

Financial Accounting Valuation Insights

FASB PROPOSED STATEMENT NO. 141 REPLACEMENT: IMPROVED FINANCIAL REPORTING OF BUSINESS COMBINATIONS?

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The Financial Accounting Standards Board removed the pooling-of-interests method of business combination accounting from U.S. GAAP in 2001 with the issuance of SFAS No. 141. Now, the FASB has released preliminary statements outlining revisions to SFAS No. 141 that could change the accounting for business combinations just as dramatically.

INTRODUCTION

The Financial Accounting Standards Board (FASB) has addressed the accounting and reporting of business combinations in two phases. The release of SFAS No. 141 in June 2001 constituted Phase 1 of the FASB business combinations project. SFAS No. 141, *Business Combinations*, eliminated the use of the pooling-of-interests method and adopted the purchase method as the single method in the financial accounting and reporting of a business acquisition.

On June 27, 2004, the FASB initiated Phase 2 of its business combinations project by issuing the *Summary of FASB Tentative Decisions on Business Combinations*. The *Summary* discusses the *Proposed Statement of Financial Accounting Standards, Business Combinations*, a replacement of *FASB Statement No. 141* (the "Proposed Statement"). This summary is not an Exposure Draft. And, it has not been subject to a final review and ballot by the FASB or the International Accounting Standards Board (IASB).

The Proposed Statement, however, provides a sneak preview of the issues that SFAS No. 141(R) will address when it is released as an exposure draft later this summer.

As of the time of this writing, the exposure draft of the Proposed Statement had not been released. The following article is not meant to be a comprehensive summary of the Proposed Statement. Instead, it is meant to highlight some of the key FASB decisions.

OVERVIEW OF THE PROPOSED STATEMENT

In the Proposed Statement, the FASB (1) summarizes its tentative decisions on the application of the purchase method on business acquisitions and (2) extends SFAS

No. 141 to combinations between mutual enterprises, which were not addressed in Phase I.

The Proposed Statement requires that the acquiring entity in a business combination account for the acquired company at its fair value at the acquisition date. Fair value is defined in the Proposed Statement as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable unrelated willing parties."

While this Proposed Statement would be applicable to all acquiring business enterprises, it would not apply to (1) the formation of a joint venture, (2) transactions or events between entities under common control, (3) combinations between not-for-profit organizations, and (4) acquisitions of a for-profit business by a not-for-profit organization.

To be clear, the Proposed Statement defines a business combination as "a transaction or other event in which an acquiring entity obtains control over one or more businesses." A business combination can result from the acquisition of net assets or the equity interest of a business (or businesses).

PURPOSE OF THE PROPOSED STATEMENT

The primary reason cited by the FASB for issuing the Proposed Statement is to improve the consistency of the procedures used in accounting for all business acquisitions. Since the Proposed Statement would require the acquiring entity to recognize and measure all assets acquired and liabilities assumed at their fair value, more complete information would be provided to investors and other users of financial statements.

In addition, the Proposed Statement has been issued in conjunction with efforts by IASB to promote the international convergence of financial accounting standards for business combinations. This convergence will increase the comparability of financial information around the world. For example, in-process research and development (IPR&D) is not currently expensed under current IASB standards. And, in a nod to international convergence under the Proposed Statement, U.S. GAAP companies will no longer be allowed to expense the IPR&D acquired in a business combination.

DIFFERENCES BETWEEN THE PROPOSED STATEMENT AND SFAS No. 141

While the Proposed Statement introduces several significant changes to the financial reporting of a business combination, it also retains some of the fundamental provisions of SFAS No. 141. For example, as in SFAS No. 141, the Proposed Statement mandates the use of the purchase method (now referred to as the "acquisition method") in (1) the accounting of all business combinations and (2) the identification of an acquirer in every merger or acquisition.

The Proposed Statement will also maintain the guidelines for identifying the intangible assets that are to be recognized as assets apart from goodwill, as provided in SFAS No. 141. Therefore, an intangible asset should be recognized as an asset apart from goodwill if (1) it arises from contractual or other legal rights, or (2) it can be separated from the acquired business. An intangible asset can also be recognized as an asset apart from goodwill if it can be sold, licensed, or exchanged.

However, the Proposed Statement would differ from SFAS No. 141 in the following key respects:

1. All acquisitions of businesses would be measured at the fair value of the businesses acquired rather than the cost-based provisions that were carried forward from APB Opinion No. 16, *Business Combinations*. Therefore, rather than allocating the cost of an acquired entity to its assets and liabilities, management would allocate the fair value of the acquired entity to its assets and liabilities. In applying the subtle difference between measuring acquired companies at their fair-value rather than cost (i.e. how much money the acquiring company paid for the target) the Proposed Statement changes SFAS No. 141 in the following key ways:

- a. Transaction costs of the acquirer incurred in connection with the acquisition would not be included in the measurement (or fair value) of the business acquired. Because these transaction costs are not considered part of the fair value of the consideration exchanged for the business acquired, these costs would be accounted for separately from the business combination.
- b. Contingent consideration would be included in the purchase price. Therefore, management, with the assistance of valuation analysts, would need to estimate the fair value of the contingent consideration associated with a transaction by assessing of the probability of events occurring that would result in the payment of the contingent amounts.

For example, let's say Big Pharma Company bought Upstart Biotech Company. Big Pharma agreed to pay an additional \$1,000,000 to Upstart Biotech Company once Upstart's primary drug completed Phase II clinical trials. If, at the date of acquisition, management determined that Upstart's primary drug had a 50% chance of completing Phase II clinical trials successfully, Big Pharma Company would add \$500,000 (\$1,000,000 times 50 percent) to the purchase price of Upstart Biotech Company. This is a departure from current accounting rules. The current rules indicate

that obligations for contingent consideration should be recognized and measured as a postcombination adjustment to the purchase price in subsequent periods in which the contingency is resolved.

- c. The fair value of the equity securities issued as consideration would be measured at the acquisition date (closing date) rather than the agreement date. For example let's assume Big Pharma Company announced its intention to acquire Upstart Biotech Company on February 1, but the transaction did not close until June 1. Under the Proposed Statement, the purchase price for Upstart Biotech would be determined and accounted for as of June 1. By contract, under current accounting rules, the purchase price (but not fair value of assets acquired and liabilities assumed) would be determined as if the transaction closed around February 1.
2. Acquired assets and liabilities assumed would be recognized and measured at their fair value, rather than allocating the cost of the acquisition to those assets and liabilities. To this effect, the Proposed Statement would required the following:

"... the Proposed Statement has been issued in conjunction with efforts by IASB to promote the international convergence of financial accounting standards for business combinations."

a. Pre-acquisition contingent assets or liabilities of the acquired entity would be recognized at fair value as of the acquisition date. This includes assets and liabilities that the acquired company may not have recognized under the criteria set forth in SFAS No. 5 *Accounting for Contingencies*. For example, if prior to its acquisition by Big Pharma Company, Upstart Biotech Company had been sued by Old Time Biotech Company for patent infringement and Big Pharma management believed it had a 1 percent chance of losing its case and having to award Old Time Biotech \$100 million in damages, Big Pharma Company would have to record a \$1 million (1 percent times \$100 million) assumed liability as part of its purchase of Upstart Biotech. This is true even if Upstart Biotech had never previously recorded a liability for this contingency.

b. Restructuring costs incurred by the target company in connection with the business combination (1) would not be considered assumed liabilities and (2) would no longer be included in the costs of an acquisition. For example, let's assume Upstart Biotech Company (in anticipation of its merger with Big Pharma Company) had eliminated its entire marketing department.

Under the Proposed Statement, the cost of that restructuring could not be included in the cost of the acquisition. This is because those costs were incurred specifically as a result of Upstart Biotech Company's combination with Big Pharma Company. Since the restructuring liability would not have existed absent the combination with Big Pharma Company, Big Pharma Company would not recognize the liability as part of the purchase price.

c. When ownership control is obtained in a partial acquisition of a company, the full fair value of the assets and liabilities (including goodwill) would be recorded on the consolidated balance sheet—including the portion attributable to the noncontrolling interest. Therefore, the acquirer would have to measure the fair value of the entire business—rather than the fair value of the interest acquired.

For example, let's assume Hungry Acquiring Company bought a 60 percent controlling ownership interest in Tasty Target Company for \$60 million. One may make the argument that the entire entity was worth \$100 million. However, a valuation analyst may determine that a 100 percent interest in Tasty Target Company is only worth \$90 million. Therefore, companies that acquire less than 100 percent of another company would be wise to seek the assistance of a valuation analyst to determine the value of the entire entity.

d. Goodwill, the excess of the fair value of the business acquired over the net amount of the recognized identifiable assets acquired and liabilities assumed, would continue to be measured as a residual. As provided in SFAS No. 142, goodwill would also continue to be tested annually for impairment.

The recognition of goodwill applies no matter what percentage ownership interest in a business is acquired. The goodwill of the controlling ownership interest acquired is determined by subtracting (1) the controlling interest's share in the fair value of the acquired identifiable net assets from (2) the fair value of the controlling ownership interest (i.e., the consideration transferred for the controlling interest).

For example, let's assume the consideration transferred for an 80 percent interest in Upstart Biotech Company is \$160 million and the fair value of 100 percent of the identifiable assets acquired and liabilities assumed are \$210 million and \$60 million, respectively. An 80 percent interest in the net identifiable assets acquired is \$120 million (i.e., 80 percent \times (\$210 million - \$60 million)). Subtracting the \$120 million from \$160 million equals the fair value of the goodwill associated with the 80 percent ownership interest, or \$40 million.

e. The recognition and measurement of the assets acquired and liabilities assumed at their fair value would also change the accounting for step acquisitions. If an acquiring entity owned a previously acquired minority equity investment in an acquired business, that investment would be remeasured at fair value at the date of the acquisition. And, any realized holding gains or losses would be recognized in the consolidated net income.

For example, let's assume Big Manufacturing Company acquires 50 percent of Little Manufacturing Company's 1,000 shares at \$10 per share. The consideration of \$10 per share is determined to be the best basis for estimating the fair value of Little Manufacturing Company.

Before the acquisition, Big Manufacturing Company already owned 100 shares of Little Manufacturing Company that were originally acquired for \$8.50 per share. Therefore, an unrealized holding gain of \$150 on the 100 shares would be recognized in the consolidated statement of operations.

f. Certain research and development assets acquired in a business combination that may have no alternative future use and were previously required to be written off under FASB Interpretation No. 4,

would be measured at their fair value. The R&D assets would be capitalized and subsequently tested for impairment during the in-process period.

For example, let's assume one of the assets Big Pharma Company acquired from Upstart Biotech Company is an IPR&D project valued at \$1 million. That asset would be capitalized at its fair value and tested for impairment during the in-process period. After the completion of the research and development project, Big Pharma Company would determine the useful life of IPR&D. The IPR&D would then be put into use and be subject to ongoing amortization.

Thus, if Big Pharma Company determined that (1) upon completion of the project, its useful life was 10 years, and (2) no impairments had occurred to the IPR&D project since it was capitalized, then the in-service amortization charge for the project would be \$100,000 annually, assuming straight line depreciation.

OTHER CHANGES TO THE PROPOSED STATEMENT

The Proposed Statement modifies the definition of a business that existed under the EITF (Emerging Issues Task Force) Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*. The Proposed Statement defines a business as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return to investors, lower costs, or other economic benefits directly and proportionately to owners, member, or participants. A business consists of inputs and processes applied to those inputs that have the ability to create output."

In addition, the Proposed Statement codified certain EITF consensus positions such as EITF Issue No. 02-17, *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*.

SUMMARY AND CONCLUSION

When the Proposed Statement replaces SFAS No. 141, all references to SFAS No. 141 would be replaced by SFAS No. 141 (Revised 2005), *Business Combinations*.

SFAS No. 141(R) would be effective for financial statements issued for fiscal years beginning after December 15, 2005. SFAS No. 141(R) would apply to business combinations with an acquisition date in or after the beginning of the fiscal year in which the Statement is adopted. Earlier application is allowed for financial statements that have not yet been issued. Retroactive application of SFAS No.

141(R) to businesses acquired before the adoption of this Statement is prohibited.

In addition, SFAS No. 141(R) is being issued concurrently with SFAS No. 1XX, *Consolidated Financial Statements, including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*.

SFAS No. 141(R) supersedes the following pronouncements:

1. SFAS No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*,
2. SFAS No. 147, *Acquisitions of Certain Financial Institutions*,
3. FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*,
4. FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method*,
5. FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations*, and
6. FASB Staff Position No. FAS 141-1 and FAS 142-1, "Interaction of SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*, and EITF Issue No. 04-2, *Whether Mineral Rights Are Tangible or Intangible Assets*."

The Proposed Statement is expected to improve financial reporting by providing a consistent method of accounting for all business combinations. The FASB believes these amendments to SFAS No. 141 will benefit companies as well as investors by:

1. simplifying the financial reporting process,
2. providing more complete information to investors and other users of financial statements of companies, and
3. improving international comparability.

The tentative decisions reached by the FASB could have a tremendous impact on how companies account for merger and acquisition transactions. As a result, it will be interesting to see how the decisions outlined in this article evolve over the next several months once the FASB (1) issues its exposure draft and (2) receives expected comments from SEC registrants, privately held companies that follow GAAP, and accounting professionals.

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