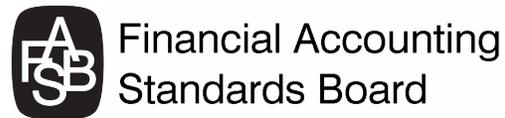


MINUTES



To: Board Members

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

Subject: Minutes of the December 19, 2006 Board Meeting **Date:** January 10, 2007

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

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

Topics: Valuation Allowances, Combinations between Mutual Entities, Accounting for Business Combinations Achieved By Contract Alone or In the Absence of a Transaction Involving the Acquirer, Accounting for Contingences in a Business Combination

Basis for Discussion: Board Memorandums No. 33–36

Length of Discussion: 9:00 to 11:30 a.m.

Attendance:

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

Staff in charge of topic: Roberge, Tamulis, and Vessels

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

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

Summary of Decisions Reached:

The Board continued redeliberations of its June 2005 Exposure Draft, *Business Combinations*, and discussed (a) valuation allowances, (b) combinations between mutual entities, (c) accounting for business combinations achieved by contract alone or in the absence of a transaction involving the acquirer, and (d) accounting for contingences in a business combination. The Board made the following decisions:

1. Receivables, including loan and finance leases, should be recognized and measured at fair value as of the date of acquisition and that recognition of a separate valuation allowance should not be permitted. The Board directed the staff to evaluate the types of disclosures that should be made, if any, relating to the credit quality of acquired receivables.
2. A combination between mutual entities should be in the scope of the final Statement on business combinations and, therefore, accounted for using the acquisition method. The Board agreed that the definition of a mutual entity in the Exposure Draft and the final Statement includes cooperative entities.
3. The acquisition method should be applied to a business combination achieved in the absence of a transaction involving the acquirer and to a business combination achieved by contract alone.
4. The final Statement should clarify that a contingency that is an intangible asset would need to meet the intangible asset recognition criteria to be recognized separately from goodwill (contractual or separable) and that it should be subsequently accounted for under FASB Statement No.142, *Goodwill and Other Intangible Assets*.

The Board discussed the proposal that all contingencies be recognized in a business combination and initially measured at fair value but did not reach any conclusions. Rather, the Board requested that the staff consider alternative approaches to the recognition and measurement of contingencies for discussion at a future meeting.

Objectives of Meeting:

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

1. Measurement and recognition of receivables acquired in a business combination
2. Whether combinations by mutual entities should be in the scope of the final Statement
3. Whether business combinations achieved by contract alone or in the absence of a transaction involving the acquirer should be in the scope of the final Statement

4. Initial and subsequent measurement and recognition of contingent assets and liabilities acquired in a business combination.

The objective was met for items 1–3. The Board will consider alternative approaches to the recognition and measurement of contingencies at a future meeting

Matters Discussed and Decisions Reached:

TOPIC 1: VALUATION ALLOWANCES

1. Mr. Roberge stated that the staff would ask Board members to consider the guidance in the Exposure Draft for recognizing and measuring receivables at fair value with no separate valuation allowance. Current guidance in FASB Statement No. 141, *Business Combinations*, and IFRS 3, *Business Combinations*, requires receivables to be measured at the present values of amounts to be received determined at appropriate current interest rates, less an allowance for losses, if necessary.

2. Mr. Roberge noted that 11 responses were received on this issue. Three were received from Big 4 firms who concurred with the guidance in the proposed Statement. One was received from a user who suggested that disclosures be enhanced to clearly provide the credit related discount considered in the valuation of the receivables. The remaining respondents were U.S. preparers. Those preparers did not agree with the proposed guidance and cited practical concerns such as insufficient loan systems, keeping two sets of books, spreadsheet accounting, and difficulty in applying AICPA Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. Additionally, some believe that Statement 141 and/or SEC Staff Accounting Bulletin Topic 2.A.5 (SAB 61), *Adjustments to Allowances for Loan Losses in Connection with Business Combination*, provide sufficient guidance and should be retained. They take note of the current consistency of reporting key metrics, such as the coverage ratio, and the lack of guidance on the accounting subsequent to the acquisition date for receivables in the scope of the proposed Statement.

3. Mr. Roberge presented the Board with three alternatives. The first is to retain the requirements in the current proposed Statement. This view is consistent with the Board's

objective to measure assets and liabilities at fair value as of the acquisition date. Under this view, subsequent accounting would be subject to existing guidance.

4. Mr. Roberge noted that some constituents may consider inconsistency and lack of comparability when comparing the guidance in Statement 141 to that in the proposed Statement. The staff believes, however, that inconsistency already exists within Statement 141 as the basis for measuring a receivable acquired is different from that of a receivable that is originated (where no adjustment is made to the face amount). Also, for loans that are in the scope of SOP 03-3, inconsistency exists because a valuation allowance is not allowed.

5. With regard to practical concerns raised in the comment letters, including the need to maintain two sets of books and systems, institutions currently account for certain items that have an effect on the effective yield, such as Statement 91 costs or fees, outside of the subledger. Furthermore, in drafting the Exposure Draft, the Board found no compelling reason to create an exception to fair value for practical reasons.

6. Mr. Roberge stated that a second alternative is to require that receivables be reported at fair value; however, with the exception of loans within the scope of SOP 03-3, the individual components would be recognized. In other words, the entity would record the gross contractual amounts with a separate discount for changes in interest rates and a valuation allowance for cash flows not expected to be received. Under this view the Board's objective of fair value would be met as the net receivable balance would be at fair value. This view, however, requires that an allowance be recognized for cash flows the entity does not expect to receive. This may conflict with current U.S. GAAP and IFRS that require allowances to be measured on an incurred losses basis. Furthermore, the overall consideration for the business already considered expected losses on the receivable, and the acquirer has not assumed any losses as of the date of acquisition. Therefore, it is difficult to provide a conceptual basis for recognizing an allowance. The staff noted that this view effectively creates a new model for accounting for receivables acquired in a transfer, which may reduce or eliminate the need for SOP 03-3.

7. Mr. Roberge stated that a third alternative is to retain the requirements of Statement 141 and IFRS 3. SOP 03-3 would continue to apply to loans within its scope. Many constituents believe that by preserving the requirements of Statement 141, the allowance for losses would be based on a consistent model for both acquired and originated receivables, which would result in consistent and comparable calculations of key metrics. Also, no incremental practical issues would have to be addressed. This view would not meet the Board's objective of recording receivables at fair value. Furthermore, some argue that the allowance for losses on receivables that were acquired at fair value as part of a transfer does seem conceptually correct.

8. The Board decided that receivables, including loan and finance leases, should be recognized and measured at fair value as of the date of acquisition and that recognition of a separate valuation allowance should not be permitted (all Board members agreed). The Board directed the staff to evaluate the types of disclosures that should be made, if any, relating to the credit quality of acquired receivables.

9. Mr. Batavick expressed interest in converging with the IASB in this area, but recognized that it was unclear what accounting treatment the IASB would prescribe. He noted that the accounting for receivables is a complex area and that, while there is merit to each of the views the staff presented, a key provision of the business combinations project is to measure assets and liabilities at fair value.

10. Ms. Seidman agreed and stated that, on balance, she supported measuring receivables at fair value. She noted that users have requested information about the uncollectible receivables and that the Board should address that request through disclosure requirements. Additionally, Ms. Seidman noted that there have been significant practice issues with the accounting for loans held for investment that are impaired and expressed support for the agenda request being developed that will ask the Board to reconsider the current accounting.

11. Mr. Herz stated that he strongly considered the benefits of retaining the current guidance but that, like the staff, he does not believe that true comparability exists under this approach.

TOPIC 2: MUTUAL ENTITIES

12. Ms. Tamulis stated that the Exposure Draft proposes that mutual entities should be included within the scope of the final Statement. Therefore, a combination between mutual entities would be accounted for using the acquisition method, and an acquirer would need to be identified in every acquisition. The Exposure Draft also proposes that if the only consideration exchanged is the member interests of the acquiree for the member interests of the acquirer, the amount equal to the fair value of the acquiree should be recognized as a direct addition to capital or equity and not retained earnings.

13. Ms. Tamulis noted that respondents raised concerns that in a combination between mutual entities:

- a. Identifying the acquirer is often difficult.
- b. There is often no reliably measurable consideration and, therefore, measuring the fair value of the acquiree is difficult if not impossible.
- c. The application of the acquisition method could negatively affect capital requirements for regulatory purposes.
- d. Valuations to measure the fair value of the acquiree are costly and do not outweigh the benefits of the information provided.
- e. Alternative accounting methods would better reflect the economics of the combinations.
- f. A cooperative entity does not meet the definition of a mutual entity.

Those concerns are outlined in the Board meeting handout along with the reasons the staff continues to believe that combinations between mutual entities should be accounted for using the acquisition method.

14. The Board affirmed that a combination between mutual entities should be in the scope of the final business combinations Statement and, therefore, accounted for using the acquisition method. Additionally, the Board agreed that the definition of mutual entity in the Exposure Draft and final Statement includes cooperative entities (five Board members agreed; two did not (DMY, RHH)).

15. Messrs. Batavick and Linsmeier and Ms. Seidman noted that fresh-start accounting might be appropriate for some combinations of mutual entities as well as some combinations between investor-owned entities. They stated that the Board should more fully consider at a future date the possibility of allowing the fresh-start method for that subset of combinations that are mergers rather than acquisitions. However, they do not believe that all combinations between mutual entities are mergers. However, at this time, they agreed that those combinations should be accounted for using the acquisition method until the Board considers when and how the fresh-start method should be applied.

16. Mr. Herz stated that the acquisition method is not representationally faithful for some combinations that are mergers of equals. He agreed with those Board members who stated that fresh-start accounting is the most appropriate method for some combinations between mutual entities and investor-owned entities, but he believes the Board should explore the fresh-start method at the present time. Mr. Young stated that he would prefer that combinations between mutual entities be accounted for by the fresh-start method.

TOPIC 3: ACCOUNTING FOR BUSINESS COMBINATIONS ACHIEVED BY CONTRACT ALONE OR IN THE ABSENCE OF A TRANSACTION INVOLVING THE ACQUIRER.

17. Ms. Vessels stated that the Exposure Draft proposes that the acquisition method should be used for business combinations that occur by contract alone or in the absence of a transaction involving the acquirer. A business combination is defined as “a transaction or other event in which an acquirer obtains control of one or more businesses.” Paragraph B28 of the Exposure Draft states that “all changes of control in which an entity acquires a business are economically similar transactions or events.” The Board concluded that these types of transactions should be accounted for by applying the acquisition method. Therefore, if an acquirer obtains control of a business by contract alone or in the absence of a transaction involving the acquirer, that transaction or event should be accounted for by the acquisition method because an acquirer obtained control. Examples of business combinations achieved by contract alone are dual listed corporation (DLC) structures and stapling arrangements. Examples of business combinations achieved in the absence of a transaction involving the acquirer are when an entity obtains

control of an business through the lapse of minority veto rights that previously kept the entity from controlling the business even though it held the majority voting interest in that business or when an investee enters into share buy-back arrangements with some of its investors and, as a result, control of the investee changes.

18. Ms. Vessels noted that there currently is some guidance in U.S. GAAP for business combinations achieved by contract alone. For example, EITF Issue No. 97-2, “Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements,” addresses transactions that involve control by contract without necessarily obtaining an ownership or voting equity interest of a physician practice management entity, and are accounted for using the acquisition method. Additionally the SEC requires DLC structures to be accounted for using the acquisition method. While the staff is not aware of stapling arrangements in the United States, the staff has found examples of such arrangements in Australia, for which the AASB has issued guidance.

19. Few respondents commented on business combinations that occur in the absence of a transaction involving the acquirer or achieved by contract alone. Those that responded commented on business combinations achieved by contract alone and generally disagreed with the proposal because they believe:

- a. Identifying the acquirer is too difficult and would not reflect the economic substance of the transaction.
- b. There is no exchange of cash or other readily measurable consideration to measure the fair value of the acquiree.

Those concerns are outlined in the Board meeting handout along with the reasons the staff continues to believe that business combinations that occur by contract alone or in the absence of a transaction involving the acquirer should be accounted for using the acquisition method.

20. In addition, several respondents questioned the appropriateness of the proposal that in a business combination achieved by contract alone (for example a DLC or stapling arrangement), the fair value of the acquiree should be attributed to the noncontrolling

interests of the acquiree. The IASB asked the staff to do more research on this issue. Therefore, the staff did not ask the Board to make a decision on that matter at this meeting.

21. The Board decided that the acquisition method should be applied to a business combination achieved in the absence of a transaction involving the acquirer and to a business combination achieved by contract alone (all Board members agreed).

22. Mr. Herz noted that a business combination achieved by contract alone can occur between more than two entities and in such circumstances it might be difficult to identify an acquirer. The staff stated that such difficulty is not limited to a business combination achieved by contract alone. Multi-party combinations are effected through the purchase of ownership interests. Statement 141 currently provides guidance for identifying the acquirer in multi-party combinations and the issues have not been insurmountable. The staff believes the guidance in Statement 141 will equally apply to multi-party combinations achieved by contract alone.

TOPIC 4: ACCOUNTING FOR CONTINGENCES IN A BUSINESS COMBINATION

23. Ms. Tamulis stated that the Exposure Draft proposes that the acquirer recognize contingencies acquired at fair value and, in the absence of other applicable U.S. GAAP, they should be continuously measured at fair value until they are ultimately settled or resolved.

Proposed Clarification

24. Ms. Tamulis stated that guidance in the Exposure Draft implies that all contingencies that are assets should be recognized and subsequently remeasured at fair value. The staff, however, believes the Board intended that contingencies that are intangible assets must meet the intangible asset recognition criteria to be separately recognized and that they should be subsequently accounted for under Statement 142. Ms. Tamulis asked the Board if they wished to clarify this in the final Statement. The Board decided that the final Statement should clarify that a contingency that is an intangible

asset would need to meet the intangible asset recognition criteria to be recognized separately from goodwill (contractual or separable) and that it should be subsequently accounted for under Statement 142. (All Board members agreed.)

Initial Recognition of Contingencies

25. The Exposure Draft proposes that an acquirer recognize a contingency acquired or assumed at fair value if it meets the definition of an asset or liability. Ms. Tamulis noted that the most compelling comment received from respondents about that proposal was that they were unsure at what point an existing condition, situation, or set of circumstances involving uncertainty as to a possible gain or loss would meet the asset or liability definition and, therefore, qualify for recognition (that is, element uncertainty).

26. To address that concern, the staff proposed a model intended to reduce the issue of element uncertainty. The staff proposed requiring:

- a. Recognition of either all contractual or all legally enforceable contingencies, because those contingencies have little or no element uncertainty. (Guidance for what would constitute “legally enforceable” would be taken from FASB Statement No. 143, *Accounting for Asset Retirement Obligations*.)
- b. Subjecting all remaining contingencies to a recognition threshold. That threshold could be either **probable** (used with the same meaning as in FASB Statement No. 5, *Accounting for Contingencies*) or **more likely than not** (used with the same meaning as in FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*.)

27. The staff also proposed that all recognized contingencies be measured at fair value. However, the staff asked the Board whether they would want to allow an exception for recognition if a contingency could not be **reasonably estimated**.

28. The Board discussed the staff’s proposals. Board members expressed the following concerns:

Contractual Versus Legally Enforceable

29. Ms. Seidman stated that while she supports recognition of contractual contingencies, she was concerned with the operational feasibility of the legally enforceable alternative. She requested that the staff further research the meaning of *legally enforceable* and what contingencies might go unrecognized if the Board decided to require recognition of contractual contingencies rather than legally enforceable contingencies. Messrs. Herz and Linsmeier, while leaning toward the legally enforceable alternative, also expressed concerns about the operational feasibility and asked the staff to do additional research.

30. Mr. Trott stated that the contractual alternative was too narrow and would miss some types of contingencies that should be recognized, such as some warranties and rights of return. Mr. Leisenring questioned the use of the contractual alternative and stated that under that alternative asset retirement obligations recognized as part of an acquisition could be derecognized after the acquisition in accordance with Statement 143 if they are deemed not to be reasonably estimable. Ms. Seidman noted that an exception could be made requiring contingencies recognized as part of the combination to not be subsequently derecognized absent a change in circumstance.

Recognition Threshold

31. Mr. Trott stated that while he would accept a more likely than not threshold, he would prefer not having a recognition threshold at all. Instead, one should be required to recognize all contingencies and incorporate the probability of the contingency in the measure.

32. Mr. Linsmeier noted that there are areas of related literature, such as IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and the conceptual framework that are subject to revision. While he supports the more likely than not threshold, he hopes that this would be only a temporary solution and that the accounting for contingencies will be comprehensively revisited and improved.

Initial Measurement of Contingencies

33. Ms. Seidman and Mr. Batavick stated that they would prefer measuring contingencies with little element uncertainty at fair value and all other contingencies using a best estimate in accordance with Statement 5. Once a recognition threshold is met—in this case, more likely than not—the amount recorded should not include all possibilities as fair value does, but should instead reflect the best estimate of what will be paid.

Exception to Recognition If the Fair Value Can Not Be Reasonably Estimated

34. Ms. Seidman and Messrs. Herz and Young stated that there are a narrow set of circumstances in which there is not enough information to provide a reasonable estimate and, therefore, an exception should be provided. Mr. Trott stated that with the issuance of FASB Statement No. 157, *Fair Value Measurements*, the Board has provided guidance on how to handle uncertainty in fair value measurements.

35. Mr. Linsmeier questioned the need for a recognition threshold (that is, more likely than not) for contingencies with element uncertainty if the Board was to provide a recognition exception if a contingency cannot be reasonably estimated. He suggested that the staff consider the technical and practical feasibility of requiring that all contingencies that can be reasonably estimated be measured at fair value. All contingencies that can not be reasonably estimated, but have a potential range of losses, should be recognized in accordance with FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. Some Board members noted that providing an exception if a contingency cannot be reasonably estimated may eliminate the need to provide recognition criteria (contractual/legally enforceable).

Follow-Up Items:

The Board directed the staff to evaluate the types of disclosures that should be made, if any, relating to the credit quality of acquired receivables.

The Board requested that the staff consider alternative approaches to the recognition and measurement of contingencies. The Board asked the staff to determine what

contingencies might go unrecognized if the Board decided to require recognition of contractual contingencies rather than legally enforceable contingencies. The Board also asked the staff to consider an approach that would require all contingencies to be recognized except those that cannot be reasonably estimated.

General Announcements:

None.