

Alert

September 2005

FASB Issues Proposed Standards for Business Combinations

“The ED would drastically change current accounting practices for business combinations.”

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) recently issued exposure drafts on business combinations as part of their joint convergence project to improve accounting for business combinations. The goal of the joint project is to develop a single standard for accounting for business combinations that could be used for domestic and international financial reporting. The FASB's exposure draft (SFAS No.141(R) or the ED), *Business Combinations - A Replacement of FASB Statement No. 141*, is being met with much resistance from the corporate community, mainly due to the complexity and effect of the accounting requirements.

SIGNIFICANT CHANGES

The proposed standards represent the second phase of the business combination project the FASB began in 2001 with the issuance of FAS 141 and FAS 142. The ED would drastically change current accounting practices for business combinations. The most significant changes are as follows:

- A shift from the purchase method to the acquisition method
- Recognition of contingent consideration and contingent assets and liabilities at fair value
- Expensing of acquisition-related transaction costs
- Capitalization of acquired in-process R&D (IPR&D)

The rules set forth in the ED could result in considerable charges to the income statement in connection with an acquisition. The changes will likely increase income-statement volatility in subsequent periods as acquisition-related contingencies change or are resolved.

ACQUISITION METHOD

The ED would apply to transactions in which an acquirer obtains control of one or more businesses. The ED will require the acquirer to measure and recognize 100% of the fair value of the acquiree even if the acquirer holds less than 100% of the equity interest. Additionally, the FASB has expanded the definition of a business such that development-stage entities are recognized as businesses and their acquisitions are therefore deemed business combinations. The ED also applies to mutual entities, step acquisitions and variable interest entities.

In applying the acquisition method, the acquirer must determine the fair value of the acquired business as of the acquisition date and recognize the fair value of the acquired assets and liabilities assumed. The ED recognizes that in the absence of evidence to the contrary, the consideration transferred is the best evidence of the fair value. However, in some business combinations, where either no consideration is transferred on the acquisition date, or the consideration transferred is not the best indicator of the acquisition fair value, the acquirer would need to determine the fair value of the acquiree. Additionally, the ED revises the

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acquisition date from the date of agreement to the date that the acquirer obtains control of the acquired business, i.e. the closing date.

CONTINGENCIES

One of the most controversial proposed changes in the ED relates to the accounting for contingent assets and liabilities. The inherent difficulty in measuring the fair value of contingent assets and liabilities is the quality and availability of information as of the acquisition date. The fair value estimate of contingent assets and liabilities will be based on certain assumptions, such as the probability of an occurrence that would result in payment of the contingency, and will likely require significant input from external parties, such as environmental experts or attorneys.

Contingent consideration is an obligation of the acquirer to transfer assets or equity interests if future events occur or certain conditions are met. An example of a contingency would be an earn-out arrangement. Under the proposed rules, contingencies would be included in the purchase price, and recorded at fair value (as liabilities) as of the acquisition date. Changes in the values of contingent assets and liabilities (that are not financial instruments) will be adjusted to fair value in each reporting period, with changes in fair value recorded in the income statement.

TRANSACTION COSTS

Under SFAS No. 141, transaction costs, such as legal fees, banking fees, accounting fees, and fees for valuation services, were included in the purchase price. The ED proposes that transaction costs be expensed immediately.

IPR&D

Under SFAS No. 141, IPR&D is measured at fair value and expensed immediately. The ED proposes that IPR&D be measured at fair value and capitalized with an indefinite life. As is the case with other indefinite-lived assets, IPR&D will be tested regularly for impairment. When the life becomes determinable (upon project completion) IPR&D will be amortized over its expected remaining life.

EFFECTIVE DATE

The Board has indicated that the ED, if adopted, would be effective for financial statements for fiscal years beginning after December 16, 2006. We have highlighted major changes proposed in the ED. There are numerous other changes that will affect accounting for business combinations. We recommend engaging a valuation expert to perform the complex valuations required under the ED. For more information, contact PJ Patel at (609) 243-7030. **VR**

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