the amount recognized as of the acquisition date, if any, and an estimate of the range of **reasonably possible** outcomes (undiscounted) or a statement that an estimate of the range cannot be made.

In periods after the business combination, the acquirer shall disclose changes in the amounts recognized for the contingencies acquired or assumed in the business combination and the reasons for the changes.

If the Board affirms that contingencies should be subsequently measured at fair value, the disclosure in paragraph 32 of FASB Statement No.157, *Fair Value Measurements*, would apply to those contingencies measured using Level 3 inputs. For assets and liabilities measured at fair value on a recurring basis, paragraph 32 requires disclosure of the level in the hierarchy in which the fair value measurement falls, a reconciliation of those contingencies measured using significant unobservable inputs (Level 3), and annual disclosure of valuation techniques. If the Board chooses to require that contingencies that would otherwise be in the scope of Statement 5 be subsequently measured at something other than fair value, the disclosure in paragraph 32 of Statement 157 would not apply.

What If Disclosure of a Litigation Contingency Impairs an Entity's Ability to Settle or Litigate?

A few respondents to the business combinations Exposure Draft were concerned that recognizing litigation contingencies at fair value would give the other party information about the acquirer's assessment of the case and could compromise the acquirer's ability to settle or litigate. Paragraph 71 of the IASB's IAS 37 Exposure Draft was carried forward from IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and affirmed by the IASB in July 2006. That paragraph would allow an entity to avoid disclosure of information (but not avoid recognition of the liability) if disclosure would adversely affect its ability to settle or litigate a legal claim. It states:

In extremely rare cases, disclosure of some or all of the information required by paragraphs 68 and 69 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the non-financial liability. In such cases, an entity need not disclose the

information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Therefore, the entity cannot avoid **recognizing** the liability in the financial statements, but it could avoid **disclosing** sensitive information about it. If the Board shares the respondents' concerns that disclosing information about legal claims could harm the entity, a similar disclosure exemption would be a way to resolve that concern. Another alternative would be to allow an entity to aggregate contingencies for purposes of disclosure. For example, the Board could allow an entity to aggregate all contingencies that are assets separately from all contingencies that are liabilities. However, the staff believes that would provide users with less information than allowing a specific disclosure exemption for litigation. Another alternative would be to allow an entity to aggregate only litigation liabilities together.

The staff seeks the Board's feedback about how to proceed on this issue.

Question 1c: Does the Board agree with the following disclosures:

For contingencies acquired or assumed in the business combination that meet the definition of an asset or a liability (recognized or unrecognized), the acquirer shall disclose the nature of the contingency, the amount recognized as of the acquisition date, if any, and an estimate of the range of reasonably possible outcomes (undiscounted) or a statement that an estimate of the range cannot be made.

In periods after the business combination, the acquirer shall disclose changes in the amounts recognized for the contingencies acquired or assumed in the business combination and the reasons for the changes.

Question 1d: Does the Board wish to allow a disclosure exemption that would allow an entity to avoid disclosing information that would adversely affect its ability to settle or litigate a legal claim?

TOPIC 2: ASSETS ACQUIRED IN A BUSINESS COMBINATION THAT ARE SUBJECT TO AN OPERATING LEASE TO WHICH THE ACQUIREE IS THE LESSOR

In May 2006, the Board discussed issues related to operating leases acquired or assumed in a business combination. The Board asked the staff to further consider the accounting for an operating lease in which the acquiree is the lessor. Specifically, the question was raised about whether the terms of an operating lease affect the fair value of the related asset. If so, any favorable or unfavorable terms of the operating lease relative to market terms at the acquisition date would be reflected in the fair value of the asset. If not, a separate asset or liability would be recognized for the fair value of the above or below market terms, respectively. The staff considered the following alternatives:

- a. **Alternative 1:** Reaffirm the provisions of the business combinations Exposure Draft and require the acquirer to measure and recognize an asset subject to an operating lease at its acquisition date fair value without considering the terms of the operating lease. That is, the acquirer would account for the above or below market value of the lease separately as an intangible asset (liability) if the terms of the operating lease are favorable (unfavorable) relative to market terms.
- b. **Alternative 2:** Require the acquirer to measure and recognize the asset subject to an operating lease at its acquisition date fair value considering the nature, location, or condition of the asset and the contractual terms of the leases and other contracts relating to the asset. Under Alternative 2, the fair value of an acquired asset that is subject to an operating lease reflects the favorable or unfavorable terms of the operating lease and a separate asset or liability is not recognized.

Analysis of Alternative 1

Alternative 1 is consistent with the guidance in Statement 141 and with the proposals of the business combinations Exposure Draft. Alternative 1 accounts for the favorable or unfavorable portion of an operating lease acquired or assumed in a business combination consistently, regardless of whether the acquiree is a lessor or a lessee. Under Alternative 1, the intangible asset (liability) for the favorable (unfavorable) terms of the operating lease would presumably be released into income over the remaining lease term. Proponents of Alternative 1 argue that if the favorable or unfavorable terms were reflected in the fair value of the asset (as they would be under Alternative 2), they would be released into income as the asset was depreciated over its remaining useful life. That period might differ significantly

from the remaining lease term. As such, proponents argue that Alternative 1 better reflects economic reality. Proponents of Alternative 1 also believe that separate recognition of the favorable or unfavorable portion of the operating lease provides better information to users of the financial reports.

Analysis of Alternative 2

Proponents of Alternative 2 argue that because the current lease model under FASB Statement No. 13, *Accounting for Leases*, does not record operating leases on the balance sheet, the fair value of the underlying asset is affected. In other words, they argue that the provisions of Statement 13 establish the level of aggregation for accounting purposes and, because the leases are not separately recorded on the balance sheet, the favorable or unfavorable nature of the leases in force affects the value of the asset in the same way as it would affect any other restriction or enhancement.

Furthermore, proponents of Alternative 2 argue that the cash flows a market participant can generate from an asset are affected by the terms of the operating leases in force. They argue that market participants would consider the terms of leases when pricing the asset just as they would consider any other contractual enhancements or restrictions attached to the asset. This is analogous to contractual restrictions that relate to an asset, which, under paragraph 6 of Statement 157, would affect the fair value of the asset.

Question 2: If the acquiree is a lessor to an operating lease, how should the acquirer account for any favorable or unfavorable (off-market) portion of the operating lease (as a separate intangible asset or liability or as part of the fair value of the related asset)?

TOPIC 3: ATTRIBUTION OF INCOME OR LOSSES AND OTHER COMPREHENSIVE INCOME TO CONTROLLING AND NONCONTROLLING INTERESTS

Issue 1: Attribution of Income or Losses and Other Comprehensive Income

The FASB's June 2005 Exposure Draft, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*, contains guidance on the attribution of income or losses and other comprehensive income to the controlling and noncontrolling interests. Paragraph 21 of that Exposure Draft states:

Net income or loss and each component of other comprehensive income shall be attributed to the controlling and noncontrolling interests. That attribution shall be based on relative ownership interests unless the controlling and noncontrolling interests have entered into a contractual arrangement that requires net income or loss or the components of other comprehensive income to be attributed differently between them. In that case, net income or loss and the components of other comprehensive income shall be attributed to the controlling and noncontrolling interests based on the contractual requirements of that arrangement. [Footnote references omitted.]

Constituents' views on the proposal in the noncontrolling interests Exposure Draft were mixed. Most constituents who agreed with the proposal did not provide a rationale for their opinion. Constituents who disagreed with the proposal made the following comments:

- a. **The proposed attribution requirement adds unnecessary complexity to the financial statements and will create confusion.** The staff disagrees that the proposed attribution adds complexity to the financial statements. Entities are already required to attribute income and losses and other comprehensive income to the controlling and noncontrolling interests (even though the noncontrolling interest's share is recognized as an expense under U.S. GAAP). As such, the proposal does not add complexity; it clarifies what is already required. In addition, providing guidance on how to do that attribution should decrease confusion rather than increase it.
- b. **Any attribution to controlling and noncontrolling interests is subjective in nature (even if it appears objective as a quantitative calculation) and is not a faithful representation of economic activity and ownership characteristics of the equity of the entity.** The staff disagrees that the attribution is subjective. It is based on ownership interests or the terms of a contract. The guidance should clarify the attribution and make it less subjective.
- c. **The statement of comprehensive income is already too confusing and the requirements of the noncontrolling interests Exposure Draft would add to that confusion.** FASB Statement No. 130, *Reporting Comprehensive Income*, already

requires that other comprehensive income be attributed between the controlling and noncontrolling interests. The proposed guidance should clarify what is already required.

Question 3a: Does the Board wish to affirm the guidance proposed in the noncontrolling interest Exposure Draft that net income or loss and each component of other comprehensive income should be attributed to the controlling and noncontrolling interests?

Issue 2: Attribution of Losses in Excess of Noncontrolling Interest's Equity

Paragraph 22 of the noncontrolling interests Exposure Draft states:

Losses applicable to the controlling and noncontrolling interests in a consolidated subsidiary may exceed their interests in the subsidiary's equity. The excess, and any further losses attributable to the controlling and noncontrolling interests shall be attributed to those interests.

Paragraphs B17 and B18 of noncontrolling interests Exposure Draft summarize the Board's basis for conclusions as follows:

In this Statement, the Board reconsidered whether losses of a partially owned subsidiary in excess of the noncontrolling interests' equity capital should be attributed to noncontrolling interests. ARB 51 required that:

In the unusual case in which losses applicable to the minority interest in a subsidiary exceed the minority interest in the equity capital of the subsidiary, such excess and any further losses applicable to the minority interest should be charged against the majority interest, as there is no obligation of the minority interest to make good such losses. [paragraph 15]

The Board concluded that that requirement was based on the view that the noncontrolling interest lacks characteristics of equity. While it is true that noncontrolling interests have no further obligation to contribute assets to the subsidiary, the parent has no further obligation either. Noncontrolling interests participate proportionately in the risks and rewards of an investment in the subsidiary. If a noncontrolling interest holder enters into an arrangement that obligates itself to the subsidiary, the Board believes that that arrangement should be accounted for separately and that arrangement should not affect the way losses are attributed to the controlling and noncontrolling interests. Thus, the Board concluded that losses applicable to noncontrolling interests should be attributed to them, even if doing so would result in a deficit noncontrolling interest.

Respondents raised two general concerns with respect to the proposed guidance. One is that there might be different levels of responsibility between the controlling and noncontrolling interests for satisfying an equity deficit. Second, the proposals do not appear to take into consideration any explicit or implicit guarantees or similar arrangements such as an arrangement that requires the parent to provide additional funding to the subsidiary in the event of subsidiary losses.

While a noncontrolling interest is not legally required to contribute additional capital to a subsidiary to satisfy its losses, some still find the attribution of losses to the noncontrolling interests in excess of its equity troublesome. This issue is broader than negative noncontrolling interests. The liabilities of a subsidiary are not liabilities of the entire group. There are often factors that restrict the ability of a parent to move assets from one part of a group to another, which means that the assets of the group are not necessarily freely available to the parent. The staff believes that it is appropriate to continue to allocate losses to noncontrolling interests even if the noncontrolling interests are in deficit. All of the subsidiary's shareholders, including the noncontrolling interests, will share in that recovery if the affected subsidiary becomes profitable again.

Question 3b: Does the Board wish to affirm the guidance in the noncontrolling interests Exposure Draft requiring that losses in excess of the noncontrolling interest in a subsidiary's equity should continue to be allocated to that noncontrolling interest?

TOPIC 4: MULTIPLE ARRANGEMENTS THAT SHOULD BE ACCOUNTED FOR AS A SINGLE ARRANGEMENT

The noncontrolling interests Exposure Draft proposes that if control of a subsidiary is lost, any resulting gain or loss should be recognized in income or loss. The gain or loss is measured as the difference between (a) the aggregate of the fair value of the proceeds from the transaction or event that resulted in the loss of control and the fair value of any investment remaining in the former subsidiary at the date control is lost and (b) the aggregate of the parent's interest in the carrying amount in the consolidated statements of the former subsidiary's net assets immediately before control is lost. In contrast, changes in ownership interest of a subsidiary after control is obtained that do not result in a loss of control are

accounted for as transactions between equity holders in their capacity as equity holders (that is, no gain or loss is recognized in earnings).

During initial deliberations, the Board expressed concerns that the proposals could provide opportunities to structure transactions to achieve a particular accounting outcome. Therefore, the Board decided to incorporate guidance about when multiple arrangements should be accounted for as a single arrangement. Some respondents expressed concerns about implementation of the requirement.

- a. **The noncontrolling interests Exposure Draft is not the right place to address the issue of linkage transactions.** Some constituents stated that the Board should consider the issue of linkage transactions more broadly rather than only in respect to the loss of control over a subsidiary. The staff agrees with constituents that it would be better if the Board developed broad principles for linkage transactions that applied in various situations rather than just for the loss of control over a subsidiary. However, it is unlikely that the Board will issue such guidance before the final noncontrolling interests Statement is issued. Hence, the staff believes that it is better to provide limited guidance in the final noncontrolling interests Statement rather than providing none at all.
- b. **The noncontrolling interests Exposure Draft should provide more principle-based guidance on multiple arrangements.** Some constituents stated that the proposed guidance on multiple arrangements should be less strict and more principle-based. The staff agrees with those constituents who stated that the guidance in the noncontrolling interests Exposure Draft seemed overly strict and not principles-based (more like a rule than an indicator). Thus, the staff proposes modifying the guidance to clarify that it provides indicators rather than requirements.
- c. **The noncontrolling interests Exposure Draft should provide examples rather than indicators.** Some constituents suggested that the Statement should include examples rather than indicators, but that those examples should not be considered a closed list. The staff believes that the Board chose to provide indicators rather than examples to provide principle-based guidance on when multiple arrangements should be accounted for as a single transaction or arrangement. The staff believes that providing indicators is preferable to providing what could be an endless list of examples to try to capture every possible structuring arrangement.

Staff Recommendation:

The staff proposes that the multiple arrangement guidance be clarified as follows:

A parent may lose control of a subsidiary in two or more arrangements (transactions). In some cases, circumstances indicate that the multiple arrangements are part of a single arrangement. In determining whether to account for the arrangements as a single

arrangement, an entity shall consider all of the terms and conditions of the arrangements and their economic effects. One or more of the following may indicate that the multiple arrangements ~~should~~ be accounted for as a single arrangement:

- (a) They are entered into at the same time.
- (b) They are entered into in contemplation of one another.
- (c) They form a single arrangement designed to achieve an overall commercial effect.
- (d) The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- (e) One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

Question 4: Does the Board wish to clarify the guidance for multiple arrangements as the staff proposes?

TOPIC 5: TRANSITION FOR THE BUSINESS COMBINATIONS AND NONCONTROLLING INTEREST STATEMENTS

Issue 1: Proposed Transition Requirements—Business Combinations

The staff will ask the Board to affirm the following transition provisions that were proposed in the business combinations Exposure Draft:

- a. The final business combinations Statement should be applied **prospectively** to business combinations whose acquisition date is on or after the date that the business combinations Statement is applied.
- b. Retrospective application of the business combinations Statement to acquisitions completed before the new business combinations Statement is applied should be precluded.
- c. The final business combinations Statement should be applied at the same time the final noncontrolling interests Statement is applied.
- d. Assuming the Board affirms that the noncontrolling interests Statement must be applied at the beginning of an annual period, that the business combinations Statement be applied at the beginning of the same annual period.

The staff continues to believe that it would be costly and likely impossible for entities to comply with retrospective application of the business combinations Statement to acquisitions completed before the business combinations Statement is issued. The assets and liabilities related to a business combination unwind and change after the acquisition date. To require a business combination to be recast would be difficult if not impossible. In addition, the staff recommends against **allowing** retrospective application of the business combinations Statement. If the Board allowed retrospective application to those combinations that an entity was able to recast, an entity might choose to recast only if recasting resulted in preferable accounting treatment. Allowing retrospective application also would impair comparability. In addition, users stated that they prefer a single transition method. Therefore, the staff believes that all business combinations accounted for under predecessor standards should not be changed.

Assuming the Board affirms that the noncontrolling interests Statement must be applied at the beginning of an annual period, the staff believes that the business combinations Statement should also be applied at the beginning of the same annual period. That is because they are complementary standards—it is not practical to apply one without the other since the business combinations Statement provides guidance on acquisitions, including partial acquisitions, and the noncontrolling interests Statement provides guidance on accounting and reporting noncontrolling interests, including changes in those interests, after the acquisition date.

Question 5a: Does the Board wish to affirm:

- a. ***That the final business combinations Statement should be applied prospectively to business combinations for which the acquisition date is on or after the date that the Statement is applied***
- b. ***To prohibit retrospective application of the business combinations Statement to acquisitions completed before the business combinations Statement is applied***
- c. ***That the final business combinations Statement must be applied at the same time the final noncontrolling interests Statement is applied***
- d. ***Assuming the Board affirms that the noncontrolling interests Statement must be applied at the beginning of an annual period, that the business combinations Statement should be applied at the beginning of the same annual period?***

Issue 2: Proposed Transition Requirements—Noncontrolling Interests

In the noncontrolling interests Exposure Draft, the Board proposed that an entity apply the presentation and disclosure requirements retrospectively. As such, an entity would recast any prior periods presented in its financial statements as if the presentation and disclosure requirements had been in effect for all periods presented. The objective of recasting prior-period financial statements is to improve the comparability of financial information. However, the Board decided that two of the noncontrolling interests proposals could not be applied retrospectively to transactions that occurred before the provisions of the new noncontrolling interests Statement are applied due to practicability and cost-benefit concerns. Therefore, the Board decided that those transactions should not be recast.

Recast Prior-Period Financial Statements (Retrospective Application)

The Board agreed that the following noncontrolling interests Statement proposals should be retrospectively applied and that prior-period financial statements should be recast to improve comparability and because they met the cost-benefit test (that is, it is not overly costly or difficult to recast these proposals):

- a. An entity would reclassify noncontrolling interests to equity from the liability or mezzanine section and present separately from the parent's shareholders' equity (paragraph 33(a)).
- b. An entity would recast consolidated net income so that consolidated net income attributable to **the noncontrolling interest** would be included in the amount reported for consolidated net income (paragraph 33(b)).
- c. An entity would reattribute consolidated net income and consolidated other comprehensive income in accordance with the requirements of the noncontrolling interests Statement. (The primary change would be that losses in excess of the noncontrolling interests balance would be attributed to the noncontrolling interests rather than attributed to the controlling interest) (paragraphs 33(c) and 33(d)).
- d. An entity would disclose the information required by the noncontrolling interests Statement for all periods presented (paragraphs 33(f) and 33(g)).
- e. An entity would reclassify any gains or losses that were recognized in income for decreases or dispositions of noncontrolling interests from income (retained earnings) to equity (paragraphs 33(e)).

Do Not Recast Prior-Period Financial Statements

The Board agreed that the following proposals should **not** be retrospectively applied and that prior period financial statements should **not** be recast because they do not meet the cost-benefit test (that is, it is costly or difficult to recast these proposals) or because recasting would require the use of hindsight to remeasure previously recognized amounts:

- f. An entity would not change the amounts recorded if the entity increased or acquired noncontrolling interests in a subsidiary before the noncontrolling interests Statement is applied (paragraph 34(a)). **(Those transactions were accounted for by the partial purchase method under U.S. GAAP so it would be impracticable to restate those transactions, which is the same reasoning the Board used to decide that the business combinations Statement should be applied prospectively.)**
- g. An entity would not change the amounts recorded in income if control of a subsidiary was lost before the noncontrolling interests Statement is applied. Therefore, the gain or loss recognized in income before the noncontrolling interests Statement is applied would not be recast to remeasure any retained noncontrolling interests in the former subsidiary to fair value (that is, in measuring the gain or loss, any retained noncontrolling interests would be measured at carrying value rather than fair value as proposed in the noncontrolling interests Exposure Draft) (paragraph 34(b)). **(The Board did not want entities to use hindsight in remeasuring any retained noncontrolling interest to fair value.)**
- h. If an entity has a partially owned subsidiary when the noncontrolling interests Statement is applied, the assets and liabilities of the partially owned subsidiary would not change upon application of the noncontrolling interests Statement. The entity would account for any subsequent acquisitions or dispositions of noncontrolling interests using the guidance in the noncontrolling interests Statement (that is, those transactions would be accounted for as equity transactions) (paragraph 34(a)). **(This is the result of the combination of the prospective business combinations transition proposals and the new guidance for accounting for acquisitions of noncontrolling interests in the noncontrolling interest Statement.)**

Comment Letter Responses

Few respondents addressed transition in their comment letters. Those that did generally agreed with the transition proposals. Some respondents disagreed or expressed concern about some of the transition proposals, which are addressed below.

Staff Analysis

Retrospective Application Is Impractical or Too Difficult (Proposals a–d)

Some respondents to the noncontrolling interests Exposure Draft disagreed that an entity should recast prior-period financial statements for the presentation and disclosure provisions because they believe it would be impracticable or too difficult to do so, particularly for entities with a substantial number of partially owned subsidiaries at the date of transition.

During initial deliberations, the Board considered the merits of a variety of transition alternatives. As noted in the basis for conclusions in the noncontrolling interests Exposure Draft, the Board believes that retrospective application is generally preferred to improve the comparability of financial information. The staff continues to believe that recasting prior-period financial statements for the presentation and disclosure provisions is not overly burdensome and that the benefits of comparability outweigh the costs. The proposed requirements do not require any new computations or measurements. They simply require reclassification of previously measured amounts within the basic financial statements.

Question 5b: Does the Board wish to affirm the guidance in the noncontrolling interests Exposure Draft and require an entity to:

- a. ***Reclassify noncontrolling interests to equity from the liability or mezzanine section and present separately from the parent’s shareholders’ equity?***
- b. ***Recast consolidated net income so that consolidated net income attributable to the noncontrolling interest would be included in the amount reported for consolidated net income?***
- c. ***Reattribute consolidated net income and consolidated other comprehensive income in accordance with the requirements of the noncontrolling interests Statement?.***
- d. ***Disclose the information required by the noncontrolling interests Statement for all periods presented?***

Should Dispositions (Decreases) of Noncontrolling Ownership Interests That Occur before the Noncontrolling Interests Statement Is Applied Be Recast (Proposal e)

A few respondents to the noncontrolling interests Exposure Draft suggested that retrospective application not be required for either decreases or increases in ownership interests. That

change would mean that the transition provisions are the same for all changes in ownership interests without a loss of control.

A decrease in a parent's controlling ownership interest (sale of an equity interest in the subsidiary) would be reported as an equity transaction under the noncontrolling interests Exposure Draft. Applying that proposal retrospectively to prior periods would require a relatively simple reclassification from retained earnings to additional paid-in capital. Therefore, requiring an entity to recast its financial statements for decreases in a parent's controlling ownership would not be too difficult or costly.

The acquisition of a noncontrolling interest would also be reported as an equity transaction under the proposal. In contrast, Statement 141 requires acquisitions of noncontrolling interests to be accounted for using the purchase method, which results in the recognition of an additional purchase layer of net identifiable assets and goodwill each time noncontrolling interests are acquired. Retrospective application of the noncontrolling interests Exposure Draft to those transactions would entail an unwinding of those prior step acquisitions, and the information needed might not be readily available at a reasonable cost. Therefore, the Board proposed in the noncontrolling interests Exposure Draft not to change the accounting for increases in a parent's controlling ownership interest in a subsidiary recognized in a prior period.

The staff believes the Board has the following alternatives to consider for transition related to increases and decreases in ownership interests:

- a. **Alternative A:** Affirm the proposed transition requirements in the noncontrolling interests Exposure Draft and require that an entity (1) **recast** prior-period financial statements for **decreases** in a parent's controlling interest that do not result in a loss of control that occurred before the new noncontrolling interests Statement is applied and (2) **not recast** prior-period financial statements for **increases** in a parent's controlling interest that do not result in a loss of control that occurred before the new noncontrolling interests Statement is applied.
- b. **Alternative B: Preclude an entity from recasting** prior period financial statements for **both increases and decreases** in a parent's controlling interest that do not result in a loss of control that occurred before the new noncontrolling interests Statement is applied.

Question 5c: Does the Board prefer Alternative A or Alternative B?

Issue 3: Issues Related to Subsequent Increases of Noncontrolling Interests after the New Noncontrolling Interests Statement Is Applied (Proposal h)

Upon adoption of the final noncontrolling interests Statement, the balance of any noncontrolling interest in subsidiaries that were classified as liabilities or in a mezzanine section would be reclassified to equity. The reported amount of that noncontrolling interest would not be remeasured. Some respondents expressed concern about that provision in light of the requirement to subsequently account for an acquisition of those interests as equity transactions. They believe that requirement might lead to an artificial reduction in the controlling interest's shareholders' equity (assuming the value of the noncontrolling shares has increased). This concern is magnified for partially owned subsidiaries acquired before the new business combinations Statement is applied because the requirements (such as full goodwill) in the business combinations Exposure Draft would be applied on a prospective basis and, thus, would not be required for partial acquisitions that occurred before the adoption of the final Statements. The Board was aware of this issue and carefully considered several alternatives before the business combinations and noncontrolling interests Exposure Drafts were issued. The following table provides the transition alternatives that have previously been considered by the Board:

Transition Alternative	Description of Alternative	Analysis
<p>Continue to allow the partial purchase method for subsidiaries that are partially owned at the date the business combinations and noncontrolling Statements are applied.</p>	<p>For subsidiaries that are partially owned at the date the business combinations and noncontrolling Statements are applied, allow the entity to account for additional acquisitions of noncontrolling interests as step acquisitions. Note: The partial purchase method is currently required in Statement 141 and was required under APB Opinion No. 16, <i>Business Combinations</i>.</p>	<p>The Board did not believe this was a practical transition alternative because it would:</p> <ul style="list-style-type: none"> • Add complexity to the business combination Statement by carrying forward guidance for applying the partial purchase method, which would apply to a small number of entities (that is, the guidance would only apply to entities with partially owned subsidiaries before the application of the Statements that subsequently acquire additional noncontrolling interests). • Result in another blended measure for assets and liabilities (that is, part fair value when control is obtained and part fair value when additional noncontrolling interests are acquired). • Result in divergence between the IASB and FASB because the partial purchase method is not required in accordance with IFRS 3, <i>Business Combinations</i>. (Note: The partial purchase method was required for business combinations accounted for in accordance with IAS 22, <i>Business Combinations</i>).
<p>Apply the requirements of the business combinations Statement retrospectively for subsidiaries that are partially owned when the business combinations and noncontrolling interests Statements are applied.</p>	<p>For subsidiaries that are partially owned at the date the business combinations and noncontrolling interests Statements are applied, retrospectively apply the requirements of the business combinations Statement to the partially owned subsidiaries on the date of application.</p>	<p>The Board rejected this alternative for the same reason they rejected retrospective application for the final business combinations Statement:</p> <ul style="list-style-type: none"> • In many circumstances, it might be impossible to retrospectively apply the requirements of the business combinations Statement to combinations completed before that Statement is applied. For example, for combinations that occurred many years ago, it would be difficult to determine the values of the acquiree's assets and liabilities. In addition, the information needed to restate prior financial statements might no longer exist. • Hindsight in measuring fair values would provide an incentive for an entity to restate its financial statements to benefit the entity, which would decrease the quality of financial reporting.

Transition Alternative	Description of Alternative	Analysis
<p>Apply the measurement requirements of the business combinations Statement to the assets and liabilities of partially owned subsidiaries on the date the business combinations and noncontrolling interests Statements are applied.</p>	<p>For subsidiaries that are partially owned at the date the business combinations and noncontrolling interests Statements are applied, apply the measurement requirements of the business combinations Statement to the assets and liabilities of those partially owned subsidiaries. That is, restate the assets and liabilities of the partially owned subsidiaries to fair value as of the date the business combinations Statement is applied.</p>	<p>The Board rejected this transition alternative because it would be costly to apply and it would allow particular entities (those with partially owned subsidiaries) to remeasure particular assets and liabilities (only those of the partially owned subsidiary) while other entities would not be afforded the same option.</p>
<p>Restate any noncontrolling interests in partially owned subsidiaries to fair value on the date the business combinations and noncontrolling interests Statements are applied.</p>	<p>For subsidiaries that are partially owned at the date the business combinations and noncontrolling interests Statements are applied, remeasure the noncontrolling interests to fair value and recognize the adjustment as a gain or loss.</p>	<p>This would be an easier alternative that would reduce the problem without requiring a revaluation of every asset and liability when the new Statements are applied.</p> <p>However, this alternative would result in some odd reporting because the entity would not revalue the controlling interest's equity, it would not affect the value of the underlying assets and liabilities of the partially owned subsidiary, and in many cases, the entity would need to measure the entire subsidiary to measure the fair value of the noncontrolling interests. Therefore, it seems like the previous alternative (revalue the assets, liabilities, and noncontrolling interests of the partially owned subsidiary upon adoption of the new Statements) would be a more faithful representation than this alternative.</p> <p>This alternative might mitigate the problem, but this issue is not just a transition issue. It will arise any time an entity acquires noncontrolling shares that have appreciated since the acquisition date (although the full goodwill proposal and more fair value measurements will decrease the problem).</p>

The staff notes that the concern expressed by some respondents about artificial reductions in equity when noncontrolling interests are subsequently acquired is not just a transition issue. The phenomenon occurs because the amount paid to subsequently acquire the noncontrolling interest is presumably its fair value, yet the carrying value of that acquired noncontrolling interest is measured using an historical cost accounting model. Thus, the difference between the fair value of the acquired interest and its historical cost carrying amount will often result in a charge or debit to equity. The difference between the fair value and carrying amount of acquired noncontrolling interest might be greater for those partially owned subsidiaries acquired before application of the new business combinations and noncontrolling interests Statements (in part because the business combinations Statement records noncontrolling interests at fair value). Such differences can also exist for noncontrolling interests arising after the new business combinations and noncontrolling interests Statements are applied (because the historical cost accounting model causes the carrying value of the noncontrolling interest and its fair value to diverge over time).

The following factors will mitigate the effect on equity when additional noncontrolling interests are acquired:

- a. Recognizing the fair value of assets and liabilities in a partial acquisition (as required by IFRS 3 and as will be required by the new business combinations Statement) and recognizing the fair value of the noncontrolling interest (or the full goodwill method).
- b. More fair value measurements in the partially owned subsidiary's financial statements after the acquisition date. As more assets and liabilities are measured at fair value, the closer the recorded amount for the noncontrolling interest will move toward fair value. As a result, the difference between the recorded amount for the noncontrolling interests and the proceeds from an acquisition or disposition of noncontrolling shares will be smaller.

Question 5d: Does the Board agree that the assets, liabilities, and noncontrolling interests of partially owned subsidiaries should not be changed upon application of the noncontrolling interests Statement?