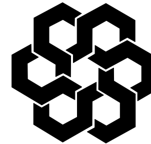

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These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB/FASB Meeting: **24 April 2007, London**

Project: **Business Combinations II**

Subject: **Sweep Issues (Agenda Paper 2I)**

PURPOSE OF THIS MEMORANDUM

1. This memo addresses the remaining sweep issues that the Boards need to address before the staff will ask for approval to begin drafting the final business combinations and noncontrolling interests standards. These are the issues that the staff is aware of at this point. If any new issues come to the staff's attention as part of the drafting process, the staff will bring those to the Boards at a later date. The identified issues include:

   a. Measuring the noncontrolling interest at fair value *(non-convergence issue).*

b. If the acquiree is a lessor to an operating lease, how the acquirer should recognize any off-market portion of the operating lease *(non-convergence issue)*.

c. Classification of long-lived assets as held for sale in a business combination *(non-convergence issue)*.

d. Measuring and recognizing an indemnification asset when the related liability is measured or recognized differently.

e. Designating an effective date other than the acquisition date.

A. MEASURING THE NONCONTROLLING INTEREST AT FAIR VALUE (*NON-CONVERGENCE ISSUE*)

2. During redeliberations, the Boards considered an alternative way of addressing the issue of full goodwill. They considered changing the focus to measuring any noncontrolling interests at fair value in a partial acquisition. The natural result of measuring the noncontrolling interest at fair value is to recognize the goodwill attributable to the noncontrolling interest (that is, full goodwill). The FASB agreed with the change in focus. The IASB still has concerns about measuring the noncontrolling interest at fair value. To address those concerns, the IASB decided to require that the noncontrolling interest be measured at fair value unless doing so would impose *undue cost or effort* on the acquirer. That approach is an exception to the fair value measurement principle. As such, the acquirer would measure noncontrolling interest at its proportionate interest in the identifiable assets and liabilities of the acquiree. (The acquirer would also be required to disclose the reasons for not measuring the noncontrolling interest at fair value.)

3. The staff continues to believe that measuring the noncontrolling interest at fair value is the preferable approach. We believe it is conceptually the right answer and is consistent with the fair value measurement principle. The Boards have concluded that goodwill meets the definition of an asset. Measuring the noncontrolling interest at fair value results in the

acquirer recognizing the noncontrolling interest's share of goodwill as an asset consistently with how the acquirer would recognize the noncontrolling interest's share in all other recognized assets. We believe it will lead to a simpler and more understandable standard and simpler and more understandable financial reporting. It will simplify goodwill impairment testing in future periods. It will also reduce the effect to equity if additional noncontrolling interests are acquired after the standards become effective. *[Sentences omitted from observer note]*

4. The IASB and the FASB have converged on most aspects of accounting for business combinations. There are a few exceptions such as when the Boards have significantly different legacy guidance (contingencies, income taxes, and pensions) and a few other less significant convergence issues discussed later in this memo. The Boards might find it acceptable to diverge on measuring the noncontrolling interest at fair value since it only affects the initial measure of noncontrolling interests and goodwill when a partial interest is acquired and the fair value of the noncontrolling interest cannot be measured without *undue cost or effort*. However, the staff is asking the FASB if it wants to pursue the approach developed by the IASB?

Question: Does the FASB want to pursue the **undue cost or effort** ***exception for measuring the noncontrolling interest at fair value developed by the IASB?***

B. IF THE ACQUIREE IS A LESSOR TO AN OPERATING LEASE, HOW THE ACQUIRER SHOULD RECOGNIZE ANY OFF-MARKET PORTION OF THE OPERATING LEASE (*NON-CONVERGENCE ISSUE*)

5. In February, the Boards reached different conclusions about how an acquirer should measure and recognize assets subject to operating leases in which the acquiree is the lessor.

6. The FASB decided that an acquirer should measure and recognize an asset subject to an operating lease at its acquisition date fair value without considering the terms of the operating lease (that is, the acquirer accounts for the above- or below-market value of the lease separately). If the terms of the operating lease are favorable (unfavorable) relative to market terms at the acquisition date, the acquirer would recognize an intangible asset (liability) separate from the asset subject to the operating lease. The FASB's decision (a) affirms the guidance that was proposed in the business combinations Exposure Draft, (b) is the same as the requirements of Statement 141, and (c) is consistent with an example provided in EITF Issue No. 01-3, "Accounting in a Business Combination for Deferred Revenue of an Acquiree." The FASB reached that conclusion because:

    a. The intangible asset (liability) for the favorable (unfavorable) terms of the operating lease would be released into income over the remaining lease term, which better reflects the economic reality, rather than over the useful life of the asset.

    b. Separate recognition of the favorable or unfavorable portion of the operating lease provides better information to users of the financial statements.

    c. It seems inappropriate to embed an attribute of a lease contract into the fair value of an asset.

    d. The lessor's and the lessee's accounting for the off-market portion of an operating lease would be the same.

7. In contrast, the IASB decided that an acquirer should measure and recognize the asset subject to an operating lease at its acquisition date fair value considering the nature, location, or condition of the asset and the contractual terms of the leases and other contracts relating to the asset. Therefore, the fair value of an acquired asset that is subject to an operating lease reflects the favorable or unfavorable terms of the operating lease and a separate asset or liability is not recognized. The IASB reached that conclusion because:

a. The cash flows a market participant can generate from an asset are affected by the terms of the in-force operating leases. Market participants would consider the terms of leases when pricing the asset just as they would consider any other contractual enhancements or restrictions attached to the asset.

b. IFRS permits an entity to "componentize" an asset and depreciate the parts over different periods. Thus, the off-market portion could be amortized/accreted over the lease term even though the asset would be depreciated over its useful life.

c. Separate recognition would create a conflict with IAS 40, *Investment Property,* and potentially a need to amend IAS 40. Since this issue would likely be reconsidered as part of the IASB's fair value measurement and leasing projects, there was no need to amend IAS 40 at this point.

8. The staff is asking whether either of the Boards wants to change their decision to reach convergence. The staff believes that that difference would not result in a significant divergence on the acquisition date because the issue is only one of where on the balance sheet to recognize the off-market portion (separately or aggregated with the related asset). Thus, the measure of goodwill would not be affected on the acquisition date. A difference might arise in subsequent periods depending on how the off-market portion is amortized or accreted. However, if the off-market portion is amortized or accreted over the lease term instead of over the life of the asset, the difference should be minimized.

9. The staff notes that differences will arise in subsequent periods anyway because of our different impairment models and underlying GAAP and IFRSs. The staff's conclusion is that this issue may not be significant enough to cause disruption to our existing practices and U.S. GAAP and IFRSs.

Question: Do either of the Boards want to change their view for the sake of convergence?

C. CLASSIFICATION OF LONG-LIVED ASSETS AS HELD FOR SALE IN A BUSINESS COMBINATION (*NON-CONVERGENCE ISSUE*)

10. The business combinations Exposure Draft proposes an exception to the fair value measurement principle for assets held for sale. Therefore, long-lived assets acquired in a business combination that meet the held-for-sale criteria would be measured at *fair value less costs to sell* in accordance with IFRS 5 and Statement 144.

11. In May 2006, the Boards redeliberated the proposed exceptions to the fair value measurement principle. The Boards decided that long-lived assets held for sale should not be an exception to the fair value measurement principle. They believed that assets held for sale should be measured at *fair value*. The Boards decided to amend Statement 144 and IFRS 5 to change the measurement attribute to *fair value* rather than *fair value less costs to sell*. Those amendments need to be exposed and will be made by the Boards separate from the business combinations project.

12. In addition, paragraph 11 of IFRS 5 and paragraph 32 of Statement 144 allow an acquirer to classify long-lived assets acquired in a business combination as held for sale if (a) the sale is expected to be completed within one year and (b) the other criteria are probable of being met within a short period from the acquisition date (usually within three months).[1]

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[1] Paragraph 30 of Statement 144 requires an entity to classify long-lived assets (disposal group) as held for sale in the period in which six criteria are met. The requirements in IFRS 5 are similar. The six criteria in Statement 144 are:

a. Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group).
b. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).
c. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated.
d. The sale of the asset (disposal group) is *probable*, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale within one year.

The staff believes the Boards had different intents with regard to the classification of assets held for sale *at* the acquisition date. The FASB decided to amend Statement 144 to eliminate the guidance in paragraph 32. Thus, the FASB decided that an acquirer would have to meet all of the criteria *at* the acquisition date to classify a long-lived asset as held for sale at that date. Because it is unlikely than an acquirer could meet all of the criteria on the acquisition date, it is unlikely that an acquirer would be able to classify long-lived assets as held for sale *at* the acquisition date.

13. The IASB did not discuss deleting the equivalent guidance in paragraph 11 of IFRS 5. Therefore, an acquirer *would be* allowed to classify long-lived assets as held for sale if (a) the sale is expected to be completed within one year and (b) the other criteria are probable of being met within a short period from the acquisition date (usually within three months). This was not an oversight. Some IASB Board and staff members believe the acquirer should be allowed to classify long-lived assets as held for sale at the acquisition date if the acquirer intends to sell the long-lived assets within one year and the other recognition criteria are probable of being met within a short period from the acquisition date.

14. The concerns of the IASB Board members and the staff fall into two categories: concerns about *presentation* and concerns about *measurement*.

15. Some IASB Board members and staff question why the Boards would want to require an acquirer to present long-lived assets it expects to sell together with the assets they intend to use in operations only to later reclassify the assets they intend to sell. They question how that would

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e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value.
f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

provide useful information to users. The staff understands that this concern was a primary motivation in providing a three-month period to meet the criteria for newly acquired assets in IFRS 5 and Statement 144.

16. Some IASB Board members and staff also question why the Boards would want to require an acquirer to measure the individual assets and liabilities at fair value in a business combination rather than allowing the acquirer to measure the fair value of the disposal group itself. In some cases, to determine the fair value of the disposal group, an acquirer may have to measure the fair value of the individual assets and liabilities to build up to the fair value of the whole disposal group. However, in other cases, the acquiree may have been marketing the disposal group or the acquirer may market the disposal group. So, the acquirer might be able to measure the fair value of the disposal group as a whole. Some IASB Board and staff members believe it would be costly to require the acquirer to measure the fair value of the individual assets and liabilities of the disposal group when the acquirer might be able to measure the fair value of the disposal group as a whole with very little cost. If the acquirer is not permitted a short period of time after the acquisition to meet the classification criteria, the acquirer will be required to separately measure the individual assets and liabilities at their fair value. This requirement would seem to add additional cost of compliance to the preparer without providing any informational benefit.

17. Some question whether allowing an acquirer to classify long-lived assets as held for sale if the criteria can be met within a short period conflicts with the decisions reached about restructuring reserves. The Boards decided that an acquirer would need to meet the criteria in Statement 146 or IAS 37, as of the acquisition date, to recognize a liability as part of the business combination for planned restructuring. The staff thinks the issues are different. The assets held for sale issue is one of balance sheet classification. For restructuring reserves, the

Boards decided to prohibit entities from prematurely recognizing liabilities as part of the business combination accounting. For that reason, the staff thinks there is no conflict.

18. The staff believes that this is an issue on which the Boards should converge. For the reasons described above, the staff recommends allowing an acquirer to classify long-lived assets as held for sale if the sale is expected to be completed within one year and the other criteria are probable of being met within a short period from the acquisition date (usually within three months).

Question: Do the Boards agree that they should reach convergence on this issue?

Question: Does the FASB want to change its decision and allow an acquirer to classify long-lived assets as held for sale if the sale is expected to be completed within one year and the other criteria are probable of being met within a short period from the acquisition date (usually within three months)? That is, does the FASB want to change its decision and retain the guidance in paragraph 32 of Statement 144?

D. MEASURING AND RECOGNIZING AN INDEMNIFICATION ASSET WHEN THE RELATED LIABILITY IS MEASURED OR RECOGNIZED DIFFERENTLY

19. A few constituents have contacted the staff about a potential inconsistency with measuring an asset for an indemnification at fair value at the acquisition date when the related liability is measured using a different measurement attribute on that date. Resource group members contacted the staff about this issue primarily in the context of Interpretation 48.

20. Interpretation 48 requires an entity to measure a tax position that meets the more-likely-than-not recognition threshold at the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority (paragraph 8, paraphrased). A

few resource group members have told the staff that the acquirer in a business combination often requires the sellers to provide the acquirer with an indemnification against particular tax uncertainties. Therefore, the sellers are required to reimburse the acquirer for any payments the acquirer eventually makes for those particular tax uncertainties. In that case, at the acquisition date, the acquirer would recognize a liability for the tax uncertainty and an asset for the indemnification. The staff believes that the acquirer would have to recognize the asset and liability separately since there would be no right of setoff since the liability is owed to the taxing authority and the reimbursement would be due from the seller. The asset would be a contingency that would be measured at fair value in a business combination. The liability would be measured in accordance with Interpretation 48 since income taxes are an exception to the fair value measurement principle. The liability would likely be measured at an amount that exceeds fair value given the measurement guidance in Interpretation 48.

21. The resource group members raised only the measurement issue. It seems like a similar issue also could exist if a liability and related indemnification asset have different recognition thresholds.

22. Constituents have not contacted the IASB staff about this issue. However, the staff notes that the measurement attribute for tax uncertainties under IAS 12 is not fair value. Thus, a similar issue could exist.

23. The staff is asking whether, at the acquisition date, an acquirer should be allowed to measure or recognize the asset for an indemnification agreement differently from the related liability?

24. IAS 37 prohibits an entity from recognizing an asset for a reimbursement in excess of the liability (provision) (paragraph 53). However, in the example described above, the asset would likely be less than the liability

given the measurement attribute in Interpretation 48. The staff believes that the Boards have two alternatives.

a. **Alternative One**: The Boards can allow an acquirer, at the acquisition date and subsequently, to measure and recognize an asset for an indemnification using a different measurement attribute or recognition threshold than the liability.

b. **Alternative Two**: The Boards can require an acquirer, at the acquisition date and subsequently, to recognize an asset for an indemnification at the same amount as the related liability. If the Boards decide that this alternative is appropriate, the staff would need to think further about any implications it could have.

25. The staff believes Alternative One might be acceptable since there are limited instances of when the liability might be measured or recognized differently. That is, most liabilities against which an acquirer would require an indemnification in a business combination would likely be contingencies that would measured at fair value and would be subject to the same recognition thresholds as the related asset. The staff is only aware of income tax related indemnifications that result in this mismatch. Thus, the population of the types of agreements that result in this inconsistency is expected to be limited.

26. The problem with Alternative One is that because the asset and the liability were measured or recognized initially at different amounts, the amount recognized in the income statement in any reporting period after the acquisition date would not off-set each other even though, economically, it seems like they should.

27. The staff notes that if the Boards require the acquirer to recognize an asset for an indemnification at the same amount as the related liability, it would be an exception to the fair value measurement principle.

28. This issue is also arising outside of a business combination. For example, constituents have raised similar concerns with mutual funds when they are indemnified from the fund manager. Other types of

transactions that have been raised include spin-off transactions in which a former subsidiary indemnifies a former parent or vice versa. In these other situations, concerns are raised with the measurement inconsistency and with the different recognition thresholds. If an indemnification was considered a gain contingency under Statement 5, the asset for the gain contingency would not be recognized at the same point in time that the liability for the tax uncertainty would be. Thus, this measurement inconsistency also exists outside of a business combination.

29. The staff believes the Boards should address the business combination aspect of this issue. Some have suggested that the FASB's TA&I committee should consider it. However, if the FASB's TA&I group considers it but the IASB does not, a potential for creating divergence exists. Therefore, the staff would prefer that the Boards consider the issue together.

Question: Do the Boards believe that this issue should be addressed further?

E. DESIGNATING AN EFFECTIVE DATE OTHER THAN THE ACQUISITION DATE

30. For convenience, Statement 141 allows an acquirer to designate as the effective date the end of an accounting period between the date the business combination is initiated and the date the business combination is consummated. If the designated effective date differs from the acquisition date, the cost of the entity and the net income is reduced by imputed interest (paragraph 48, paraphrased).

31. The BC ED proposed eliminating that convenience exception. Eliminating the exception is consistent with the current requirements of IFRS 3. The basis for conclusions states that "the [FASB] Board

concluded that to faithfully represent an acquirer's financial position and results of operations, the acquirer should account for all business combinations at the acquisition date. That is, its financial position should reflect the assets acquired and liabilities assumed at the acquisition date—not before they are obtained or assumed. Moreover, the acquirer's financial statements for the period should include only the cash inflows and outflows, revenues and expenses, and other effects of the acquiree's operations after the acquisition date."

32. Two respondents raised this issue in their comment letters. They disagreed because of cost-benefit and practicability concerns. One respondent stated:

> We disagree with the proposal, as discussed in paragraphs B53 – B55, to eliminate the "convenience" exception. This exception allowed the acquirer to designate an alternative date for the acquisition (i.e., as if it took place at the beginning of the acquirer's reporting period). Given the disruption that occurs in an acquired entity, forcing a mid-month closing can be onerous, can delay the preparation of quarterly and annual filings (the timing for which gets tighter and tighter) and, frankly, can produce a slow start for the more important process of the fair value allocations. Allowing for a date of convenience permits the acquiree to close on its historical closing schedule without developing an artificial stub-period that disrupts general ledger closings and adds tremendous work to the process without any clear benefit.
>
> The requirement to report for the period ending other than on a regular closing schedule creates several challenges most of which stem from the imbedded functionality of the accounting systems. Typically, these systems do not have the faculty to close mid-period. The acquirer would be presented with extraordinary challenges when the acquiree is a large organization that utilizes multiple accounting systems and various data-managing platforms that could not be easily and timely converted to allow the cut-off information to be accumulated for accurate reporting. If the acquirer will be obligated to report on the mid-period financial results, it would entail creating estimates and backtracking from the period end. Estimating adjustments might potentially cause incorrect reporting of the stub-period. In addition, the acquirer would undertake the project to covert the

books and records of the acquiree to the same platform as used in-house. These projects present their own obstacles and can sometimes take a year to complete. [CL #240]

33. The staff believes that the practical issues raised by the two respondents are a matter of materiality. That is, the difference between the effective date and the acquisition date is most likely not going to have a material effect on the financial statements. If, however, using the effective date would have a material effect on the financial statements, the staff believes that the acquisition date should be used. The staff is asking the Boards whether they want to allow such a convenience exception in the final business combinations standard? That said, the staff recommends that no such exception be made.

Question: Do the Boards want to allow such a convenience exception in the final business combinations standard?