

Alert

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FASB Issues Business Combinations Statement

“Post-transaction, the changes (in FAS 141) will likely increase income-statement volatility as acquisition-related contingencies change or are resolved.”

The FASB recently completed the second phase of its business combination project by issuing SFAS 141(R), *Business Combinations*, and SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements*. The FASB began the first phase of the business combination project in 2001 with the issuance of SFAS 141 and SFAS 142. The new Statements are part of a joint project with the International Accounting Standards Board (IASB) to converge U.S. and international accounting standards. SFAS 141(R) presents several significant changes from current accounting practices for business combinations, most notably the following:

- Revised definition of a business;
- 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; and
- Capitalization of acquired in-process research and development (IPR&D).

Implementation of SFAS 141(R) could have a significant impact on the acquisition balance sheet. Post-transaction, the changes will likely increase income-statement volatility as acquisition-related contingencies change or are resolved.

ACQUISITION METHOD

SFAS 141(R) applies to transactions in which an acquirer obtains control of one or more businesses. FASB has expanded the definition of a business such that it is “*an integrated set of activities and assets that are capable of being managed to provide a return to investors or economic benefit to owners, members, or participants.*” As a result, development-stage entities are now recognized as businesses and their acquisitions are therefore deemed as business combinations. The Standard 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 acquisition date is the date on which the acquirer obtains control of the target, generally the closing date. Historically, under SFAS 141, the purchase price was measured at the announcement date while assets and liabilities were measured at the acquisition date. Furthermore, the new standard requires the acquirer to measure and recognize the assets and liabilities of the acquired entity at full fair value even if it acquires less than 100% of the target.

CONTINGENT CONSIDERATION

One of the most controversial parts of SFAS 141(R) deals with accounting for contingent assets/liabilities, i.e. amounts that may or may not be paid depending on the resolution of certain future events. Under the old rules, contingencies were not recognized until they were resolved. Under the new rules, contingencies will be measured at fair value on the acquisition date. SFAS 141(R) calls for

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contingencies to be divided into two categories: contractual, such as a warranty, and non-contractual, such as a lawsuit. Contractual contingencies are measured at their estimated fair value as of the acquisition date. Non-contractual contingencies, such as lawsuits, will be measured at fair value only if it is determined that the liability is *more likely than not* to exist (i.e. probability of greater than 50%) as of the acquisition date.

For day two accounting, the company will report contingent liabilities acquired in a business combination at the higher of day one fair value or the amount that would be recognized if applying SFAS No. 5 *Accounting for Contingencies*. A contingent asset acquired in a business combination is measured at the lower of day one fair value or the best estimate of its future settlement amount.

TRANSACTION COSTS AND RESTRUCTURINGS

Under SFAS 141, transaction costs, such as legal fees, banking fees, accounting fees, and fees for valuation services, were included in the purchase price. SFAS 141(R) mandates that transaction-related costs be expensed. Similarly, restructuring costs, which historically were recognized as a liability, will be recognized when they meet the criteria in SFAS No. 146.

IPR&D

Under SFAS 141, in-process research & development (IPR&D) was measured at fair value and expensed on the acquisition date. Under SFAS 141(R) IPR&D will 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 for impairment in accordance with SFAS 142. When the life of the IPR&D project becomes determinable (upon project completion or abandonment) IPR&D should be amortized over its expected remaining life.

SFAS 160

SFAS 160 requires companies to measure an acquisition of a noncontrolling (minority) interest at fair value in the equity section of the acquiring entity's balance sheet. FASB's intent is to improve the comparability and transparency of financial data as well as to help prevent manipulation of earnings.

EFFECTIVE DATE

The new accounting rules further increase the need for valuation services in connection with a business combination. At the time of an acquisition, the acquiring company will need to value the consideration exchanged and the net assets acquired including contingent assets and liabilities. Post-transaction, companies will need to value certain assets and liabilities, (i.e. contingent consideration), as well as test indefinite-lived intangibles, such as trademarks and goodwill (as well as IPR&D under SFAS 141(R)) for impairment. Both SFAS 141(R) and SFAS 160 are effective for fiscal years beginning after December 15, 2008. For more information contact your Valuation Research representative or PJ Patel at 609-243-7030.

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Chicago	312.957.7500
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