FASB FINANCIAL ACCOUNTING STANDARDS BOARD

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May 30, 2013

Mr. John Davidson
Mrs. Cynthia P. Eisenhauer
Co-Chairs, Standard-Setting Process Oversight Committee
Financial Accounting Foundation
401 Merritt 7
Norwalk, CT 06856-5116

Dear Mr. Davidson and Mrs. Eisenhauer:

Response of the Financial Accounting Standards Board

The Financial Accounting Standards Board (FASB) is pleased to respond to the Financial Accounting Foundation's *Post-Implementation Review (PIR) Report on FASB Statement No. 141 (Revised 2007), Business Combinations,* dated May 22, 2013 (the PIR Report).

The FASB appreciates that PIRs are an important feedback mechanism that provide insights into the effectiveness of our standards and opportunities to improve the standard-setting process. The PIR process has provided the Board with some important stakeholder feedback on the benefits and costs of Statement 141(R) in light of actual experience in using and preparing the information. The process also identified ways the FASB might improve the effectiveness, efficiency, and transparency of the standard-setting process.

The FASB evaluated the PIR Report findings following the review procedures in the *FASB Rules of Procedure* (Section IV.H.5) that lay out criteria for the review or reexamination of existing standards. Under those criteria, review or re-examination of existing standards might be indicated if information or evidence is obtained that had not previously or adequately been considered by the Board, such as evidence that the transactions or the environment have changed significantly since the standards were issued, that there have been consequences or costs that differ significantly from the Board's expectations, or that investors and other users broadly do not find the information useful. Those criteria were designed to ensure that the financial reporting system is not unduly burdened by the system-wide cost of frequent changes in accounting requirements.

In summary, the PIR Report indicates that some believe additional guidance would be helpful to resolve some of the operational aspects of Statement 141(R), including the definition of a business, separate reporting of some intangibles and goodwill, and practice issues associated with the fair value measurement guidance in FASB Statement No. 157, *Fair Value Measurements*. The FASB will consult with other parties, including certain FASB advisory groups, to understand the significance of these issues and their priority in relation to other potential agenda items. It is noted that the International Accounting Standards Board (IASB) is beginning a PIR of IFRS 3 (as issued in 2008), *Business Combinations,* which is largely converged with Statement 141(R), and the Financial Accounting Foundation (FAF) is beginning a PIR of Statement 157. The FASB believes that any plan to undertake a separate project to review or amend Statement 141(R) should be coordinated with the IASB once the PIR of IFRS 3 is complete and should consider the results of this PIR Report, the PIR Report on IFRS 3, and the PIR Report on Statement 157. We will report back to the FAF's Oversight Committee as progress is made.

Evaluation of the Findings in the FAF PIR Report

Potential Need for Standard-Setting Action

The FASB welcomes the positive PIR Report findings that Statement 141(R) (a) is operational, and the requirements are understandable and generally can be applied as the FASB intended, (b) addresses all of the significant practice issues encountered in applying the purchase (acquisition) method of accounting for business combinations, and (c) generally improves the relevance, representational faithfulness, and comparability of business combination information, and that information is generally useful for understanding and analyzing business combination transactions. The PIR Report also states that investors generally view the information provided by Statement 141(R) as decision useful, including the measurement of the assets acquired and liabilities assumed at fair value.

The PIR Report also relays some concerns about certain technical provisions of Statement 141(R). Those concerns are discussed further below.

Fair Value Measurement Using Guidance in Statement 157

The PIR report outlines concerns that the requirement to measure the assets acquired and liabilities assumed using the fair value guidance in Statement 157 results in (a) some difficulty with applying the requirements of Statement 141(R), including difficulty with measuring the fair value of some hard to value assets and liabilities such as contingent consideration and certain intangibles, (b) unanticipated consequences such as increased complexity of models being used to measure assets and liabilities that do not have readily determinable fair values and structuring the timing of business combinations to allow sufficient time to complete the required valuations, and (c) increased complexity and costs related to the extensive external valuation expertise being sought by both preparers and auditors of financial statements.

Statement 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." As stated in paragraph B247 of Statement 141(R), the FASB considered using the definition of fair value from IFRS 3 (as issued in 2004), which was "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." However, the Board decided that to do so would be inappropriate in light of the concurrent issuance of Statement 157, which it intended for use in all situations in which a new standard requires measurement at fair value. The FASB acknowledged certain difficulties in applying the fair value measurement guidance in Statement 157 and formed the Valuation Resource Group (VRG) in June 2007 to provide the Board and staff with information on existing implementation issues related to fair value measurements used for financial statement reporting purposes and the alternative viewpoints that may be associated with those implementation issues. The VRG discussed issues related to business combinations, including fair value measurement of contingent consideration in a business combination.

The FASB also notes that after the issuance of Statement 141(R), the Public Company Accounting Oversight Board (PCAOB) has increased its focus on auditing fair value measurements as evidenced by public PCAOB inspection reports for large public accounting firms. This has resulted in greater focus by preparers and auditors on testing and documenting significant assumptions and inputs used in fair value measurements, which in turn may affect the complexity of valuation techniques used to measure fair value, the time required to complete required valuations and the use of external valuation expertise to measure the fair value of assets acquired and liabilities assumed in a business combination. The FASB has recently heard similar concerns about determining the fair value of other assets and liabilities. The FASB welcomes the FAF's recent announcement that Statement 157 will undergo a PIR, and we request that the team inquire about these environmental issues that may be contributing to the cost and complexity of applying the requirements.

Issues Not Resolved by Statement 141(R)

The PIR Report's findings indicate that there are certain issues that Statement 141(R) did not resolve, including identifying when a new basis of accounting is appropriate and accounting for combinations between entities under common control and joint ventures. The FASB believes that these scope issues were carefully considered during the development of Statement 141(R) and were intentionally excluded from the scope during Phase 2 of the business combinations project. Paragraphs B59 through B61 of Statement 141(R) explain that formations of joint ventures and combinations of entities under common control were excluded from the scope of both Statement 141 and IFRS 3 (as issued in 2004), and the Boards were not aware of anything that had happened since Statement 141 and IFRS 3 were issued to suggest that the issuance of Statement 141(R) should be delayed to address the accounting for those events. Accounting issues related to new basis first were moved to a separate project and then subsequently removed from the Board's agenda due to higher priority projects. However, recently a new project was added to the Emerging Issues Task Force (EITF) agenda to address certain issues relating to the appropriateness of a new basis of accounting. Specifically, EITF Issue No. 12-F, *Recognition of New Accounting Basis (Pushdown) in Certain Circumstances,* addresses whether an acquired entity should establish a new accounting basis in its standalone financial statements as a result of a purchase transaction accounted for as a business combination by the acquiring entity, and if so, the level of change in ownership at which the new accounting basis should be required.

The findings also indicate that some preparers and practitioners have difficulties identifying and measuring the intangible assets acquired in a business combination. The Private Company Council (PCC) recently added a project to address those concerns.

Determining Whether a Transaction Is a Business Combination or an Asset Purchase (Definition of a Business)

The PIR findings indicate that some preparers also have difficulty applying the requirements of Statement 141(R) that relate to determining whether a transaction is a business combination or an asset purchase. As outlined in paragraphs B15 through B22 of Statement 141(R), the FASB responded to some stakeholders' concerns on this issue in Phase 2 of the business combinations project by reconsidering previous guidance on whether a group of net assets constitutes a business in EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*. The result is that the definition of a business combination in Statement 141(R) provides that a transaction or other event is a business combination only if the assets acquired and liabilities assumed constitute a business (an acquiree), with paragraph 3(d) of Statement 141(R) defining a business as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants." In response to certain stakeholders' concerns that arose after the issuance of Statement 141(R), in November of 2011, the FASB chairman added a research project to the Board's agenda to explore whether and when asset- or entity-based guidance should be applied to the acquisition (or disposition) of an entity that substantially consists of a nonfinancial asset or nonfinancial assets. More recently, on May 29, 2013, the FASB added a standard-setting project to clarify the definition of a business with the objective of addressing whether transactions involving in-substance nonfinancial assets (held directly or in a subsidiary) should be accounted for as acquisitions (or disposals) of nonfinancial assets or as acquisitions (or disposals) of businesses.

Reliability or Decision Usefulness of Certain Information

The PIR Report indicates that some stakeholders that participated in the review question the reliability or decision usefulness of the reported information about business combinations that (a) include assets and liabilities that are difficult to measure at fair value, (b) result in a bargain purchase, and (c) in substance are asset purchases. In particular, some review participants believe that some business combination disclosure requirements are too generic to provide the information that investors need to understand the reported fair values, that the definition of a business may be overly broad, and that bargain purchases and the required treatment of the bargain purchase gain may not accurately portray the nature of the transaction.

The findings also indicate that users and preparers question the relevance and complexity of the reporting of loans acquired in a business combination. The Board has been aware of this issue and has been working to address it as part of its financial instruments project.

Overall Implications and Next Steps

Overall implications in the PIR Report suggest that additional guidance would be helpful to resolve some of the operational aspects of Statement 141(R), including practice issues associated with the fair value measurement guidance in Statement 157. For the issues that are not being addressed by other current projects, the FASB will consult with other parties, including certain FASB advisory groups, to understand the significance of these issues and their priority in relation to other potential agenda items.

It is noted that the IASB is beginning a PIR of IFRS 3 and the FAF is beginning a PIR of Statement 157. The FASB believes that any plan to undertake a separate project to review or amend Statement 141(R) should be coordinated with the IASB once the PIR of IFRS 3 is complete and should consider the results of this PIR Report, the PIR Report on IFRS 3, and the PIR Report on Statement 157. We will report back to the FAF's Oversight Committee as progress is made.

Process-Related Recommendations

The PIR Report contains recommendations about various aspects of the process that the FASB used in Phase 2 of the business combinations project. The FASB had previously identified and has taken action to address some of the areas that are the focus of the PIR Report process recommendations, particularly user outreach and cost-benefit considerations. In the years since Statement 141(R) was issued, we have been working continuously to expand and improve our procedures in those areas. Some of these efforts relate to the PIR Report recommendations, and other efforts undertaken or planned are discussed below.

Formal Tracking and Updates of Significant Financial Reporting Issues

The PIR Report recommends that the FASB enhance and formalize its process for identifying, prioritizing, tracking, and resolving significant financial reporting issues and to report regularly on and update the status of those issues and their relative priorities. In particular, the findings state that for certain issues not resolved by Statement 141(R) (new basis of accounting issues, the accounting for combinations between entities under common control and joint ventures, the exception in Statement 141(R) to measure assets held for sale at an amount other than fair value, and the inconsistent accounting for research and development assets acquired outside of a business combination) the documentation is not clear about the significance of these issues relative to other issues that the FASB had on its agenda, how the FASB made its priority determination, and whether and when the issues will be addressed.

The basis for conclusions of Statement 141(R) describes the reasons for continuing to exclude from the scope the accounting for combinations between entities under common control and joint ventures. Additionally, the removal of new basis of accounting issues from the scope of Statement 141(R) was discussed in a public Board meeting, minutes were prepared, and the decision was documented on the FASB's website. During Phase 2 of the business combinations project, the FASB also decided to reconsider the measurement of assets held for sale other than those acquired in a business combination and the accounting for research and development assets acquired outside of a business combination. Those projects were included as discrete items on the FASB-only portion of the Board's technical plan until the FASB chairman decided to remove them from the agenda in April 2008 and January 2009, respectively. We acknowledge that the process for identifying and prioritizing significant financial accounting and reporting issues was not widely communicated or easily retrievable and we will strive to formalize this process so that the results are more widely communicated, consistently documented, and retrievable.

Identifying and Documenting the Need for a Project

The PIR Report recommends that the FASB clearly identify and document the need that a project will address and how that determination was made. When resuming a deferred project, the FASB should document its reassessment of the need for the project. In particular, the findings state that the Statement 141(R) project files did not contain documentation of any additional research on business combination practice issues before the resumption of Phase 2 of the business combinations project or any documentation of the reasons why the scope was expanded to include the issue of allocating cost based on relative fair values (purchase price allocation) versus recognizing assets acquired and liabilities assumed at their fair values.

The FASB evaluates the need for a project in the context of several factors, including whether there is an identified and pervasive need for a change to the accounting standards and whether there is at least one technically feasible, cost-effective alternative for meeting that need. While the significant business combination practice issues and the expanded scope were extensively considered by the FASB before and during Phase 2 of the business combinations project, the FASB acknowledges that the project files did not contain robust documentation of the considerations. After the issuance of Statement 141(R), the FASB has been working to enhance and formalize the process for pre-agenda research that includes documentation of whether or not the criteria have been met for adding a project to the Board's standard-setting agenda. The FASB will continue to monitor the process to evaluate whether further refinements are necessary.

Continue Efforts to Improve User Input in Agenda-Setting and Early Deliberation Phases

The PIR Report recommends that the FASB continue its efforts to obtain user input about their informational needs early in the agenda-setting and deliberation phases to help the Board evaluate how various accounting and reporting alternatives will address those needs.

The objective of Statement 141(R) is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. In 2003 and 2005, the FASB discussed certain business combination issues with the User Advisory Council, a FASB advisory group that included representation from individual and institutional investors, equity and debt analysts, lenders, and credit agencies. We acknowledge that other user feedback was received primarily during the comment period. However, as noted above, since the issuance of Statement 141(R) we have been working to enhance and formalize the pre-agenda research process, including understanding and documenting user perceptions of the need for a change to the accounting standards. We also have made significant progress in gathering user input since the completion of the Statement 141(R) project through various means, including consistently involving users in our various advisory groups and roundtable meetings and adding senior staff members who have investment analysis experience to proactively lead project-specific outreach efforts with a broad range of investors and other users. In addition, we have expanded user representation on the Board. We will strive to more consistently engage users in each phase of a project, including the pre-agenda research.

Research During the Agenda-Setting and Deliberation Phases

The PIR Report states that the Board deliberated the bargain purchase issue in both Phase 1 and Phase 2 under the assumption that bargain purchases were "rare;" however there was no reference to the origin or basis of that assumption. In addition, the PIR Report suggests that academic research on Statement 141(R) contradicts that assumption. The PIR Report, therefore, recommends that the FASB consider conducting key research (field work and reviewing academic studies) as early as possible in the agenda-setting and deliberation phases and that the FASB and its staff fully identify (e.g., in a standard's basis for conclusions) the research and/or economic principles relied upon when concluding on a significant issue.

Paragraph B371 of Statement 141R states the following:

> The Boards consider bargain purchases to be anomalous transactions—business entities and their owners generally do not knowingly and willingly sell assets or businesses at prices below their fair values. However, bargain purchases have occurred and are likely to continue to occur. Circumstances in which they occur include a forced liquidation or distress sale (for example, after the death of a founder or key manager) in which owners need to sell a business quickly, which may result in a price that is less than fair value.

The FASB notes that the academic research referenced in the PIR Report refers to four papers that examine bargain purchase acquisitions, and a significant number of the transactions examined were acquisitions of distressed commercial banks that occurred after the issuance of Statement 141(R). The academic research, however, is not inconsistent with statements that bargain purchases are expected to be either rare or anomalous. These statements only refer to the expected frequency of bargain purchase gains when entities are acquired at orderly (non-distressed) exchange prices.

The FASB considered the feedback of users, preparers, auditors, and others during Phase 1 of the business combinations project; however, we acknowledge that more robust documentation should be included in the project files and in the basis for conclusions about the research and economic principles upon which we relied. The FASB will strive to explain in the project files and in all future standards how it considered academic research and economic principles when concluding on a significant issue.

Consideration of Costs and Benefits

The PIR Report recommends that the FASB continue its efforts to improve its consideration of costs and benefits as it deliberates significant issues, particularly when it makes a significant change in redeliberations, and should continue its efforts to clearly document those cost-benefit considerations. In particular, the PIR Report states that no information was identified in the Phase 2 project files about what costs the Board considered in its decision-making process, and there was no information about how the changes made during redeliberations—such as the change to the fair value definition in Statement 157—would affect the expected costs of applying Statement 141(R).

The cost-benefit relationship was an important consideration of the FASB during Phase 2 of the business combinations project. The Board obtained stakeholders' feedback through comment letters and the FASB's advisory groups, and paragraphs B46 through B48, B70 and B71, and B427 of the basis for conclusions describe several stakeholders' concerns related to the cost-benefit relationship and the FASB's response to those concerns. The FASB agrees, however, that the information in the basis for conclusions does not fully describe the Board's evaluation of benefits and costs, and the project files should contain complete documentation of all cost-benefit considerations, including the effects of changes made during redeliberations. As noted in the PIR Report, the FASB has recently reassessed and enhanced the steps it takes to consider and communicate about both the costs and benefits associated with its proposed standards and will consider the PIR Report findings in its ongoing process improvement initiatives.

Future Work Plan in Response to the PIR Report

IFRS 3 and Statement 141(R) are the products of a FASB-IASB joint project, and, as noted above, the IASB is beginning a PIR of IFRS 3. Once the PIR on IFRS 3 is complete, the FASB staff will work with the IASB staff to understand the commonality and significance of the issues raised and their priority in relation to other potential agenda items. The FASB also will consider the results of the PIR on Statement 157 in determining whether operational aspects of Statement 141(R) could be improved with additional guidance. Until that time, the FASB will consider the PIR Report's findings in relation to the following projects that are already underway:

- Accounting for Financial Instruments—Impairment: Issues related to purchased financial assets with an explicit expectation of credit losses at acquisition

- Clarification of the Definition of a Business, including guidance for partial sales or transfers and the corresponding acquisition of partial interests in a nonfinancial asset or assets

- PCC projects related to separately identifying intangible assets acquired in a business combination and goodwill

- EITF Issue 12-F, *Recognition of New Accounting Basis (Pushdown) in Certain Circumstances.*

We will report back to the FAF's Oversight Committee and the full Board of Trustees as progress is made.

On behalf of the FASB, I would like to thank the FAF for undertaking this important process and all the individuals and organizations who gave their time to share their insights and experiences with the PIR staff.

Sincerely,

Leslie F. Seidman

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cc: FAF Board of Trustees, Teresa S. Polley