SMALL BUSINESS ADVISORY COMMITTEE
December 8, 2006 - - - - 9:00 A.M.
FASB Offices - - - - Norwalk, Connecticut

Agenda

1. Introductory Remarks (Mr. Batavick)	
2. Report of the FASB Chairman (Mr. Herz)	Mr. Herz will comment on Board activities not otherwise on the meeting agenda. (Attachment A)
3. Report from the SEC (Mr. Hewitt)	Mr. Hewitt will comment on accounting and related matters at the SEC.
4. Report from the PCAOB (Mr. Fletcher)	Mr. Fletcher will comment on Public Company Accounting Oversight Board matters.
5. Conceptual Framework (Mr. Hague)	Committee members will discuss the proposed working definition of an asset. (Attachment B)
B R E A K	
6. Financial Statement Presentation (Mr. Young and Ms. Petrone)	Committee members will discuss the Board's tentative decisions to date. (Attachment C)
7. Quantification of Materiality (Mr. Glotzer)	Committee members will discuss the need for the FASB to issue guidance on quantifying misstatements in current year financial statements. (Attachment D)
L U N C H	
8. Liabilities and Equity (Mr. Linsmeier and Ms. Carnrick)	Committee members will discuss the Board's approach to this project and its plans to issue a Preliminary Views document. (Attachment E)
9. Business Combinations (Mr. Crooch and Ms. Tamulis)	The Committee will discuss aspects of the Board's project on business combinations. (Attachment F)
10. Other Current Issues and Closing Remarks (Mr. Batavick)	Committee members will discuss any new issues that may require the Board's attention.
A D J O U R N M E N T	

Note: These materials are provided to facilitate understanding of the issues to be addressed at the December 8, 2006 SBAC meeting. These materials are for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

ATTACHMENT A

SBAC MEETING

DECEMBER 8, 2006

FASB CHAIRMAN'S REPORT

- **TECHNICAL ACTIVITIES**
- **PRIVATE COMPANY REPORTING**
- **XBRL**

ATTACHMENT B

JOINT CONCEPTUAL FRAMEWORK PROJECT

Small Business Advisory Committee
December 2006

BACKGROUND

1. In the last year, the FASB and IASB (the Boards) commenced discussion of Phase B of the conceptual framework project, which involves consideration of the elements of financial statements, as well as recognition. In particular, the Boards have focused on developing an improved and converged definition of an asset. In November each Board reviewed a proposed working definition, provided the staff with further suggestions, and agreed to seek further counsel from FASAC, the FASB's Small Business Advisory Committee, the IASB's Standards Advisory Council, and other technical experts.

2. Development of the asset definition is the first step of a multi-step process to determine how to account for an asset. The Boards' discussions to date, and this paper, focus on the existence of an asset and NOT on whether it should be recognized or how it should be measured. Recognition and measurement involve other matters, including cost-benefit considerations, that will be considered in later parts of the project. Therefore, conclusions reached as to what items meet the proposed working definition of an asset do not necessarily mean that all assets (as defined) would be recognized in financial statements.

Purpose of SBAC Discussion

3. The objective of this session is to inform, and solicit views of, SBAC members about the proposed working definition of an asset.

4. SBAC members will be asked to discuss the proposed working definition, focusing, in particular, on the questions in paragraph 27 of this paper.

Purpose and Structure of this Paper

5. This paper summarizes the need to change and improve on the existing definitions and discusses each of the key aspects of the proposed working definition of an asset that the Boards think will achieve the desired improvements. It then recaps the working definition and raises a series of questions for SBAC members, which are directed at learning whether the intended improvements are desirable and can be achieved. The Board also seeks to learn of any negative consequences that members may foresee, and if any, whether those can be overcome.

DEFINITION OF AN ASSET—NEED FOR CHANGE AND CURRENT PROPOSAL

Need to Change the Existing Definitions

6. Assets are the most fundamental real-world economic phenomena that financial reporting seeks to portray. If the definition of an asset is too vague or subject to interpretation, then the foundation of financial reporting is at risk of being undermined. Therefore, it is necessary that this definition be as robust as possible. The following paragraphs outline some of the shortfalls of the existing FASB and IASB asset definitions and explain how the proposed working definition seeks to overcome those shortfalls.

7. The existing FASB and IASB definitions of an asset are as follows:[1]

> **Assets** are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [FASB Concepts Statement 6, paragraph 25; Footnote reference omitted.]
>
> An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. [IASB Framework, paragraph 49]

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[1] The Appendix to this paper shows other existing definitions that the Boards and their staff have considered.

8. *Likelihood*—Likelihood (“probability” in the case of the FASB and “expectation” in the case of the IASB) was referred to in the existing definitions in response to constituents’ concerns on earlier proposals that the definition would require that an item be certain in order to qualify as an asset. Since few things in life are certain, they observed that few items that are commonly thought to be assets would qualify in accordance with the definition. Accordingly, the Boards included likelihood with the intent of indicating that the item in question need not be certain (that is, it could be less than certain) to meet the definition.

9. Both the FASB and IASB definitions have been misinterpreted as implying that there must be a high probability (FASB) or high expectation (IASB) of future economic benefits before the definition is met. Thus, some think that when there is a low probability, or expectation, of future economic benefits, the asset definition is not met. That is not the intent.[2]

10. To avoid this continued misinterpretation, the working definition makes it clearer that it does not depend on an assessment of likelihood. The Boards think it is sufficient that the economic resource in question be capable of producing cash inflows or reducing cash outflows. If there is any question of likelihood to be considered, that might be a factor in assessing whether a particular asset (or asset class) qualifies for recognition or in determining its measurement, not in the definition of an asset.

11. *Future economic benefits*—This phrase, used in both the FASB and IASB definitions, focuses on identifying a future flow of economic benefits to demonstrate that an asset exists. The Boards think that is the wrong focus. Financial statements can be viewed as reporting on things that exist (sometimes referred to as *stocks*) and changes in things that exist (sometimes referred to as *flows*). The Boards think that the definition of an asset should focus on stocks—the things, both tangible and intangible, that are capable of producing cash inflows or reducing cash outflows. An asset is not an inflow, but rather an inflow is a consequence of it. The problem is that the existing FASB definition defines a “stock” by reference to a “flow.”

12. Additionally, an asset is something that exists in the present rather than in the future. However, the wording in the existing definition suggests otherwise by equating the asset with *future* economic benefits. This is sometimes misinterpreted as meaning that the asset is the ultimate future inflow. This can lead to a conclusion that some items, such as lottery tickets or research in progress, are not assets, because the *future* economic benefit is associated with a future event—the drawing of the winning ticket or the successful outcome of the research. As applied to the lottery ticket, that argument confuses the ticket with the cash prize by equating the asset with the future prize when the asset represented by the ticket is the right to participate in the lottery drawing for the prize.[3] Similarly, the asset represented by the research in progress is the present access to the research knowledge, not the eventual outcome of the particular research project.

13. To avoid this misinterpretation, the working definition replaces *future economic benefits* with *present economic resources*. The use of *economic resources* rather than *economic benefits* indicates that the item is a stock, rather than a flow, and the use of *present* rather than *future* indicates that the item must presently exist.

14. *Control*—In applying the existing definitions, some view *control* of probable future economic benefits (FASB), or of a resource (IASB), as being used in the same sense as that used to determine whether one has control in a business combination or for purposes of consolidation accounting. The Boards think that was not the intention.

15. In today's complex business world, the Boards think the term "rights or other privileged access" better reflects the manner in which an entity is associated with economic resources than control. It is not necessary that an entity controls the economic resource; merely that it has some rights or other privileged access to it. "Rights or other privileged access," a term derived from the UK *Statement of*

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[2] A footnote to the FASB definition in Concepts Statement 6, paragraph 25, footnote 18, attempts to explain that, but perhaps not as effectively as it might do.

[3] The measurement of such an asset might be very small, or immaterial, if the likelihood of future cash inflows is remote. Nonetheless, that does not mean that an asset does not exist.

Principles for Financial Reporting (UK SOP),[4] reflects an entity's ability to use a particular economic resource and the fact that others' use of the resource is limited.

16. Rights can be legally enforceable, but also can be enforceable by other equivalent means, such as those arising within a self-regulatory structure such as a professional organization. For example, the right to issue assurance opinions on financial statements conferred on a qualified accountant by a professional accounting organization. If such rights are enforced similarly to how rights would be legally enforced (even though the consequences of enforcement might differ), they are regarded as the equivalent of legally enforceable rights.

17. An entity also can produce cash inflows or reduce cash outflows in the absence of legally enforceable rights. For example, an entity might have no legally enforceable right to secret know-how, or an unpatented invention, but the entity can use or sell the knowledge or invention (to produce cash inflows) and access to it is protected by secrecy. Therefore, the ability to access an item and preclusion or limitation of access by others also creates other privileged access for the entity to an asset in that it creates an advantage to the entity beyond the common advantages of others.

18. *Past transaction or event*—The Boards think that references to "past transaction or event" were included in the definitions primarily to exclude future assets from meeting the definition. However, in applying both the FASB and IASB definitions, some people place undue emphasis on identifying the past transaction or event that gave rise to an asset. Though that identification might be helpful, it can be a distraction and lead to debates about which event is the triggering event instead of focusing on whether the economic resource and the access to it exist at the balance sheet date. How the economic resource and access to it were obtained does not affect whether something under consideration meets the definition of an asset at the present time. Although an observed transaction or other event might provide a signal that an asset might be present and provide a clue as to its nature, the failure to observe such a transaction or other event does not demonstrate that an asset is

[4] Accounting Standards Board, *Statement of Principles for Financial Reporting*, October 1999

not present. Conversely, just because a transaction or other event has occurred, that does not mean an asset has resulted from it. For example, expenditure could have resulted in an expense rather than an asset.

19. To avoid undue emphasis on seeking out a past transaction or event, the working definition focuses on what is necessary for an asset to exist "at the present" (that is, a *present* right or other privileged access to a *present* economic resource). This also has the advantage that the economic resource and access to it must exist today—so they cannot be economic resources or access that will not arise until the future or that existed in the past, but no longer exist at the balance sheet date.

20. *Contractual promises*—The amplifying texts supporting the existing FASB and IASB definitions are not clear regarding the application of the definitions to contractual promises. Concepts Statement 6 suggests that contractual promises may be assets, but does not indicate which features might distinguish between those promises that are assets and those that are not. The IASB Framework is silent on this matter.

21. The Boards have previously discussed inbound contractual promises and whether they qualify as assets both in the conceptual framework project and in other projects such as revenue recognition. The Board has observed that such promises may be:

    a. *Conditional*—Performance of the promise is subject to an event that is not certain to occur.

    b. *Unconditional*—Nothing other than the passage of time is necessary for performance of the promise to occur.

    c. *Mature*—Performance of the promise is not subject to any event, including the passage of time.

22. The Boards have concluded that inbound promises that are conditional are not assets because their performance is not presently required. However, inbound promises that are unconditional and mature (that is, non-conditional) may qualify as assets. In doing so, the Boards observed that conditional promises commonly are accompanied by an unconditional promise and, in those cases the unconditional promise may be an asset even though the conditional promise is not an asset.

23. For example, a fire insurance policy on a home may be seen as involving two promises from the insurance company. One is an unconditional promise to provide insurance coverage during the policy's term, and the other is a conditional promise to pay damage claims *if* a fire occurs. Unless a fire occurs, the policyholder only has an asset relating to the unconditional promise of coverage for the remainder of the policy term. However, if a fire occurs, the policyholder has two assets, one for payment of the claim for fire damage, and another for coverage for the remainder of the policy term.

24. To be clear about whether inbound contractual promises may be assets, the Boards propose to explicitly indicate that economic resources encompass those non-conditional promises (those that are unconditional or mature). The reason for doing so is to clearly communicate that non-conditional contractual promises are economic resources because that may not be intuitively obvious to some.

25. The fire insurance example illustrates an unconditional promise that does not require the promisor or the insurance company to take a particular action, but rather to "stand ready" to do so. Specifically, the promise to provide insurance coverage for the policy term is a contractual promise to stand ready. Concepts Statement 6 acknowledges promises to stand ready to provide services, but only in the context of liabilities (paragraph 36). While such promises give rise to liabilities for their promisors, it also should be acknowledged that they give rise to assets for their promisees or the recipients of the promises.

Current Proposal

26. Based on the shortfalls identified and proposed changes, the Boards are seeking counsel on the following working definition of an asset, which is the latest version discussed by the Boards in November 2006:

An **asset** is a present economic resource to which the entity has a present[5] right or other privileged access. a. *Present* means that both the economic resource and the right or other privileged access to it exist on the date of the financial statements. b. An *economic resource* is something that has positive economic value. It is scarce and capable of being used to carry out economic activities such as production and exchange. It can contribute to producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources include non-conditional contractual promises that others make to the entity, such as promises to pay cash, deliver goods, or render services. Rendering services includes standing ready to perform or refraining from engaging in activities that the entity could otherwise undertake.[6] c. *A right or other privileged access* enables the entity to use the present economic resource directly or indirectly and precludes or limits its use by others. *Rights* are legally enforceable or enforceable by equivalent means (such as by a professional association). Other privileged access is not enforceable, but is otherwise protected by secrecy or other barriers to access.

Note that the definition focuses on the *capability* of producing cash inflows (or reducing cash outflows), rather than on the cash flows themselves that may result from that capability.

[5] The IASB suggested that this second use of the word “present” could be deleted.

[6] The IASB suggested that the last two sentences of this definition of an economic resource be moved to amplifying text as they are an example of an economic resource and not essential component of an economic resource.

QUESTIONS FOR DISCUSSION

27. To assist the Boards in evaluating the proposed working definition of an asset, below are questions to consider for discussion.

> Is the working definition an *improvement* over the existing definitions (clearer, more understandable, captures the right items, etc.)?
>
> Consider, for example, whether it is preferable to:
>
> a. Not refer to *likelihood* of economic benefit in the asset definition?
>
> b. Focus on *present economic resources*, rather than future economic benefits?
>
> c. Use “*right or other privileged access*” rather than “control”?
>
> d. Focus on the need for “*present*” rights and other privileges rather than the need for a past transaction or event?
>
> e. Explicitly incorporate the analysis of *contractual arrangements* in paragraphs 20-26?

Australia	**"Assets"** are future economic benefits controlled by the entity as a result of past transactions or other past events; and "control of an asset" means the capacity of the entity to benefit from the asset in the pursuit of the entity's objectives and to deny or regulate the access of others to that benefit. (paragraph 14)
Canada	**Assets** are economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained. (paragraph 29)
Germany	An **asset** is a resource controlled by an enterprise as a result of past events. (paragraph 66)
Japan	**Assets** are economic resources or their equivalents that the reporting entity controls as a result of past transactions or events. (paragraph 4)
New Zealand	**Assets** are service potential or future economic benefits controlled by the entity as a result of past transactions or other past events. (paragraph 7.7)
United Kingdom	**Assets** are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. (paragraph 4.6)
CFA Institute – Comprehensive Business Reporting Model[7]	An enterprise must recognize an economic resource as an asset in the financial statements when all of the following conditions are met: a. The resource is a present right or other access to a future benefit that will flow to the company and will contribute directly or indirectly to future net cash inflows; b. The right to the future benefit is controlled by the company; c. There is a nonzero probability that the benefit will occur; d. The right to the future benefit is separable from the company; that is, it can be transferred to an external party; e. The right to the future benefit is the result of past events; and f. The fair value of the right to future benefits can be measured. (page 19)
FASAB[8]	An **asset** is a resource that embodies economic benefits or services that the federal government can control. (paragraph 17)
GASB[9]	**Assets** are resources that the entity presently controls.

[7] *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, CFA Centre for Financial Market Integrity, September 2005. Note that this definition mixes both the definition of an asset and recognition criteria.

[8] Federal Accounting Standards Advisory Board, July 2006 Exposure Draft, *Proposed Statement of Federal Financial Accounting Concepts: Definition and Recognition of Elements of Accrual-Basis Financial Statements.*

[9] Governmental Accounting Standards Board, August 2006 Exposure Draft, *Proposed Statement of Governmental Accounting Standards Board on Concepts Related to Elements of Financial Statements.*

FINANCIAL STATEMENT PRESENTATION

Small Business Advisory Committee
December 2006

Introduction

The financial statement presentation project is a joint project with the IASB. Since April 2006 the FASB and IASB (the Boards) have been discussing fundamental issues related to the presentation and display of information in the financial statements. The current plan is to issue an initial discussion document on those issues in the second quarter of 2007. That discussion document will be in the form of a Preliminary Views for the FASB and a Discussion Paper for the IASB.

What is a Preliminary Views Document?

A Preliminary Views is designed to set forth and seek comments on the Boards' current views at a relatively early stage of a project. The FASB is not required to issue a Preliminary Views before an Exposure Draft. However, while not a mandatory step in IASB due process, the IASB normally publishes a Discussion Paper on any major topic it is addressing. Thus, the FASB may issue a Preliminary Views on many of its joint projects.

One of the primary reasons the Boards agreed to issue a Preliminary Views prior to issuing an Exposure Draft is the potential this project has for making significant changes to how financial information is displayed and presented in the financial statements. Developing a Preliminary Views provides the Boards as well as their constituents with not only an opportunity to do some early-stage "outside the box" thinking but a venue to discuss potentially ground-breaking ideas—all prior to the Exposure Draft stage. Issuing a Preliminary Views also will provide the Boards with an opportunity to consult with their constituents about the issues and gain more information about both the conceptual and practical aspects of the proposed presentation format.

The Preliminary Views will be similar to an Exposure Draft in that it will include the more significant alternatives considered by the Boards, and indicate the Boards' preference from those alternatives. However, the Boards' preferences in the Preliminary Views will be more "tentative" than in an Exposure Draft. The Preliminary Views will differ from an Exposure Draft in the following ways:

- It will include higher level principles rather than the detailed requirements that are included in an Exposure Draft.
- The Boards' views on some of the issues in the project may not be included in the Preliminary Views (such as EPS and other per-share amounts)—either because they are so dependent on the answers to the first level of issues, or they are of the type that the Boards are seeking more input prior to deliberating.
- There is no separate basis for conclusions; the basis for the Boards' preferences is embedded within the discussion of those preferences.

Summary of Preliminary Views

The Boards identified the following five working principles to guide it in making decisions about how information should be presented on the financial statements.

Financial statements should present information in a manner that:

1. Portrays a cohesive financial picture of an entity.
2. Separates an entity's financing activities from its business and other activities and further separates financing activities into transactions with owners in their capacity as owners and all other financing activities.
3. Helps a user assess the liquidity of an entity's assets and liabilities (nearness to cash or time to conversion to cash).
4. Helps a user understand:
   a) The basis on which assets and liabilities are measured.
   b) The uncertainty in measurements of individual assets and liabilities.

c) What causes a change in reported amounts of individual assets and liabilities.

5. Disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows.

Those working principles and how the Boards have applied them in forming their preliminary views on presentation and display issues are summarized below.

Cohesiveness of the Financial Statements

The Boards decided that first and foremost the financial statements should present a cohesive financial picture of an entity such that the relationships between items on the different financial statements are clear (sometimes thought of in terms of articulation or linkage). This “cohesiveness” working principle is the governing (first priority) working principle.

Separate Financing Activities from Business Activities

Another key working principle is that the business activities of an entity—that is, how it creates value—should be presented separately from how that value creation is financed or funded. Thus, there would be two primary sections on each of the financial statements: business and financing. The business section would be further divided into operating and investing categories; the financing section would be further divided into financing assets, financing liabilities, and equity categories.

Assets and liabilities would be classified in one of those categories on the statement of financial position following an eyes-of-management approach. This approach will result in financial statements reflecting the way an entity manages its businesses as opposed to being based on a uniform and fairly rigid format. The broad classification criteria are provided below. Changes in assets and liabilities would be classified consistently in the statement of comprehensive income and the statement of cash flows—thus achieving the goal of presenting a cohesive financial picture of an entity. That is, for example, revenues and expenses related to operating assets and liabilities would be presented in the operating income category and the cash flows related to an investing asset would be presented in the cash flows from investing activities category.

Classification Guidelines and Related Accounting Policy Disclosure

Financing Section

Financing assets and **financing liabilities categories**—financial assets and financial liabilities that management views as part of the financing of the entity's business activities (referred to as *financing assets and liabilities*).

- In determining whether a financial asset or liability should be included in the financing section, an entity should consider whether the item is interchangeable with other sources of financing and whether the item can be characterized as independent of specific business activities.
- Examples of items that might be classified in this category for a non-financial institution are: cash and cash equivalents, bank loans, AFS financial instruments, bonds, and leases, plus financial instruments held to hedge any of these items. (The definition of *cash and cash equivalents* will be revisited by the Boards to address current practice issues.)

Equity category—all equity items without exception.

Business Section

Investing category—assets and liabilities that are not related to financing an entity's business activities that management views as not integral to its main business activities (referred to as *investing assets and liabilities*).

- Examples of items that might be classified in this category for a non-financial institution are: AFS financial instruments and financial instruments held to hedge items included in the investing category.

Operating category—assets and liabilities that are not related to financing an entity's business activities that management views as integral to its main business activities (referred to as *operating assets and liabilities*) plus any asset or liability not otherwise classified.[10]

- Operating assets and liabilities would be included in the same category; they would not be separated into operating assets and operating liabilities.

[10] The Boards have yet to discuss these criteria for the operating category.

- Examples of items that might be classified in this category for a non-financial institution are: accounts receivable, inventory, goodwill, and pension obligation.

Accounting Policy Disclosure

An entity would be required to explain, as a matter of accounting policy, its basis (or bases) for classifying assets and liabilities in the financing categories, the investing category, and the operating category. Any change in the basis for classification would be viewed as a change in accounting policy and would be implemented through retrospective application to prior periods.

Discontinued Operations

Because a discontinued operation can be viewed as being separate from the on-going activities of an entity, the Boards decided that there should be a separate section on the financial statements for discontinued operations. The **discontinued operation section** would include all assets and liabilities of a discontinued operation (as defined in the standards). (In discussing the presentation issues related to discontinued operations, the Boards agreed to revisit their respective definitions of *discontinued operations* so that U.S. GAAP and IFRS have the same definition.)

The assets and liabilities of a discontinued operation would be presented on a net basis on face of the statement of financial position. Similarly, the profit (loss) of the discontinued operation and any gain (loss) from measurement to fair value or disposal would be combined on the face of the statement of comprehensive income and the total cash flows related to the discontinued operations would be combined on the statement of cash flows. Information currently required to be provided in the notes to financial statements related to discontinued operations would continue to be disclosed in the notes.

Income Taxes section

As income tax-related activities can be viewed as a discrete managerial function, the Boards decided that there should also be a separate section in the financial statements for income taxes. The **income taxes section** would include all *income* taxes, including taxes related to transactions with owners.

One advantage of presenting income taxes separately is that it would eliminate what many view as an arbitrary allocation of income taxes to continuing operations, discontinued operations, and so forth. Thus, discontinued operations and other comprehensive income (OCI) items would be presented on a pre-tax basis. The notes to financial statements will include information to assist users in analyzing income tax information due to this change in presentation.

Working Format

The four sections and related categories described above constitute what is referred to as the financial statement presentation working format. That format is illustrated below. (Extraordinary items would not be presented as a separate section or category in the financial statements and the concept of extraordinary items would be eliminated from US GAAP.)

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
Business ◆ Operating assets and liabilities ◆ Investing assets and liabilities	**Business** ◆ Operating income ◆ Investment income	**Business** ◆ Operating cash flows ◆ Investing cash flows
Discontinued operations	**Discontinued operations, net**	**Discontinued operations**
Financing ◆ Financing assets ◆ Financing liabilities ◆ Equity	**Financing** ◆ Financing income ◆ Financing expenses	**Financing** ◆ Financing asset cash flows ◆ Financing liability cash flows ◆ Equity cash flows
Income taxes	**Income taxes**	**Income taxes**

It should be noted that this working format has been discussed only in the context of non-financial institutions. Potential modifications for financial institutions will be considered by the Boards beginning in December 2006. It should also be noted that the

Boards have not addressed totals, subtotals, or the order in which sections would be presented; nor have they settled on the names of the categories and sections.

Liquidity Information

Another of the working principles is that the financial statements should present information in a manner that helps a user assess the liquidity of an entity's assets and liabilities (nearness to cash or time to conversion to cash). The Boards addressed this working principle in two ways.

First, they decided that all assets and liabilities in each of the categories should be further classified into short-term and long-term subcategories. An asset or liability (other than a deferred tax asset or liability) would be classified as short-term if the shorter of (a) the contractual maturity or (b) the expected realization or settlement of the asset or liability is within one year. Otherwise, the asset or liability would be classified as long-term.

Second, they decided that if not already disclosed, details of long-term maturities should be presented in the notes for long-term assets and liabilities that have a contractual term (such as contractual receivables and lease obligations). In addition, total short-term assets, total long-term assets, total assets, and similar totals for liabilities also would be disclosed in the notes to financial statements.

Disaggregation of Information on the Face of the Financial Statements

The fourth working principle is that the financial statements should present information in a manner that disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows. The Boards discussed how to apply that working principle to the statement of comprehensive income and tentatively decided that information should be presented on that statement based on its function (for example, sales, cost of sales, and marketing expenses). In addition, information that is important in understanding the business of an entity would be presented by nature (for example, labor costs, depreciation, and amortization) in the notes to financial statements. (This issue will be discussed further by the Boards in 2007.)

Measurement Information

The fifth and final working principle states that financial statements should present information in a manner that helps a user understand: (a) the basis on which assets and liabilities are measured, (b) the uncertainty in measurements of individual assets and liabilities, and (c) what causes a change in reported amounts of individual assets and liabilities.

The Boards agreed that this working principle would best be attained by note disclosures as described below.

- Information about the measurement basis (or bases) of the assets and liabilities presented on the statement of financial position would be disclosed in the summary of significant accounting policies. In deciding whether a particular accounting policy should be disclosed, management would consider whether disclosure would assist users in understanding how transactions, other events, and conditions are reflected in the financial statements.

- The financial presentation standard will include a general requirement that the notes to financial statements describe any significant uncertainty in the current measure of assets and liabilities and explain why the measured amount was selected. Individual accounting standards would include more specific disclosures about measurement uncertainty as appropriate.

- The financial statements should provide information that will allow a user to distinguish between the various changes in assets and liabilities, some of which are due to fair value changes and changes in estimates (that is, remeasurements) while others are not due to remeasurements, but are due to cash transactions or accruals. The Boards asked the staff to consider which types of changes should be presented separately, which should be aggregated, and the manner in which that information should be presented. The Boards will discuss this issue further in 2007.

Other Comprehensive Income and Recycling

While not specifically addressed in any of the working principles, the Boards did discuss the notion of recycling and the treatment of other comprehensive income (OCI) items. The Boards tentatively decided that

- OCI items, such as gains or losses on AFS financial instruments and actuarial gains or losses, should be classified in one of the financial statement categories (financing, operating, or investing)
- Any subtotal within comprehensive income should be based on changes in assets and liabilities that have occurred in the current period.

Thus, the mechanism of recycling OCI items would be eliminated and a net income subtotal would not be presented on the statement of comprehensive income. However, in the short-term, the changes in assets in liabilities that are currently reclassified (recycled) between other comprehensive income and net income may need to be shown separately from the current period changes and it may be necessary to keep OCI items in a separate section of the statement of comprehensive income (the Boards will discuss these presentation issues in December).

Recognizing that changes to current standards that give rise to OCI items will need to be made to achieve the Boards' long-term goals related to those items, the Boards asked the staff to develop a plan for achieving that long-term goal, such as whether those issues would be addressed in separate projects or as part of the financial statement presentation project.

Remaining Issues

The Boards still have a number of issues to discuss, some of which are noted above. Other remaining issues include:

- The direct and indirect method on the statement of cash flows and related reconciliation.
- The statement of changes in equity.

Questions for SBAC members

1. Do SBAC members have any questions or concerns with the working principles and the Boards' tentative decisions about their application?

2. Are there other principles that the Boards should consider in developing their preliminary views on financial statement presentation matters?

ATTACHMENT D

QUANTIFICATION OF MATERIALITY AND CORRECTION OF PRIOR YEAR MISSTATEMENTS

Small Business Advisory Committee
December 8, 2006

PURPOSE

Later this month, the Board will consider the issuance of a document to clarify whether the requirements of SEC Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, should apply to private companies and how to apply them if they do. For your convenience, SAB 108 is attached.

The purpose of the December 8, 2006 meeting is to discuss with Committee members issues that should be considered by the Board as it deliberates the applicability of SAB 108 to private companies.

BACKGROUND

On September 13, 2006, the SEC issued SAB 108. SAB 108 discusses the effects of prior year misstatements when quantifying misstatements in current year financial statements. That bulletin sets forth two methods for quantifying misstatements and requires public companies to utilize both. Method 1, the "rollover approach," quantifies a misstatement based on the amount of the error originating in the current year income statement. Method 2, the "iron curtain approach," quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year irrespective of the misstatement's year of origination or years of accumulation. Prior to issuance of SAB 108, companies were using either the rollover approach or the iron curtain approach, but not both.

SAB 108 also discusses the accounting upon initial application. The SEC will allow a public company, when first applying SAB 108, to use a cumulative effect adjustment rather than have it restate prior periods, as long as management properly applied the method it used previously, either the iron curtain approach or the rollover approach, and as long as all relevant qualitative factors were considered. If management did not properly apply either the rollover approach or the iron curtain approach, SAB 108 requires that prior year financial statements be restated in accordance with the requirements of FASB Statement No. 154, *Accounting Changes and Error Corrections.*

Since the issuance of SAB 108, the FASB has received inquiries about whether private companies could apply the guidance in SAB 108. Discussion with staff and Board members identified the following alternatives to address this issue:

1. Do nothing because it is not a significant issue in the private sector.
2. Modify existing standards to address the methodology for quantification of misstatements in determining materiality and allow a one-time correction without requiring a prior year restatement.
3. Modify existing standards to address the initial year correction of balance sheet misstatements arising from the accumulation of passed adjustments without addressing the methodology for quantifying the misstatements.

QUESTIONS FOR COMMITTEE MEMBERS

1. How do Committee members deal with misstatements occurring in the current year or the accumulation of prior year errors on the balance sheet? Is there diversity in practice in the small business community?
2. Should the Board change current standards to require that all companies use the two-method approach when quantifying the effects of prior year misstatements in current year financial statements? Why or why not?
3. Should the Board allow private companies a one-time opportunity to correct errors on the balance sheet that arose from the accumulation of passed adjustments without restating prior year statements? Why or why not?

4. Are there any other issues for the Board to consider relative to the application of SAB 108 requirements to the private sector?

ATTACHMENT E

LIABILITIES AND EQUITY

Small Business Advisory Committee

December 8, 2006

INTRODUCTION

In this session, Committee members are invited to discuss their views on the Board's approach to developing a converged, high-quality standard on accounting for financial instruments with characteristics of liabilities (assets) and equity. This paper (1) describes the approach to the project and (2) provides a high-level overview of the three approaches developed to date. Examples illustrating the application of the approaches are presented in the appendix.

APPROACH— A "MODIFIED" JOINT PROJECT

The accounting for financial instruments with characteristics of liabilities and equity is a good example of the complexity in existing U.S. GAAP. Currently, there are approximately 62 different pieces of literature that address various aspects of accounting for instruments in the project's scope. Many find aspects of that guidance to be internally inconsistent, conceptually flawed, rules-based, and easy to circumvent. For those reasons, FASB members and many of its constituents view improved accounting and reporting in this area to be a high priority.

The IASB and its constituents share the goal of developing common standards of reporting for financial instruments. However, the IASB has understandably placed a higher priority on projects to fill gaps in their existing literature (for example, accounting for insurance contracts and extractive industries).

To enable the Boards to achieve their objectives of improving reporting in their jurisdictions and converging, they decided to pursue what has become known as a "modified" joint approach for projects like liabilities and equity. Under that approach, the

FASB is conducting initial deliberations independent of the IASB. Those deliberations will conclude with the issuance of a due process document referred to as a Preliminary Views.

The Preliminary Views will be similar to an Exposure Draft in that it will describe the alternatives considered by the FASB, their perceived advantages and disadvantages, and indicate the Board's preference among those alternatives. However, the Board's preferences in the Preliminary Views will be more "tentative" than in an Exposure Draft. Thus, the Preliminary Views will differ from an Exposure Draft in the following ways:

- It will include higher level principles rather than the detailed requirements that might ultimately be included in an Exposure Draft.
- The Board's views on some of the issues in the project may not be included in the Preliminary Views (such as certain presentation issues) either because they are so dependent on the answers to the first level of issues or they are of the type for which the Boards (the FASB and the IASB) are seeking input before deliberations.
- There is no separate basis for conclusions; the basis for the Board's preferences is embedded within the discussion of those preferences.

It is possible that none of the three approaches described in the Preliminary Views will attract support from a majority of FASB members. In that case, the Board plans to issue a document that describes the approaches with equal prominence, including the level of Board support for each.

Because the IASB is not involved in the deliberations leading up to the Preliminary Views, it will not be in a position to express views on the issues addressed. However, the IASB will issue a discussion paper to its constituents that contains the FASB Preliminary Views as a way of seeking input on (1) whether to undertake a project with the FASB to jointly develop a common standard and (2) the relative merits of the identified accounting alternatives. Based on the input received, the FASB and the IASB will decide whether to undertake a joint project. It is expected the Boards will work jointly toward an Exposure Draft, redeliberate comments received on the Exposure Draft, and ultimately issue a common final standard.

Based on the progress made to date, the FASB expects to issue a Preliminary Views in mid-2007.

BRIEF DESCRIPTIONS OF THE THREE APPROACHES

The Ownership Approach.

The objective of the ownership approach (a narrower view of equity) is to identify the instruments that represent ownership interests. There are two types of instruments classified as equity under this approach: (1) perpetual instruments (which are not required to be redeemed), and (2) direct ownership instruments (such as common stock but not preferred stock). No instruments would be reported as separate components unless there is a possibility of a distinct nonequity payment and, after settlement, an equity share would remain outstanding (for example, stock with required dividend payments). The obligation under the nonequity payoff is measured first before allocating the equity component. All other instruments that are not equity instruments or are not separated are classified as assets or liabilities (for example, convertible debt or puttable stock). Instruments or components with varying payoffs at the settlement date are measured at fair value through income unless other GAAP would apply. Instruments or components with fixed payoffs at the settlement date are accreted or amortized under APB Opinion No. 21, *Interest on Receivables and Payables*.

The Ownership-Settlement Approach

The objective of the ownership-settlement approach is to identify equity instruments or equity components based on the existence of settlement requirements and the nature of the payoffs to the counterparties. The ownership-settlement approach builds off the ownership approach and classifies one additional type of instrument as equity: indirect ownership instruments with counterparty payoffs that are based on direct ownership instruments and that are settled by delivering direct ownership instruments (for example, many stock options, forward contracts on stock, and convertible debt). An instrument is separated into equity and nonequity components if it embodies a settlement obligation and has both equity and nonequity settlement alternatives with differing counterparty payoffs at the outcome date (for example, convertible debt or puttable stock). Instruments would be measured in the same manner as under the ownership approach (note that more instruments would be separated under this approach).

Reassessed Expected Outcomes (REO) Approach

The main objective of the REO approach is to achieve the same accounting for instruments with similar economic outcomes regardless of how the instrument (or instruments) are structured and issued. This is accomplished by measuring freestanding and embedded instruments in the same way. The REO approach utilizes a probability-based measurement approach based on contingent claims modeling techniques. The approach is designed to determine the probability of an equity or nonequity payoff (or payoffs) at the outcome date and to separate and classify the instrument's components accordingly. Under this approach, equity and nonequity payoffs are identified using the same process as under the ownership-settlement approach. Moreover, exchange instruments (such as options and forwards on an entity's own stock) are identified as having two possible payoffs based on the exchange components.

Although equity and nonequity payoffs are identified using the same process as under the ownership-settlement approach, REO relies on different classification criteria. An instrument or component is classified as equity or contra-equity if it is (1) a direct ownership instrument or (2) an instrument whose fair value is based directly or inversely on a reporting entity's direct ownership instruments. Therefore, perpetual preferred shares would be liabilities if they have a fixed payoff structure.

Under the REO approach, the components of separated instruments are measured at fair value, which would result in a gain or loss through income for the change in the entire instrument's fair value. Common shares are the only equity instruments that would not be remeasured under REO.

QUESTIONS FOR COMMITTEE MEMBERS

1. Do you have any questions, comments, or concerns about any of the approaches or the examples in the appendix?

2. What are your views regarding the importance of the Board choosing a preferred approach that is not consistent with the current element definitions in the conceptual framework?

BUSINESS COMBINATIONS: APPLYING THE ACQUISITION METHOD
Preacquisition Contingencies
Small Business Advisory Committee
December 2006

INTRODUCTION

At the December 19, 2006 meeting, the Board will begin redeliberations of the accounting for contingencies (assets and liabilities) acquired or assumed in a business combination. This paper includes a brief discussion of the current accounting for contingencies in FASB Statement No. 141, *Business Combinations*, the proposed accounting for contingencies in the June 30, 2005 Exposure Draft, *Business Combinations* (BC ED), and some other alternatives the Board will consider as part of its redeliberations. At this meeting, Board would like to solicit input from Committee members about the proposals in the BC ED and other possible alternatives in preparation for the December Board meeting.

EXISTING GUIDANCE IN STATEMENT 141 FOR PREACQUISITION CONTINGENCIES

Statement 141 carried forward without reconsideration the guidance in FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises.* Statement 38 was developed to provide guidance for recognizing and measuring "preacquisition contingencies" in a business combination, that is, to explain the application of FASB Statement No. 5, *Accounting for Contingencies,* and APB Opinion No. 16, *Business Combinations,* to preacquisition contingencies.

That guidance requires the acquirer to include in the purchase price allocation all preacquisition contingencies in existence before the consummation of the business combination. An acquirer is to measure the preacquisition contingency (asset or liability) at fair value if that fair value can be determined during the allocation period. Otherwise, the contingency is measured based on the guidance in paragraph 8 of Statement 5 (the amount that is *probable* and can be *reasonably estimated*). The guidance applies equally to both liabilities and assets even though the guidance in Statement 5 relates only to loss contingencies (liabilities).

Under Statement 5, gain contingencies (assets) are only recognized when the contingency is resolved.

If during the acquisition period the acquirer becomes aware of facts about the contingency that existed at the acquisition date, the acquirer is required to make adjustments to the initial measure of that contingency through a corresponding adjustment to goodwill. If an acquirer cannot reasonably estimate the fair value of a contingency by the end of the allocation period, and the application of the guidance in Statement 5 assigns no value to the contingency, the acquirer would record all postacquisition date changes in the amount of the contingency through a corresponding charge to net income.

PROPOSALS IN THE BUSINESS COMBINATIONS EXPOSURE DRAFT

The BC ED proposes that an acquirer recognize a contingency at fair value as of the acquisition date if it meets the definition of an asset or a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements.* Thus, unlike Statement 141, an amount would be assigned to all contingencies, even those that would be allocated no value under Statement 141 (that is, those for which fair value cannot be measured and for which the possible gain or loss is not probable or cannot be reasonably estimated). The BC ED also proposes that if the acquirer becomes aware of a contingency during the measurement period that existed as of the acquisition date but was not recognized in the initial accounting for the business combination, the acquirer would recognize the asset or liability as a measurement period adjustment.

Subsequent to the business combination, the acquirer would apply any applicable GAAP other than Statement 5 in accounting for the contingency. Acquired contingencies that otherwise would be in the scope of Statement 5 would continue to be measured at fair value with any changes in fair value recognized in income in each reporting period.

Respondents to the BC ED raised concerns about the proposed initial recognition and measurement of contingencies. In response, the Board will consider different alternatives that might address those concerns.

ALTERNATIVES FOR INITIAL RECOGNITION OF CONTINGENCIES

The primary concern expressed by many respondents related to the requirement to recognize all contingencies that meet the asset or liability definition because there can be uncertainties about the existence of a present obligation or other aspects of the elements definition (element uncertainty). That is, at what point does an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss meet the asset or liability definition and, therefore, qualify for recognition? For example, if the acquiree is being sued, but the acquirer believes that the lawsuit has no merit, does that "existing condition or situation" meet the definition of a liability? The Board will consider the following alternatives to address element uncertainty.

Alternative One: Require Recognition of All Contingencies That Meet the Definition of an Asset or Liability. Do Not Provide Guidance for Determining when the Asset or Liability Definition Is Met.

This alternative is proposed in the BC ED. Some respondents said that if the Board does not provide additional guidance for determining when the asset or liability definition is met, this alternative might not be applied consistently in practice.   Others support the recognition criteria and understand that retaining it means that judgment is required in applying it. They accept that judgment and possible differences in application is an acceptable consequence of issuing a principles-based standard.

Alternative Two: Limit Recognition to Contractual Contingencies

One respondent to the BC ED suggested that the Board require initial recognition of all contractual contingencies because a contract provides evidence of an asset or liability and there would be no (or little) element uncertainty with a contractual contingency.

While this alternative has merit, it is not broad enough to capture all those contingencies for which there is little or no element uncertainty. This alternative also conflicts with existing GAAP. For example, *asset retirement obligations* (a) often are not contractual but often meet the definition of a liability (no element uncertainty), (b) are required to be recognized under U.S. GAAP (assuming they can be reasonably estimated), and (c) are similar to contingencies in the sense that often the amount and timing of the payment is uncertain.

Alternative Three: Limit Recognition to All Legally Enforceable Contingencies

Another alternative is to require recognition of all *legally enforceable* contingencies. This alternative "casts a wider net" and would result in recognition of more contingencies than Alternative Two. It also would eliminate much of the concern about element uncertainty, but, unlike Alternative Two, it may not eliminate the issue of element uncertainty all together.

Under this alternative, the Board could build off of FASB Statement No. 143, *Accounting for Asset Retirement Obligations,* which provides guidance for determining whether an asset retirement obligation meets the definition of a liability. Statement 143 requires an entity to "recognize the fair value of a liability for an asset retirement obligation in the period in which it is incurred if a reasonable estimate of fair value can be made" (paragraph 3). Paragraphs A2 and A3 further describe the requirements of Statement 143:

> This Statement applies to legal obligations associated with the retirement of a tangible long-lived asset. For purposes of this Statement, a legal obligation can result from (a) a government action, such as a law, statute, or ordinance, (b) an agreement

> between entities, such as a written or oral contract, or (c) a promise conveyed to a third party that imposes a reasonable expectation of performance upon the promisor under the doctrine of promissory estoppel. *Black's Law Dictionary,* seventh edition, defines *promissory estoppel* as, "The principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment."
>
> In most cases involving an asset retirement obligation, the determination of whether a legal obligation exists should be unambiguous. However, in situations in which no law, statute, ordinance, or contract exists but an entity makes a promise to a third party (which may include the public at large) about its intention to perform retirement activities, facts and circumstances need to be considered carefully in determining whether that promise has imposed a legal obligation upon the promisor under the doctrine of promissory estoppel. A legal obligation may exist even though no party has taken any formal action. In assessing whether a legal obligation exists, an entity is not permitted to forecast changes in the law or changes in the interpretation of existing laws and regulations. Preparers and their legal advisors are required to evaluate current circumstances to determine whether a legal obligation exists.

ALTERNATIVES FOR INITIAL RECOGNITION OF CONTINGENCIES THAT DO HAVE ELEMENT UNCERTAINTY

If the Board selects either Alternative Two or Three above, it will need to decide whether contingencies that are either not contractual or not legally enforceable should be recognized if they meet a particular recognition threshold. The Board will consider the following alternatives.

Alternative One: Prohibit Recognition of Contingencies That Are Not Contractual or Legally Enforceable

One alternative could be to prohibit recognition of contingencies that are either not contractual or not legally enforceable. If one thinks about this alternative in the context of a lawsuit, it could result in nonrecognition of a significant liability. For example, an entity is being sued for discrimination. The entity does not believe it is guilty, but past experience indicates that the entity will be found guilty. The possible loss is not contractual or legally enforceable, but it might meet the definition of a liability. Under this alternative, that liability could go unrecognized.

Alternative Two: Subject Contingencies That Are Not Contractual or Legally Enforceable to a *More Likely than Not* Recognition Threshold

Another alternative could be to subject contingencies that are either not contractual or not legally enforceable to a *more likely than not* recognition threshold. In U.S. GAAP, *more likely than not* usually means a likelihood of more than 50 percent.

A more likely than not threshold would result in the recognition of more non-contractual contingencies than would a *probable* threshold, which is discussed next. It would also be consistent with the recognition threshold required in FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes.* However, a *more likely than not* threshold would introduce another model for accounting for contingencies (other than tax contingencies) and would result in four models:

a. Contractual/legally enforceable contingencies (assets and liabilities) acquired in a business combination recognized (no recognition threshold)

b. Non-contractual/non-legally enforceable contingencies acquired in a business combination recognized if they are *more likely than not*; otherwise not recognized

c. All contingent gains acquired outside of a business combination recognized when realized

d. All contingent losses incurred outside of a business combination recognized when probable (and can be reasonably estimated); otherwise not recognized.

Alternative Three: Subject Contingencies That Are Not Contractual or Legally Enforceable to a *Probable* Recognition Threshold

Another alternative could be to subject contingencies that are either not contractual or not legally enforceable to a *probable* recognition threshold. *Probable* is generally interpreted to mean a likelihood of 70 percent or 80 percent or greater. A *probable* recognition threshold is consistent with the loss contingencies recognition threshold in Statement 5. That would result in three models for accounting for contingencies (other than tax uncertainties):

a. Contractual/legally enforceable contingencies (assets and liabilities) acquired in a business combination recognized (no recognition threshold)

b. All contingent gains acquired outside of a business combination recognized when realized

c. Non-contractual/non-legally enforceable contingencies acquired in a business combination and all contingent losses incurred outside of a business combination recognized when *probable* (and can be reasonably estimated); otherwise not recognized.

ALTERNATIVES FOR MEASURING CONTINGENCIES

Many respondents to the BC ED expressed concerns about whether the fair value of a contingency can be reliably measured. The Board will consider whether a different measurement attribute should be used for measuring contingencies.

Alternative One: Measure the Contingency at Fair Value

This is the alternative proposed in the BC ED and is consistent with the fair value measurement principle the Board affirmed in redeliberations. If the Board was to select a different measurement attribute, the measurement of contingencies would be an exception to the fair value measurement principle. Under Alternative One, an entity would use the measurement guidance in FASB Statement No. 157, *Fair Value Measurements.*

The majority of users stated that they support recognizing contingencies at fair value. They believe that fair value provides the most useful and relevant information. A fair value measure does not embed management's expectations in the measure of the asset or liability. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* discusses the reasons why fair value provides the most relevant measurement attribute:

> While the expectations of an entity's management are often useful and informative, **the marketplace is the final arbiter of asset and liability values.** Present value measurements with an objective of fair value are, within the limits of estimation, independent of the entity performing the measurement. As a result, fair value provides a neutral basis for comparing one entity with another. A particular entity may, in fact, possess advantages or disadvantages relative to others. The use of fair value in measurements at initial recognition or fresh-start measurements results in accounting recognition of the economic impact of those advantages or disadvantages as they are realized, rather than at initial recognition. For measurements at initial recognition or fresh-start measurements, **fair value provides the most complete and representationally faithful measurement of the economic characteristics of an asset or a liability.**
>
> Finally, fair value represents a price and, as such, provides an unambiguous objective for the development of the cash flows and interest rates used in a present value measurement. In contrast, the alternative measurements all accept an element of arbitrariness in the selection of the estimated cash flows and interest rate. For example, some might argue that an asset-earning rate is appropriate for cost-accumulation measurement of liabilities. Others might argue for an incremental-borrowing or embedded interest rate. There is little conceptual basis, if any, for judging which of those arguments is correct. Proponents of those alternatives often judge the acceptability of a measurement objective based on the intent of management as to how it plans to use an asset or settle a liability. However, **an entity must pay the market's price when it acquires an asset or settles a liability in a current transaction, regardless of its intentions or expectations.** [Paragraphs 36 and 37; **emphasis** added.]

Alternative Two: Retain Statement 5 for Measuring Contingencies

Some constituents questioned whether measuring and recognizing a contingency at fair value provides relevant information since that measurement does not reflect the amount that will ultimately be paid or received. Therefore, they suggested that the FASB retain Statement 5 for measurement and recognition of contingencies.

Statement 5 does not clearly specify a measurement base for recognized contingencies. It only states that an estimated loss from a loss contingency shall be accrued by a change to income when it is probable and the *amount* of the loss can be reasonably estimated. It does not describe how to measure the *amount.* For example, Statement 5 does not state whether the amount should be discounted, undiscounted, best estimate of future outcome, based on management's intent or fair value, and so on. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* provides some guidance about what the Board meant by *reasonably estimated* in Statement 5 when the estimate is a range, but like Statement 5, it does not describe how to measure the *amount.* As a result, it is unlikely that relying on Statement 5 and Interpretation 14 for measurement could result in consistent measurements and whether inconsistent measurements provide more relevant information than fair value.

QUESTIONS FOR COMMITTEE MEMBERS

1. Do you believe the Board should address the issue of "element uncertainty" and, if so, how should the Board address it?

2. Do you think contingencies should be measured at amounts other than fair value? If so, how should they be measured and why?

BUSINESS COMBINATIONS: APPLYING THE ACQUISITION METHOD
Summary of Project Status

Small Business Advisory Committee
December 2006

INTRODUCTION

In January 2006, the Board began redeliberations of its June 30, 2005 Exposure Drafts, *Business Combinations,* and *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries,* by discussing the comment letters received and by affirming the project's objectives and the staff's plan for redeliberations. The following summarizes:

1. The provisions of the Exposure Drafts that the Board has affirmed in redeliberations
2. The provisions of the Exposure Drafts that the Board has changed in redeliberations
3. The remaining issues the Board has yet to discuss.

PROPOSALS IN THE EXPOSURE DRAFTS THE BOARD AFFIRMED IN REDELIBERATIONS

1. **Principles, Assertions, and Definitions—**The Board affirmed the definitions, assertions, and principles that will provide the basis for the final Statement on business combinations. The Board agreed that if it decides to make an exception to one of the principles, the final Statement on business combinations should label the exception clearly and provide the Board's basis for allowing such an exception.

    a. **Assertions and Definitions**

        (1) A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.

        (2) An acquirer can be identified in every business combination.

        (3) The business combination acquisition date is the date the acquirer obtains control of the acquiree.

        (4) A business combination is accounted for by applying the acquisition method.

        (5) By obtaining control of an acquiree, an acquirer becomes responsible and accountable for all of the acquiree's assets,

liabilities, and activities, regardless of the percentage of its ownership in the acquiree.

b. **Main Principles for Applying the Acquisition Method**

(1) *Recognition Principle*: In a business combination, the acquirer recognizes all of the assets acquired and all of the liabilities assumed.

(2) *Fair Value Measurement Principle*: In a business combination, the acquirer measures each recognized asset acquired and each liability assumed at its acquisition date fair value.

(3) *Disclosure Principle*: Users of the acquirer's financial statements should be able to evaluate the nature and financial effect of business combinations recognized by the acquirer.

2. **Assessing the Components of a Business Combination**

a. The Board affirmed that an acquirer should assess whether a business combination includes any transactions that are substantively separate from the acquisition of assets and assumption of liabilities that make up the acquiree. Only the consideration transferred and the assets acquired or liabilities assumed that make up the acquiree shall be accounted for using the acquisition method. Other transactions should be accounted for separately in accordance with other IFRS/U.S. GAAP.

b. A transaction is substantively separate from a business combination if it was arranged by or on behalf of the acquirer and/or initiated primarily for the economic benefit of the acquirer or the combined entity (rather than for the benefit of the acquiree or its former owners prior to the business combination).

c. The acquirer shall consider the following factors, which are neither mutually exclusive nor individually conclusive, to determine whether a transaction or event was initiated primarily for the economic benefit of the acquirer or combined entity, rather than for the acquiree or its former owners prior to the business combination.

(1) The reasons for the transaction or event

(2) Who initiated the transaction or event

(3) The timing of the transaction or event.

3. **Scope**

a. All transactions or other events in which an entity obtains control of one or more businesses should be accounted for by applying the acquisition method.

b. A **business** is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:

(1) A return to investors

(2) Dividends, lower costs, or other economic benefits directly and proportionately to owners, members, or participants.

c. **Joint ventures** are not business combinations because none of the entities involved obtain control of another. Therefore, joint ventures are excluded from the scope of the final Statement on business combinations.

4. **Measuring and Recognizing Assets Acquired and Liabilities Assumed**

a. **Acquisition-Related Costs**—The costs the acquirer incurs in connection with the business combination would be accounted for separately from the business combination accounting, generally by recognizing those costs as expenses when incurred.

b. **Restructuring Costs**—An acquirer should recognize restructuring or exit costs as liabilities assumed in a business combination *only if* those costs meet the recognition criteria in FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities, and* those liabilities are deemed a liability of the acquiree assumed as part of the business combination. Restructuring or exit costs that do not meet the criteria for recognition in Statement 146 or that arise from transactions or events substantively separate from the business combination should be recognized as separate transactions when the costs are incurred in the postcombination period.

c. **Intangible Assets**—An intangible asset that is *identifiable* (that is, contractual or separable) should be recognized separately from goodwill.

d. **Assembled Workforce**—An assembled workforce should not be recognized as an intangible asset separately from goodwill on the basis that it generally does not meet the separability criterion. (In contrast, the IASB decided that an assembled workforce should be separately recognized if it is identifiable. The Boards will discuss that issue again.)

e. **Research and Development (R&D) Assets**—Identifiable R&D assets (including tangible and intangible R&D assets to be used in R&D activities that have no alternative future use) acquired would be recognized as assets and measured at fair value, superseding the existing guidance in FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.* Subsequent expenditures related to acquired R&D projects would generally be expensed as incurred.

f. **Reacquired Rights**—An acquirer should recognize a reacquired right in a business combination as a separately identifiable intangible asset.

g. **Employee Benefit Obligations**—An acquirer would recognize any changes to the acquiree's employee benefit plans (such as amendments, curtailments, or terminations) that it *expects* to make as postcombination expenses rather than include such changes in the measurement of the assumed benefit plan obligations recognized on the acquisition date.

h. **Operating Leases**—An acquirer should recognize the rights and obligations related to an operating lease in which the acquiree is the lessee as a net amount rather than as a separate asset and a separate liability. Also, an acquirer should recognize an intangible asset or a liability if the terms of an acquired operating lease are favorable or unfavorable relative to market terms at the acquisition date.

i. **Measurement Period**—Measurement period adjustments should be recognized retrospectively rather than prospectively.

5. **Measuring the Consideration Transferred**

a. **Measurement Date for Equity Instruments Issued as Consideration**—The fair value of equity instruments issued as consideration in a business combination should be measured at the acquisition date.

b. **Identifying the Components of a Business Combination**—An acquirer should assess whether a business combination includes any transactions that are substantively separate from the acquisition of assets and assumption of liabilities that make up the acquiree. Only the consideration transferred and the assets acquired or liabilities assumed that make up the acquiree should be accounted for using the acquisition method. Other transactions should be accounted for separately in accordance with other IFRS/U.S. GAAP.

c. **Preexisting Relationships—**The effective settlement of a preexisting relationship between the parties to a business combination should be accounted for as a settlement separate from the business combination.

6. **Business Combinations That Are Not Exchanges of Equal Values**

a. **Bargain Purchase**—If the acquisition date fair value of the acquirer's interest in the acquiree *exceeds* the acquisition date fair value of the consideration transferred for that interest, the acquirer should reduce to zero any goodwill related to that acquisition and then recognize any remaining excess as a gain on the acquisition date.

b. **Overpayment**—If the acquisition date fair value of the acquirer's interest in the acquiree is *less than* the acquisition date fair value of the consideration transferred for that interest, the acquirer would not recognize an expense on the acquisition date. Therefore, any overpayment would be subsumed in goodwill and subsequently tested for impairment.

7. **Accounting for Partial and Step Acquisitions**

a. In a partial or step acquisition, the acquirer would measure and recognize the acquiree's assets (including goodwill) and liabilities at 100 percent of their acquisition date values (generally fair value, with some exceptions).

b. In a step acquisition, the acquirer would remeasure its preacquisition noncontrolling equity investments to fair value at the acquisition date and would recognize any gain or loss in income.

8. **Accounting and Reporting of Noncontrolling Interests and Loss of Control of a Subsidiary**

a. Noncontrolling interests in subsidiaries should be presented in the consolidated balance sheet within equity separate from the parent shareholders' equity.

b. Any acquisitions or dispositions of noncontrolling interests that do not result in a change of control should be accounted for as equity transactions.

PROPOSALS IN THE EXPOSURE DRAFTS THE BOARD CHANGED IN REDELIBERATIONS

1. **Measuring and Recognizing Assets Acquired and Liabilities Assumed**

   a. **Assets Held for Sale**—The Exposure Draft on business combinations proposed an exception to the fair value measurement principle for assets held for sale (it proposed that those assets be measured at fair value less cost to sell). The Board decided instead that those assets should be measured at fair value and decided to amend FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* to replace "fair value less cost to sell" with "fair value." The decision to amend Statement 144 will be subject to future due process.

   b. **Employee Benefit Obligations**—The Exposure Draft on business combinations proposed an exception to the fair value measurement principle for obligations that are measured using actuarial methods. The Board affirmed that exception and also extended it to all employee benefit obligations (except for obligations associated with share-based payment arrangements, which the Board plans to consider at a later date). That is, all benefit obligations would be measured based on guidance in existing standards (often a measure other than fair value). If a standard allows employee benefit obligations to be measured or recognized in various ways, the acquirer would be required to measure those assumed obligations in a manner consistent with its existing accounting policies.

REMAINING ISSUES THE BOARD HAS TO DISCUSS IN REDELIBERATIONS

1. Applicability of the acquisition method to mutual entities and cooperatives and business combinations achieved by contract alone (to be discussed in December 2006).
2. Accounting for contingencies and contingent consideration (to be discussed in December 2006 and January 2007).
3. Accounting for insurance contracts (to be discussed in January 2007).
4. Recognition of separate valuation allowances for financial assets measured at fair value (to be discussed in December 2006).
5. Accounting for share-based payment awards exchanged in a business combination (to be discussed in January 2007).
6. Accounting for income taxes (to be discussed in January 2007).
7. Disclosures, transition, and effective date (to be discussed in 2007).