Financial Accounting Standards Board

International Accounting Standards Board

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## INFORMATION FOR OBSERVERS

**IASB/FASB Meeting:** **24 October 2006, London**

**Project:** **Business Combinations II**

**Subject:** **Measurement Attribute (Agenda Paper 5A) (also issued as observer note for IASB meeting Agenda Paper 2E)**

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The Board will have an **education session** on Agenda Paper 2E at its 17 October 2006 meeting. The paper will be discussed at the joint FASB-IASB meeting in Norwalk, Connecticut, USA on 24 October 2006.

Part of Agenda Paper 2E is a non-technical discussion of the strategies available to the Boards for achieving the objective of the business combinations project (to develop a converged standard on applying the acquisition method). As a result, more paragraphs have been omitted from the observer note than usual. Because the omitted paragraphs are non-technical in nature, the staff believes that this will not hinder observers from following the discussion.

## INTRODUCTION

1. At the October 2006 joint FASB-IASB meeting, the staff plans to ask the Boards to discuss the measurement attribute used in business combinations. The purpose of the meeting is to allow the Boards to have a joint discussion about the impact of recent developments in the Boards' respective fair value measurement (FVM) projects on the business combinations project. The staff does not expect the Boards to make a final decision on the measurement attribute for business combinations at the joint meeting. Rather, the staff seeks input from the Boards on what additional analysis the Boards would like the staff to perform as part of the business combinations project before a measurement attribute can be selected.

2. The first part of this paper provides the Boards with background information about developments in the Boards' FVM projects since the issuance of the Business Combinations Exposure Draft (BC ED).

3. The second part of this paper discusses the alternatives available to the Boards for selecting a measurement attribute for the assets acquired and the liabilities assumed in a business combination. The paper focuses on clarifying the measurement attribute for those assets and liabilities that the Boards previously have decided should be measured at fair value. The Boards' decisions on this paper would not apply to those assets and liabilities that the Boards have decided (or might decide in future meetings) should be an exception to the fair value measurement principle (eg, post-employment benefits).

## BACKGROUND

4. The BC ED defines *fair value* based on the definition in the FASB's Fair Value Measurements (FVM) ED as 'the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties'.

5. Since the issuance of the BC ED in June 2005, a number of decisions and changes have been made in the Boards' FVM projects.

**Update on the FASB's FVM Project**

6. On 15 September 2006, the FASB published FASB Statement No. 157, *Fair Value Measurements.* During redeliberations, the FASB clarified that the objective of a fair value measurement is an *exit price* and revised the definition of fair value to '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'.

7. The FASB's FVM project arose, in part, to provide FVM guidance for the business combinations project. In addition, Statement 157 includes several examples that refer to the accounting for assets acquired in a business combination (eg, licensing arrangements and finished goods inventory in paragraph A24).

**Update on the IASB's FVM Project**

8. In September 2005, the IASB added a FVM project to its agenda. The initial plan in the IASB's FVM project was to publish Statement 157 as an exposure draft. In June 2006, the IASB decided instead to publish Statement 157 as a discussion paper. As a result, the IASB is unlikely to have its own FVM IFRS with an effective date before 2010.

9. In recent discussions in the IASB's FVM project, some IASB members have suggested that an entry price measurement attribute also is encompassed within the concept of fair value and also would reflect current market-based expectations of flows of economic benefit into or out of the entity.[1]

[Paragraphs 10 and 11 omitted from observer note].

12. In addition, as part of its FVM project, the IASB will complete a standard-by-standard review of FVM currently in IFRSs to assess whether the measurement objective intended in those standards is consistent with any revised definition of fair value. If the IASB concludes that the intended measurement objective in a

[1] In the IASB's FVM project, an entry price measurement objective was defined for discussion purposes as 'the price that would be *paid to acquire* an asset or *received to assume* a liability in an orderly transaction between market participants at the measurement date'.

particular standard is inconsistent with the revised definition of fair value, either that standard will be excluded from the scope of the FVM ED or the intended measurement objective will be clearly communicated using a term other than *fair value* (such as *current entry price*).

## ALTERNATIVES FOR MEASURING THE ASSETS ACQUIRED AND LIABILITES ASSUMED IN A BUSINESS COMBINATION

13. The BC ED proposes that the assets acquired and liabilities assumed as part of a business combination be recognised at their acquisition-date fair values (with limited exceptions).

14. In the BC redeliberations, the Boards affirmed a fair value measurement attribute for business combinations.[2] However, the Boards did not discuss the definition of fair value at that time.

[Paragraphs 15 and 16 omitted from observer note].

### Alternatives

17. The primary objective of the business combinations project is to develop a converged standard on applying the acquisition method. The Boards' goal is to issue final standards that are as close to identical as possible. Given that objective, the staff believes that the Boards have the following alternatives for measuring the assets acquired and liabilities assumed in a business combination:[3]

    a. Alternative A—Each Board uses its existing definition of fair value.

    b. Alternative B—Both Boards use an exit price measurement attribute.

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[2] Refer to minutes for the March 2006 Board meetings.

[3] The staff also considered and rejected another alternative—using the fair value definition and related guidance in Statement 157, but *from the perspective of the acquiree* rather than *from the perspective of the acquirer*. That is, the acquirer would measure the assets acquired and liabilities assumed in a business combination based on the acquiree's exit prices for those assets and liabilities. The acquiree's exit price would presumably be the acquirer's entry price for those assets and liabilities. This alternative could be viewed as a way to reconcile the guidance in Statement 157 and an entry price objective from the perspective of the acquirer. However, the staff rejects this alternative because we view it as inconsistent with the objective of Statement 157. In the staff's opinion, if the Boards decide that an entry price measurement attribute is appropriate, the Boards should be explicit about that decision and select Alternative C.

c. Alternative C—Both Boards use an entry price measurement attribute.

18. The staff developed these alternatives on the presumption that the Boards want to retain a current exchange price measurement attribute (ie, either entry or exit price) for the assets acquired and liabilities assumed in a business combination. The staff seeks input from the Boards on whether there are other alternatives that they would like the staff to consider.

***Alternative A***

19. Alternative A is for each Board to use its existing definition of fair value. That is, the FASB would use the definition of fair value and related guidance in Statement 157 and the IASB would use the definition of fair value in IFRS 3. [Remainder of paragraph omitted from observer note].

20. Alternative A would be an interim step for the IASB that would be reviewed as the IASB's FVM project progresses. As noted above, in its FVM project, the IASB will review existing standards to determine whether the measurement attribute is consistent with any revised definition of fair value. Therefore, the IASB might decide to amend the FVM guidance in the revised IFRS 3 at that time.

21. If the Boards select Alternative A, the staff suggests that the Boards' final business combinations standards include a discussion of when and why measurements using the fair value definition in IFRS might differ from those using the fair value definition in Statement 157.

***Alternative B***

22. Alternative B is for both Boards to use an exit price measurement attribute for the assets acquired and liabilities assumed in a business combination. The FASB would describe the measurement attribute as *fair value.* The FASB's final business combinations standard would be in the scope of Statement 157. Therefore, the definition of fair value and related guidance in Statement 157 would apply. That is, the acquirer would measure the assets acquired and the liabilities assumed in a business combination at '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' (an exit price objective).

23. The staff believes that the IASB cannot change the definition of fair value in the business combinations project because the IASB is in the middle of its FVM project. However, the staff believes that this does not preclude the IASB from deciding to use an exit price measurement attribute in the final business combinations standard. That is, the IASB could decide to use an exit price measurement attribute in the final business combinations standard but use a label other than fair value for that measurement attribute. The most obvious way to define that attribute is to use the wording in Statement 157.

***Alternative C***

24. Alternative C is for both Boards to use an entry price measurement attribute. Neither the FASB nor the IASB have well-developed guidance for measuring entry prices at this time. Therefore, this alternative could involve developing an entry price measurement attribute and related guidance in the business combinations project (or as part of another project).

**Factors to Consider**

25. The staff outlines the following factors for the Boards to consider.

[Paragraphs 26 and 27 omitted from observer note].

***Decision Usefulness***

28. The goal of the business combinations project is to develop a standard that includes a common set of principles and related guidance that produces decision-useful information and minimises exceptions to those principles. The standard should improve the completeness, relevance, and comparability of financial information about business combinations. The Boards have decided that one way to improve the decision usefulness of financial information is to require that the assets acquired and the liabilities assumed be measured consistently at a relevant attribute. The Boards previously have decided that

fair value is the relevant measurement attribute. However, now that Statement 157 has clarified the difference between exit prices and entry prices, the question for the Boards is whether exit prices or entry prices provide more decision-useful information about the assets acquired and liabilities assumed in a business combination.

29. The Basis for Conclusions in Statement 157 includes the following discussion in support of an exit price objective:

> C26 The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received for the asset or paid to transfer the liability at the measurement date, that is, an exit price. The Board concluded that an exit price objective is appropriate because it embodies current expectations about the future inflows associated with the asset and the future outflows associated with the liability from the perspective of market participants. The emphasis on inflows and outflows is consistent with the definitions of assets and liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements.* Paragraph 25 of Concepts Statement 6 defines assets in terms of future economic benefits (future inflows). Paragraph 35 of Concepts Statement 6 defines liabilities in terms of future sacrifices of economic benefits (future outflows).

30. Some IASB members believe that an entry price also reflects current market-based expectations of flows of economic benefit into or out of the entity and therefore also would be consistent with the definitions of assets and liabilities in the *Framework*.

31. The question for the Boards is whether the measurement of the assets acquired and liabilities assumed in a business combination at initial recognition should reflect (a) the characteristics of the asset or liability at the time of the transaction considering the markets in which the reporting entity could acquire the asset or assume the liability (an entry price) or (b) a measure of the recoverability of an asset or the expected economic outflow of a liability (an exit price).

[Paragraphs 32-34 omitted from observer note].

***Importance of Control***

35. Some staff members have questioned whether measuring the assets acquired and liabilities assumed in a business combination at an exit price is consistent with the emphasis that has been placed on control in the business combinations project.[4] Those staff members believe that an acquirer cannot access a different market (ie, the exit market) for an asset or liability until it has control over that asset or liability. Therefore, those staff members believe that the assets acquired and liabilities assumed in a business combination should be measured at an entry price at initial recognition. If another IFRS/US GAAP requires an asset or liability to be remeasured at fair value, the acquirer would recognise a gain or loss on remeasurement after initial recognition when the acquirer has obtained control of that asset or liability.

36. Other staff members believe that the assets acquired in a business combination *are* controlled by the acquirer at the acquisition date (otherwise, they would not be assets of the acquirer). Therefore, those staff members do not believe that control is a factor influencing the selection of a measurement attribute.

***Financial Instruments***

37. If the Boards decide that the assets acquired and liabilities assumed in a business combination should be measured at an exit price, the staff is considering whether the final business combinations standard should require that any 'day one' gains or losses on financial instruments should be recognised separately from goodwill. The staff is considering this matter to align the accounting for financial instruments acquired as part of a business combination with the acquisition of financial instruments outside a business combination. If a financial instrument is acquired outside a business combination, any 'day one' gain or loss is recognised in profit or loss/income. In contrast, if that financial instrument was acquired as part of a business combination and measured at exit

[4] In Phase II of the business combinations project, the Boards have defined a business combination as 'a transaction or other event in which an acquirer obtains **control** of one or more businesses.' 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.

value at initial recognition, any ‘day one’ gain or loss might be measured in goodwill.[5] [Remainder of paragraph omitted from observer note].

[Remainder of paper omitted from observer note].

[5] The ‘day one’ gain or loss would be the difference between the consideration transferred for that financial instrument (an entry price) and the amount at which the financial instrument is recognised on initial recognition (an exit price).