

# Alert

November 2008

*“Implementation of SFAS 141R is likely to have a material impact on the acquisition balance sheet.”*

## Effective Date for SFAS 141R Approaching Fast

With the effective date for SFAS 141R, *Business Combinations*, approaching fast, it is important to understand its implications. SFAS 141R is effective for fiscal years beginning after December 15, 2008 and is part of a joint project with the International Accounting Standards Board (IASB) to converge U.S. and international accounting standards. SFAS 141R presents significant changes from current accounting practices for business combinations, most notably the following:

- Broader definition of a business;
- Same period disclosure of provisional purchase accounting entries;
- Recognition of contingent consideration and certain contingent assets and liabilities at fair value;
- Expensing of acquisition-related transaction costs and restructuring costs; and
- Capitalization of acquired in-process research and development (IPR&D).

Implementation of SFAS 141R is likely to have a material impact on the acquisition balance sheet. Post-transaction, the changes will likely increase income-statement volatility as restructuring expenses are recognized and acquisition-related contingencies change or are resolved.

## ACQUISITION METHOD

SFAS 141R applies to transactions in which an acquirer obtains control of one or more businesses. The FASB has expanded the definition of a business to be “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 considered 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 assets acquired and liabilities assumed. The acquisition date is the date on which the acquirer obtains control of the target, generally the closing date. 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.

## SFAS 141 VS. SFAS 141R

Under SFAS 141, companies were required to allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition. In contrast, SFAS 141R requires a company to recognize the fair value of the assets acquired, liabilities assumed and any noncontrolling interest with limited exceptions.

Under SFAS 141R, there will be greater time pressure. SFAS 141 allowed a company one year to complete its purchase accounting. SFAS 141R requires companies to report provisional amounts

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in their financial statements in the reporting period in which the transaction occurs. Subsequently during the measurement period, these provisional amounts are adjusted retrospectively to reflect information about facts and circumstances that existed as of the acquisition date.

One of the most controversial aspects of SFAS 141R is accounting for contingent assets/liabilities, i.e. amounts for which payment depends on the resolution of future events. SFAS 141 did not mandate recognition of contingent assets/liabilities. Instead, contingent liabilities were handled by SFAS 5, *Accounting for Contingencies*, and contingent assets were not recognized. Under SFAS 141R, contingencies are divided into two categories: contractual, such as a warranty, and non-contractual, such as a lawsuit. Contractual contingencies are measured at fair value as of the acquisition date. Non-contractual contingencies will be measured at fair value only if it is determined that the liability or asset is more likely than not to exist (i.e. probability of greater than 50%) as of the acquisition date.

Subsequently, if new information is obtained, 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 5. Similarly, 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. Controversy still surrounds contingent assets and liabilities. Additional guidance may be forthcoming.

Under SFAS 141, transaction costs, such as legal fees, banking fees, or fees for valuation services, were included in the purchase price. SFAS 141R mandates that transaction costs be expensed. Similarly, restructuring costs will be recognized when they meet the criteria in SFAS No. 146.

In a departure from SFAS 141, SFAS 141R requires 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 for impairment in accordance with SFAS 142. When the IPR&D project is completed or abandoned, it is amortized or written off, respectively.

## VALUATION CONSIDERATIONS

SFAS 141R increases the need for valuation services in connection with a business combination. The requirement to disclose provisional amounts in the period of the transaction will likely lead to earlier, potentially pre-transaction, inclusion of an outside valuation professional. Additionally, there are increased fair value requirements including consideration exchanged, the net assets acquired, and contingent assets and liabilities. Post-transaction, companies will need to test indefinite-lived intangibles, such as trademarks, goodwill, and IPR&D for impairment. For more information contact your Valuation Research representative or PJ Patel at 609-243-7030. **VR**

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