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## Proposed Requirements on Business Combinations and Noncontrolling Interests

Companies will record business combinations at full fair value and treat noncontrolling or minority interests as components of equity in the consolidated financial statements, if two new proposed FASB Statements are adopted.<sup>1</sup> The proposed Statements would also expand the definition of a business, change the accounting for “step acquisitions,” and require companies to account for acquisitions of mutual entities using the purchase method, which would be renamed the “acquisition method.”

The proposed Statement on business combinations would replace Statement 141, and the proposed Statement on noncontrolling interests would replace ARB 51.<sup>2</sup> However, much of the guidance in the replaced pronouncements would be retained.

### Scope of Business Combinations Proposal

The business combinations proposal would apply to transactions in which an entity (the acquirer) obtains control of one or more businesses (the acquiree or acquirees). The ED’s definition of a “business” would include a “mutual entity,” as that term is defined.<sup>3</sup> The proposal would therefore extend the acquisition method to combinations that include mutual entities, which are currently accounted for using an “as-if pooling method,” but would not apply to not-for-profit entities.<sup>4</sup> The acquisition method would also have to be applied if control is

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<sup>1</sup> FASB Proposed Statement, Business Combinations: a replacement of FASB Statement No. 141, June 30, 2005; FASB Proposed Statement, Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries: a replacement of ARB No. 51, June 30, 2005; both available at [www.fasb.org](http://www.fasb.org).

<sup>2</sup> FASB Statement No. 141, Business Combinations, June 2001, available at [www.fasb.org](http://www.fasb.org); Accounting Research Bulletin No. 51, Consolidated Financial Statements, August 1959.

<sup>3</sup> A mutual entity is defined in the proposed Statement as an entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants.

<sup>4</sup> The FASB is expected to issue a separate Exposure Draft addressing business combinations involving not-for-profit organizations in the fall of 2005.

obtained through means other than a purchase of equity interests or net assets, such as by contract alone. This can occur, for example, when a minority shareholder's substantive participating rights expire.<sup>5</sup> The proposal would make explicit that the acquisition method applies to initial consolidations of variable interest entities that are businesses.

The acquisition method's applicability would also be broadened by the proposed Statement's definition of a business, which would supersede the one in EITF 98-3.<sup>6</sup> The new definition is based on the notion that a collection of activities and assets that are *capable* of being managed to provide economic benefits to owners, members, or participants is a business. Thus, a set of activities and assets can be a business under the proposed definition even if it cannot currently access customers and even if it is a development-stage entity. However, applying the new definition would demand subjective judgments, as did EITF 98-3's.

### The Acquisition Method

Under the acquisition method, the acquirer must determine the acquisition-date fair value of the acquired business and measure and recognize the individual assets acquired and the liabilities assumed. The acquisition date is the date that the combination is consummated and the acquirer obtains control over the acquired business.

The proposal explicitly requires that the acquirer be identified in all business combi-

nations and provides guidance on how to make the identification. The fundamental concept is the same as Statement 141's—the acquirer is the entity that obtains control of the other business or businesses. However, the proposal requires that the guidance in Interpretation 46R on determining the primary beneficiary in a variable interest entity be used to identify the acquirer.<sup>7</sup> If the acquirer cannot be identified in this way, the proposal looks to the form of consideration transferred. In an exchange of equity interests, the following factors would be considered:

- The relative voting rights in the combined entity,
- Whether a minority voting interest in the combined entity is larger than that of any other owner's or organized group of owners' voting interest,
- The composition of the combined entity's governing body,
- The composition of the combined entity's senior management, and
- The terms of the exchange of equity securities.

### The Acquiree's Fair Value

The acquirer must determine the acquisition-date fair value of the acquired business, not its cost. In most cases, the fair value of the consideration transferred by the acquirer to the acquiree or its owners would be a basis for measuring the fair value of the acquirer's interest in the acquiree. Some exceptions are explained below.

When fair value is determined by the consideration given by the acquirer, all forms of consideration transferred to the acquired entity's owners would be measured at acquisition-date fair value. This would nullify EITF 99-12, which requires in many circumstances that an earlier measurement date, such as the announcement date, be used to value the equity securities the acquirer will issue to effect the combination.<sup>8</sup>

The proposal would also require the acquirer to include the fair value of any contingent consideration when measuring the consideration transferred at the acquisition date. This would be a significant departure from Statement 141's prohibition against recognizing contingent consideration until the outcome of the contingency is determinable beyond a reasonable doubt. Under the proposal, subsequent changes in the fair value of the contingent consideration would be recognized in income. Contingent consideration that meets the definition of a derivative would be subject to Statement 133's requirements after the acquisition date.<sup>9</sup> Statement 133's requirements would apply, for example, to a written put when the acquirer's shares serve as the underlying.

Costs to effect the acquisition would not enter the determination of the acquired entity's fair value. Instead, such costs (for example, fees paid to bankers, lawyers, and accountants) would be expensed. Under Statement 141, these costs are included in the purchase price.

<sup>5</sup> Minority shareholder's substantive participating rights are described in EITF Issue No. 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*.

<sup>6</sup> EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*.

<sup>7</sup> FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, December 2003, available at [www.fasb.org](http://www.fasb.org).

<sup>8</sup> EITF Issue 99-12, *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination*.

<sup>9</sup> FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, June 1998, available at [www.fasb.org](http://www.fasb.org).

The consideration transferred will not always be the best basis for measuring the acquiree's acquisition-date fair value. In some business combinations, for example, no consideration is transferred on the acquisition date. The acquirer may obtain control without making a payment, as when a majority shareholder obtains control when the minority shareholders' substantive participating rights expire. Partial acquisitions may evidence that the acquirer paid a significant premium to obtain control of the acquiree. This may occur, for example, when control is obtained from a relatively small transaction, say, if the acquirer previously owned a 49 percent interest in the acquiree and obtains control by acquiring an additional 2 percent interest.

In these and other cases when the consideration transferred is not the appropriate evidence of fair value, the acquirer would be required to use other valuation techniques. The proposal includes guidance on measuring the acquiree's fair value in these circumstances and also refers to the FASB's proposed Statement on fair-value measurement, which is expected to be issued and effective before the final Statement on business combinations is issued.<sup>10</sup>

**Partial and Step Acquisitions.** Under the proposal, an entity that obtains control but acquires less than 100 percent of an acquiree or achieves control in stages ("step acquisitions") would have to record at the acquisition date 100 percent of the fair value of the acquiree's entire set of assets and liabilities, including goodwill. This would differ significantly from existing accounting for these transactions.

Under today's requirements, when an acquiring company buys less than 100 percent of the acquired entity, it adjusts the assets and liabilities only for its proportionate ownership interest. In a step acquisition, each investment tranche is reflected in the consolidated financial statements at its basis. Under the proposal, when control is obtained, the carrying amount of the previously acquired tranches would be adjusted to fair value and a gain or loss would be recognized.

A transaction to acquire additional interests that occurs after control is obtained would be accounted for as an equity transaction. (See the example below titled *Capital-Transaction Approach to a Change in Ownership of a Subsidiary with Control Retained.*)

#### ***Exchanges Apart from the Business***

**Combination.** The proposal would require that the acquiring business determine whether any portion of the consideration transferred or assets acquired or liabilities assumed or incurred is not part of the business combination. Payments or other transactions that are not part of the business combination would be accounted for separately.<sup>11</sup> These kinds of payments and transactions include payments that settle earlier relationships between the acquirer and acquiree, such as to settle purchase-supply agreements; payments to reimburse the acquiree for its acquisition-related costs; payments to acquiree owner-employees for future services; and transfers by the acquirer of assets or liabilities to the acquiree (rather than the acquiree's former owners) that remain within the combined entity after the business combination.

#### **Individual Assets and Liabilities**

The proposal would require that the identifiable assets acquired and liabilities assumed be measured and recognized at their fair values as of the acquisition date, with limited exceptions. Although Statement 141 states that fair value is the measurement objective, some of the Statement's guidance is inconsistent with that objective. These proposed requirements, for example, would differ from requirements in place today:

- The acquiree's accounts receivable would be recognized at fair value without a separate reserve for uncollectible accounts. Uncertainty about collections and future cash flows would be reflected in the fair-value amount. Accordingly, in an acquisition of a financial institution, no loan-loss allowance would be recorded.
- An asset acquired or liability assumed for a contingency would be measured at fair value and recognized as an asset or liability as of the acquisition date if it meets the definition of an asset or liability in Concepts Statement 6, even if the contingency does not meet the recognition criteria in Statement 5.<sup>12</sup> The assets or liabilities would subsequently be adjusted for changes in fair value. Changes in fair value would be recognized in income of the period—not treated as adjustments to goodwill.
- Costs associated with restructuring or exit activities that do not meet the recognition criteria in Statement 146 as of the acquisition date would be recognized as post-combination expenses when the criteria are met.<sup>13</sup> However, a liability recognized by an acquiree before the acquisition in

<sup>10</sup> FASB Proposed Statement, *Fair Value Measurements*, June 2004, available at [www.fasb.org](http://www.fasb.org).

<sup>11</sup> These requirements are similar to what is in EITF Issue No. 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*, and EITF Issue No. 04-1, *Accounting for Preexisting Relationships between the Parties to a Business Combination*.

<sup>12</sup> FASB Concepts Statement No. 6, *Elements of Financial Statements*, December 1985; FASB Statement No. 5, *Accounting for Contingencies*, March 1975, both available at [www.fasb.org](http://www.fasb.org).

<sup>13</sup> FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, June 2002, available at [www.fasb.org](http://www.fasb.org).

compliance with Statement 146 would be assumed by the acquirer and recognized at fair value.

- Tangible long-lived assets and identifiable intangible assets that meet criteria for recognition apart from goodwill would be recognized at fair value without consideration of the acquirer's specific planned use (or non-use) of the asset.

- The acquiree's in-process research and development projects would be measured at fair value and recognized as an asset rather than immediately expensed.<sup>14</sup>

However, post-combination research and development costs would continue to be expensed as incurred.<sup>15</sup> In subsequent periods, a capitalized in-process research and development asset would be accounted for as an indefinite-lived intangible asset until the project is completed or abandoned.<sup>16</sup> When the project is completed, a useful life would need to be determined for amortization purposes.

**Measurement Period.** The proposal defines the measurement period as the period after the acquisition date during which the acquirer may make adjustments to the "provisional" amounts recognized at the acquisition date. Adjustments to the acquisition accounting would be permitted if new information is obtained about facts and circumstances that existed as of the acquisition date, but were not known at that time. The measurement period ends as soon as the acquirer receives all relevant information needed to put the acquisition accounting in final form or learns the information is not obtainable. However, as is the case under Statement 141, in no circumstances would the period exceed one year from the acquisition date. Any adjustments to the provisional amounts made in the measure-

### Allocating Goodwill to Controlling and Noncontrolling Interests

Company A acquires 80% of Company B's outstanding common stock for \$160 million in cash. No evidence suggests the transaction is an exchange of unequal values. Therefore, the \$160 million is presumed to be the fair value of the 80% interest in Company B. The fair value of Company B as a whole is determined to be \$195 million (that is, the \$160 million paid for the 80% interest included a control premium). As of the acquisition date, the book value and fair value of the separately recognizable identifiable net assets acquired are \$100 million and \$150 million, respectively. Amounts allocated to identifiable net assets, goodwill, noncontrolling interests, and controlling interest in Company B under the current purchase method and the proposed acquisition method are:

	Millions	
	Purchase Method	Proposed Acquisition Method
Identifiable net assets	\$140 <sup>1</sup>	\$150 <sup>2</sup>
Goodwill	\$ 40 <sup>3</sup>	\$ 45 <sup>4</sup>
Noncontrolling interests	\$ 20 <sup>5</sup>	\$ 35 <sup>6</sup>
Controlling interest	\$160	\$160

- 1 Book value of identifiable net assets plus Company A's share of the difference between fair value and book value of identifiable net assets  $(\$100 + ((\$150 - \$100) \times 80\%))$
- 2 Fair value of identifiable net assets
- 3 Purchase price paid by Company A less Company A's share of the fair value of identifiable net assets  $(\$160 - (\$150 \times 80\%))$
- 4 Fair value of Company B less fair value of identifiable net assets  $(\$195 - \$150)$
- 5 Noncontrolling interests' share of the book value of identifiable net assets  $(\$100 \times 20\%)$
- 6 Noncontrolling interests' share of the fair value of identifiable net assets plus the noncontrolling interests' share of goodwill  $(\$150 \times 20\%) + \$5$

Goodwill is allocated to controlling and noncontrolling interests as follows:

Fair value of Company A's 80% interest	\$160
Less: fair value of Company A's share of identifiable net assets $(\$150 \times 80\%)$	<u>(120)</u>
Company A's share of goodwill	\$ 40
Remaining goodwill allocated to noncontrolling interests	<u>5</u>
Total goodwill	\$ 45

ment period would be reflected by retrospectively adjusting the prior-period information.

### Goodwill

The amount of goodwill to be recognized would be the difference between the fair value of the acquiree and the fair value of the identifiable net assets acquired. If the

acquirer owns less than 100 percent of the equity interests in the acquired business at the acquisition date, the goodwill would have to be allocated to the controlling and noncontrolling interests using procedures in the proposal. The amount of goodwill allocated to the controlling interest would be the difference between the fair value of the control-

<sup>14</sup> FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, February 1975, available at [www.fasb.org](http://www.fasb.org).

<sup>15</sup> FASB Statement No. 2, *Accounting for Research and Development Costs*, October 1974, available at [www.fasb.org](http://www.fasb.org).

<sup>16</sup> FASB Statement No. 142, *Goodwill and Other Intangible Assets*, June 2001, available at [www.fasb.org](http://www.fasb.org).

ling interest and the controlling interest's share in the fair value of the identifiable net assets acquired. Any remaining goodwill would be allocated to the noncontrolling interests. This is illustrated in the boxed example on page 4.

### Tax Benefits

The proposal would change accounting for tax benefits from an acquired entity's deductible temporary differences or operating-loss or tax-credit carryforwards at the acquisition date that are recognized subsequent to the acquisition date by the elimination of a valuation allowance. There would be a rebuttable presumption that tax benefits that are recognized within one year following the acquisition date are applied first to reduce any goodwill related to the acquisition and then to reduce income-tax expense. In all other cases, the adjustment would be included in income-tax expense. Statement 109 requires that those amounts be applied to reduce both goodwill and other noncurrent intangible assets before reducing income-tax expense.<sup>17</sup>

The proposal would also require changes in accounting for the acquirer's deferred tax benefits that are recognizable as a result of the business combination. They would be accounted for separately from the business combination either in income from continuing operations in the period of the combination or to contributed capital depending on the circumstances. Statement 109 requires that a reduction of the acquirer's valuation allowance as a result of a business combination be recognized through a corresponding reduction to goodwill or specified noncurrent assets or an increase in negative goodwill.

### Bargain Purchase

In a "bargain purchase" the fair value of the acquired company exceeds the value trans-

ferred by the acquiring company. Under the proposal, this excess would first be used to reduce the amount of goodwill. If goodwill is reduced to zero, any remaining amount would be recognized as a gain at the acquisition date. Under current requirements for "negative" goodwill, the reported amounts of specified identifiable assets acquired are also reduced to zero before a gain is recognized.

### Noncontrolling Interests

The proposed Statement on noncontrolling interests would require parent companies to present noncontrolling interests in subsidiaries as a separate component of equity, not as a liability or as a so-called "mezzanine" item between liabilities and equity.

The accounting requirements would be consistent with the change in presentation. All increases or decreases in the parent's ownership interest that leave control intact would be accounted for as capital transactions and would result in no gain or loss. The carrying amount of the noncontrolling interests would be adjusted to reflect the change in ownership interests. Any difference between the amount by which the noncontrolling interests is adjusted and the fair value of the consideration paid or received would be recognized directly in equity attributable to the controlling interest (i.e., additional paid-in capital). This would significantly change current practice. Under today's requirements, an acquisition of minority interests is accounted for as a step acquisition, and the disposal of a part of the controlling interest results in a gain or loss.

Under the proposal, the parent's surrender of control would be considered a remeasurement event, and a gain or loss would be recognized in net income. If the parent loses control but retains an ownership interest in

the former subsidiary, the gain or loss would be the sum of two different computations. First, the gain or loss related to the portion of the ownership interest sold would be computed as the difference between the fair value and the carrying value of the interest surrendered. Second, the interest retained would be revalued to its fair value with a gain or loss computed as the difference between its fair value and its carrying value.

The following examples illustrate the capital-transaction approach to a change in ownership with control retained and the remeasurement approach to a change in ownership that ends control.

**Capital-Transaction Approach to a Change in Ownership of a Subsidiary with Control Retained.** Assume that on January 1, 20X5, Company A acquires 60 percent of Company B's common stock for \$600, which is the fair value of a 60 percent interest in Company B. The fair value of Company B, as a whole, is \$1,000. After the acquisition, the consolidated financial statements would report these amounts:

Net assets	<u>\$1,000</u>
Noncontrolling interests	\$ 400
Controlling interest	<u>600</u>
Total equity	<u>\$1,000</u>

Company B's net income and comprehensive income for 20X5 were zero. On January 1, 20X6, Company A acquires an additional 20 percent of Company B's common stock for \$250. Since Company A already had control, it would be treated as a capital transaction. Noncontrolling interests would be adjusted by the carrying amount of the proportionate interest relinquished ( $\$400 \times 20\% / 40\%$ ). The difference between the carrying amount of noncontrolling interests acquired (\$200)

<sup>17</sup> FASB Statement No. 109, *Accounting for Income Taxes*, February 1992, available at [www.fasb.org](http://www.fasb.org).

and the amount paid (\$250) is reported as an adjustment to additional paid-in capital. The consolidated financial statements would report the following amounts:

Net assets	<u>\$750</u>
Noncontrolling interests	\$200
Controlling interest	<u>550</u>
Total equity	<u>\$750</u>

Company B's net income and comprehensive income for 20X6 again were zero. On January 1, 20X7, Company A sells 10 percent of Company B's common stock for \$100. Since Company A retains control of Company B, the transaction would be recorded as a capital transaction. Noncontrolling interests is increased by the carrying amount of the interest sold by Company A (\$550 x 10% / 80%). The difference between the increase to noncontrolling interests (\$69) and the selling price is reported as an increase to additional paid-in capital. The consolidated financial statements would report the following amounts:

Net assets	<u>\$850</u>
Noncontrolling interests	\$269
Controlling interest	<u>581</u>
Total equity	<u>\$850</u>

#### ***Gain Recognized Because Control Is Given Up.***

Assume that on January 1, 20X5, Company A acquires 60 percent of Company B's common stock for \$600, which is the fair value of a 60 percent interest in Company B. The fair value of Company B, as a whole, is \$1,000. For the year 20X5, Company B reported \$100 of net income, of which \$60 is attributable to the controlling interest. Therefore, at December 31, 20X5, Company A's carrying value in Company B is \$660.

On January 1, 20X6, Company A sells 20 percent of Company B's common stock for \$250, which is the fair value of a 20 percent interest in Company B. The fair value of Company B, as a whole, is now \$1,250.

Company A would report a gain on the date of the sale according to this computation:

Sales proceeds	\$250
Basis in portion sold (\$660 x 20% / 60%)	<u>220</u>
Gain on portion of investment sold	<u>\$ 30</u>
Fair value of remaining portion	\$500
Basis in portion retained (\$660 x 40% / 60%)	<u>440</u>
Holding gain on portion of investment retained	<u>60</u>
Gain recognized on January 1, 20X6	<u>\$ 90</u>

***A Series of Transactions.*** The proposal contains criteria designed to prevent manipulation of the income statement through a series of planned transactions. If the criteria are met, a series of transactions would be accounted for as a single transaction that creates only one "remeasurement" event.

***Allocation of Income or Loss.*** The proposal would require that net income or loss and each component of other comprehensive income be attributed to the controlling and noncontrolling interests based on relative ownership interests unless the controlling and noncontrolling interests have entered into a contractual arrangement that requires a different attribution between them. In addition, losses applicable to the noncontrolling interests would be attributed to the noncontrolling interests even if those losses exceed the noncontrolling interests' basis in the subsidiary's

equity and even if the noncontrolling interests have no obligation to fund those losses.

***Display and Disclosure.*** The proposed changes in the measurement and presentation of noncontrolling interests and results of operations of consolidated subsidiaries would reshape the way results of operations, earnings per share, and equity are presented in consolidated financial statements. Net income and other income components, earnings per share, and comprehensive income would have to be displayed for both the controlling and the noncontrolling interests.

In addition, the proposal would require additional disclosures, including a separate schedule that shows the effects of any transactions with the noncontrolling interests in the equity attributable to the controlling interest and displays an additional earnings per share metric that captures the effects of any equity transactions with the noncontrolling interests.

#### **Effective Dates and Transitions**

The provisions of the proposed Statement on business combinations would be applied prospectively to business combinations for which the acquisition date is in the annual period beginning on or after December 15, 2006, with earlier application encouraged. The proposed Statement on noncontrolling interests would also be effective for annual periods beginning on or after December 15, 2006 with earlier application encouraged, but would be applied retrospectively, with the following exceptions:

- Amounts previously recorded for acquisitions of noncontrolling interests that were accounted for by the purchase method,
- Amounts previously recorded for the loss of control of one or more subsidiaries, and



- Amounts previously reported for noncontrolling interests.

If either proposed Statement is applied before the effective date, both proposed Statements must be applied at the same time.



The FASB's project on business combinations is being conducted jointly with the IASB and is the two Boards' first fully coordinated standard-setting effort. Both Boards issued substantially equivalent proposals on the same day, and they plan to coordinate their subsequent deliberations, including joint public roundtable meetings in October and November.<sup>18</sup> Their shared goal is to issue fully converged standards on accounting for business combinations.

Comments on the exposure drafts are due by October 28, 2005. The FASB and IASB plan to issue the final Statements in mid-2006.

The descriptive and summary statements above are not intended to substitute for the texts of what the FASB and IASB might issue as final Statements. Reporting entities complying with adopted requirements that might emerge should consult the texts of the Statements, the particular circumstances to which the requirements are to be applied, and their accounting and legal advisors.

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<sup>18</sup> IASB, Exposure Draft of Proposed Amendments to IFRS 3, Business Combinations, June 2005.