Newly Effective Accounting Rules for Mergers and Acquisitions May Alter the Structure of Acquisitions in 2009

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On December 15, 2008, Statement of Financial Accounting Standards No. 141(R), Business Combinations (FAS 141(R)), became effective. The statement governs certain accounting principals with respect to mergers and acquisitions. Any company that is require to report financial statements according to U.S. GAAP will be required to follow the new standards for any business combinations that close on or after January 1, 2009 (for companies with calendar year fiscal years). FASB has stated that the objective of FAS 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 essence, the revised standards are intended is to move U.S. principals closer to standardization with international principals.

International principals generally encompass the concept of “fair value” reporting with respect to assets and earn-outs associated with business combinations. To accomplish that, FAS 141(R) establishes principles and requirements for how an acquirer:

- Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the target;
- Recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and
- Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

FAS 141(R) applies to all transactions or other events in which any business entity obtains control of one or more targets. Those transactions include both mergers and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. However, FAS 141(R) does not apply to:

- The formation of a joint venture;
- The acquisition of an asset or a group of assets that does not constitute a business;
- A combination between entities or businesses under common control;
- A combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

There are several significant changes that may impact the structure of business combinations as well as the predictability of earnings of the combined entity following closing. Those significant changes include:

- The requirement to use “fair value” when accounting for a target’s assets and liabilities;
- Use of the acquisition date to determine the “fair value” of the consideration paid rather than the previously used signing date. This includes accounting for the “fair value” of contingent consideration (e.g. earn-outs and future stock issuances) as of the acquisition date and a true-up to actual payments in the future;
Accrue pre-acquisition contingencies such as law suits at their “fair value” if, at the time of the acquisition, they are “more likely than not” to occur (this is under review by FASB – see proposed FAS 141(R)-a below);

Expensing restructuring and exit costs at the time of acquisition and other acquisition related costs as the occur; and

No longer expensing in-progress research and development costs at the time of acquisition but rather accounting for them as an indefinite-lived intangible asset.

Publicly traded companies are likely to feel the greatest impact from the revised rules. However, any privately held company that is required by loan covenants or otherwise to report financial statements in accordance with U.S. GAAP will also be impacted. In addition, privately held companies that are or may become targets of other U.S. GAAP reporting companies should also consider the impact of the new standards on their financial statements going forward.

As stated above, FASB has issued proposed FAS 141(R)-a, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies. The proposed amendment would amend FASB Statement No. 141 (revised 2007), Business Combinations, related to the accounting for assets and liabilities arising from contingencies in a business combination. The proposed amendment would require that an asset or a liability arising from a contingency in a business combination be recognized at “fair value’ if fair value can be reasonably determined and would provide guidance on how to make that determination.

Both FAS 141(R) and the proposed FAS 141(R)-a are available at www.fasb.org.

While decisions to pursue transactions should continue to be driven by underlying economics, rather than by accounting standards, companies should understand the impact of the new accounting standards when structuring and effecting M&A transactions. Companies should structure their transactions where possible to achieve the most effective accounting treatment.

Please contact your Morrison & Foerster LLP attorneys if you have any questions as to the matters discussed in this client alert.

FASB recently decided, however, to reconsider one of the more controversial aspects of the revised standards that otherwise could require more detailed reporting of contingent liabilities (such as lawsuits) of a target company.
Summary of Statement No. 141 (revised 2007)

Business Combinations

Summary

Why Is the FASB Issuing This Statement?

The objective of this Statement 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. To accomplish that, this Statement establishes principles and requirements for how the acquirer:

- Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
- Recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase
- Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

What Is the Scope of This Statement?

This Statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree), including those sometimes referred to as “true mergers” or “mergers of equals” and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This Statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to:

- The formation of a joint venture
- The acquisition of an asset or a group of assets that does not constitute a business
- A combination between entities or businesses under common control
- A combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

How Will This Statement Improve Current Accounting Practice?

This Statement replaces FASB Statement No. 141, Business Combinations. This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. Statement 141 did not define the acquirer, although it included guidance on identifying the acquirer, as does this Statement. This Statement’s scope is broader than that of Statement 141, which applied only to business combinations in which control was obtained by transferring consideration. By applying the same method of accounting—the acquisition method—to all transactions and other events in which one entity obtains control over one or more other businesses, this Statement improves the comparability of the information about business combinations provided in financial reports.

This Statement retains the guidance in Statement 141 for identifying and recognizing intangible assets separately from goodwill. The main features of this Statement and the more significant improvements it
makes to how the acquisition method was applied in accordance with Statement 141 are described below.

Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree

This Statement requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the Statement. That replaces Statement 141’s cost-allocation process, which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. Statement 141’s guidance resulted in not recognizing some assets and liabilities at the acquisition date, and it also resulted in measuring some assets and liabilities at amounts other than their fair values at the acquisition date. For example, Statement 141 required the acquirer to include the costs incurred to effect the acquisition (acquisition-related costs) in the cost of the acquisition that was allocated to the assets acquired and the liabilities assumed. This Statement requires those costs to be recognized separately from the acquisition. In addition, in accordance with Statement 141, restructuring costs that the acquirer expected but was not obligated to incur were recognized as if they were a liability assumed at the acquisition date. This Statement requires the acquirer to recognize those costs separately from the business combination. Therefore, this Statement improves the relevance, completeness, and representational faithfulness of the information provided in financial reports about the assets acquired and the liabilities assumed in a business combination.

This Statement also requires the acquirer in a business combination achieved in stages (sometimes referred to as a *step acquisition*) to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with this Statement). In accordance with Statement 141 and related interpretative guidance, an entity that acquired another entity in a series of purchases (a step acquisition) identified the cost of each investment, the fair value of the underlying identifiable net assets acquired, and the goodwill on each step. Statement 141 did not provide guidance on measuring the noncontrolling interest’s share of the consolidated subsidiary’s assets and liabilities at the acquisition date. The result of applying Statement 141’s guidance on recognizing and measuring assets and liabilities in a step acquisition was to measure them at a blend of historical costs and fair values—a practice that provided less relevant, representationally faithful, and comparable information than will result from applying this Statement. In addition, this Statement’s requirement to measure the noncontrolling interest in the acquiree at fair value will result in recognizing the goodwill attributable to the noncontrolling interest in addition to that attributable to the acquirer, which improves the completeness of the resulting information and makes it more comparable across entities.

**Assets and Liabilities Arising from Contingencies**

This Statement improves the completeness of the information reported about a business combination by changing the requirements for recognizing assets acquired and liabilities assumed arising from contingencies. Statement 141 permitted deferred recognition of preacquisition contingencies until the recognition criteria for FASB Statement No. 5, *Accounting for Contingencies*, were met. This Statement requires an acquirer to recognize assets acquired and liabilities assumed arising from *contractual contingencies* as of the acquisition date, measured at their acquisition-date fair values. An acquirer is required to recognize assets or liabilities arising from all other contingencies (*noncontractual contingencies*) as of the acquisition date, measured at their acquisition-date fair values, only if it is more likely than not that they meet the definition of an asset or a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*. If that criterion is not met at the acquisition date, the acquirer instead accounts for a noncontractual contingency in accordance with other applicable generally accepted accounting principles, including Statement 5, as appropriate.

This Statement provides specific guidance on the subsequent accounting for assets and liabilities arising from contingencies acquired or assumed in a business combination that otherwise would be in the scope of Statement 5. It requires that an acquirer continue to report an asset or a liability arising from a
contingency recognized as of the acquisition date at its acquisition-date fair value absent new information about the possible outcome of the contingency. When new information is obtained, the acquirer evaluates that new information and measures a liability at the higher of its acquisition-date fair value or the amount that would be recognized if applying Statement 5, and measures an asset at the lower of its acquisition-date fair value or the best estimate of its future settlement amount.

Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase

This Statement requires the acquirer to recognize goodwill as of the acquisition date, measured as a residual, which in most types of business combinations will result in measuring goodwill as the excess of the consideration transferred plus the fair value of any noncontrolling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired.

Statement 141 also required goodwill to be recognized and measured as a residual. However, as described below, this Statement improves the way in which an acquirer's obligations to make payments conditioned on the outcome of future events (often called contingent consideration) are recognized and measured, which in turn improves the measure of goodwill. This Statement also includes in the definition of contingent consideration arrangements that give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

This Statement requires the acquirer to recognize contingent consideration at the acquisition date, measured at its fair value at that date. Under Statement 141, in contrast, contingent consideration obligations usually were not recognized at the acquisition date. Rather, they usually were recognized when the contingency was resolved and consideration was issued or became issuable. In addition, the issuance of additional securities or distribution of additional cash or other assets upon resolution of contingencies based on reaching particular earnings levels was recognized as an adjustment to the accounting for the business combination, but issuance of shares or distribution of assets upon resolution of contingencies based on security prices was recognized differently. This Statement therefore improves the representational faithfulness and completeness of the information provided about an acquirer's obligations and rights under contingent consideration arrangements.

A Bargain Purchase

This Statement defines a bargain purchase as a business combination in which the total acquisition-date fair value of the identifiable net assets acquired exceeds the fair value of the consideration transferred plus any noncontrolling interest in the acquiree, and it requires the acquirer to recognize that excess in earnings as a gain attributable to the acquirer. In contrast, Statement 141 required the "negative goodwill" amount to be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to particular assets acquired. This Statement therefore improves the representational faithfulness and completeness of the information provided about both the acquirer's earnings during the period in which it makes a bargain purchase and the measures of the assets acquired in the bargain purchase.

What Other Changes Does This Statement Make to Existing Accounting Pronouncements?

This Statement makes significant amendments to other Statements and other authoritative guidance. For example, this Statement supersedes FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, which required research and development assets acquired in a business combination that have no alternative future use to be measured at their acquisition-date fair values and then immediately charged to expense. Therefore, the acquirer will recognize separately from goodwill the acquisition-date fair values of research and development assets acquired in a business combination, which improves the representational faithfulness and completeness of the information provided in financial reports about the assets acquired in a business combination.

This Statement amends FASB Statement No. 109, Accounting for Income Taxes, to require the acquirer to recognize changes in the amount of its deferred tax benefits that are recognizable because of a business combination either in income from continuing operations in the period of the combination or
directly in contributed capital, depending on the circumstances. (Such changes arise through the increase or reduction of the acquirer’s valuation allowance on its previously existing deferred tax assets because of the business combination.) Previously, Statement 109 required a reduction of the acquirer’s valuation allowance because of a business combination to be recognized through a corresponding reduction to goodwill or certain noncurrent assets or an increase in so-called negative goodwill. This Statement therefore improves the representational faithfulness of the information provided about the effect of a business combination on both the acquirer’s deferred tax assets and the related valuation allowance and the goodwill and noncurrent assets acquired in the business combination.

This Statement makes various other amendments to the authoritative literature intended to provide additional guidance or to conform the guidance in that literature to that provided in this Statement. For example, this Statement amends FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to, among other things, provide guidance on the impairment testing of acquired research and development intangible assets and assets that the acquirer intends not to use.

This Statement also eliminates many EITF issues and other interpretative guidance on accounting for business combinations and incorporates the parts of that guidance that remain pertinent. Therefore, in addition to improving the guidance provided about accounting for a business combination in the authoritative literature, this Statement makes that guidance easier to use.

**What Is the Effect of This Statement on Convergence with International Reporting Standards?**

This Statement, together with the IASB’s IFRS 3, *Business Combinations* (as revised in 2007), completes a joint effort by the FASB and the IASB to improve financial reporting about business combinations and to promote the international convergence of accounting standards. Statement 141 and IFRS 3 (as issued in 2004) both required use of the acquisition method rather than the pooling-of-interests method to account for business combinations. In this Statement and the revised IFRS 3, the Boards in large part achieved their goal of reaching the same conclusions on the more significant issues involving application of the acquisition method of accounting for a business combination. Appendix G describes the substantive differences between this Statement and IFRS 3 (as revised in 2007). One significant difference is the measurement requirements for a noncontrolling interest in an acquiree. This Statement requires an acquirer to measure a noncontrolling interest at its acquisition-date fair value. IFRS 3 (as revised in 2007) provides the acquirer a choice for each business combination to measure a noncontrolling interest either at its fair value or on the basis of its proportionate interest in the identifiable net assets of the acquiree. The Boards’ requirements for recognizing at the acquisition date assets and liabilities arising from contingencies also differ, in part because the IASB decided to carry forward IFRS 3’s requirements for those assets and liabilities on an interim basis, pending completion of its project to revise IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

**What Is the Effective Date of This Statement?**

This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The effective date of this Statement is the same as that of the related FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. 
FASB Issues Proposed FASB Staff Position FAS 141(R)-a, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies

Norwalk, CT, December 15, 2008—The Financial Accounting Standards Board (FASB) today issued proposed FASB Staff Position (FSP) FAS 141(R)-a, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies. The proposed FSP would amend FASB Statement No. 141 (revised 2007), Business Combinations, related to the accounting for assets and liabilities arising from contingencies in a business combination. Constituents have until January 15, 2009, to review and provide comments on the proposed FSP.

The proposed FSP is intended to improve financial reporting by addressing concerns from preparers, auditors, and members of the legal profession about the application of Statement 141(R) related to the initial and subsequent recognition and measurement, and disclosure of assets and liabilities arising from contingencies in a business combination.

The proposed FSP would require that an asset or a liability arising from a contingency in a business combination be recognized at fair value if fair value can be reasonably determined and would provide guidance on how to make that determination. If the fair value of an asset or liability cannot be reasonably determined, the FSP would require that an asset or liability be recognized at the amount that would be recognized in accordance with FASB Statement No. 5, Accounting for Contingencies, and FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, for liabilities and an amount using similar criteria for assets. The proposed FSP also would amend the subsequent measurement and accounting guidance and the disclosure requirements for assets and liabilities arising from contingencies in a business combination.

“While the FASB believes that fair value is the most relevant measurement attribute for assets acquired and liabilities assumed in a business combination, the Board also acknowledges concerns raised by preparers, auditors, and members of the legal profession,” said FASB member Larry Smith. “The proposed FSP addresses those concerns by requiring the use of fair value to value assets and liabilities arising from contingencies only when fair value is reasonably determinable.”

Proposed FSP FAS 141(R)-a is available at www.fasb.org.

About the Financial Accounting Standards Board

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