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Get Ready For FAS 141(R)

New Accounting Rules for Business Combinations

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On December 7, 2007, the Financial Accounting Standard Board released a revised version of Statement of Financial Accounting Standards No. 141, Business Combinations. FAS 141(R) is the result of a joint project between FASB and the International Accounting Standards Board to create convergence between U.S. and international financial reporting standards for purchase accounting. The stated purpose of FAS 141(R) is to improve the relevance, representational faithfulness and comparability of the information that a company provides in its financial reporting about a business combination and its effects.

To accomplish this purpose, FAS 141(R) sets out rules and guidelines for how an acquiring company must:

(a) recognize and measure in its financial statements the identifiable assets acquired and liabilities assumed in a business combination, as well as any non-controlling interest in the acquisition target;

(b) recognize and measure the goodwill acquired in a business combination or a gain in a "bargain purchase"; and

(c) determine what information to disclose to enable users of the acquirer's financial statements to evaluate the nature and financial effects of the business combination.

FAS 141(R) is effective for acquisitions that close in fiscal years beginning after December 15, 2008. It presents several significant changes from accounting practices for business combinations, which are likely to affect the timing and structuring of M&A transactions.

Definition of Business and Business Combination

FAS 141(R) defines a business combination as a transaction or event in which an entity (the acquirer) obtains control of one or more businesses, even if control is not obtained by purchasing equity interests or net assets. This definition is broader than the previous definition and now includes not only typical mergers but also acquisitions achieved by contract or when a minority shareholder's substantive participating rights expire. Additionally, the new definition of business combination does not require that consideration be transferred when an entity obtains control. Further, FAS 141(R) defines a business as "*an integrated set of activities and assets that are capable of being managed to provide a return to investors or economic benefits to owners, members or participants*." As a result of this broader definition, development-stage entities are now recognized as businesses and their acquisitions are therefore deemed business combinations.

The FAS141(R) definition of a business does not include the formation of a joint venture, the acquisition of an asset or group of assets that does not constitute a business, a combination of entities or businesses already under common control, or the combination between not-for-profit businesses or the acquisition of a for-profit business by a not-for-profit organization.

Acquisition/Fair Value Method

FAS 141(R) requires all business combinations to be accounted for by applying the acquisition method of accounting (formerly referred to under FAS 141 as the purchase method). While the fundamental requirements of the acquisition and purchase methods are largely the same, FAS 141(R) replaces the original FAS 141 cost-allocation methodology which, when allocating the cost of an acquisition to the individual assets acquired and liabilities assumed, permitted some assets and liabilities to be excluded from such allocation and permitted the measuring of some assets and liabilities at other than their fair values at the acquisition date.

In applying the acquisition method, the acquirer must determine the fair value of most classes of identifiable assets acquired and liabilities assumed as of the acquisition date. The acquisition date is the date on which the acquirer obtains control of the target, typically the closing date. This is unlike the current FAS 141, which provides that the measurement date for some components of a business combination can be different than the acquisition date (e.g. the announcement date for a transaction). Accordingly, under FAS 141, the purchase price may be measured at the announcement date while acquired assets and assumed liabilities are valued at the acquisition date.

FAS 141(R) requires an expanded range of identifiable assets and liabilities to be included in the fair value recognition, including acquired contingencies (discussed in further detail below), in-process research and development (current expensed under FAS 141), indemnification assets and liabilities and tax benefits. This expanded scope of assets and liabilities to be recognized and valued will require increased and more complex valuation work on the part of acquirers.

Currently, FAS 141 requires acquisition transaction costs, such as legal fees, banking fees and valuation service fees, to be included in the purchase price and allocated to acquired assets and assumed liabilities. Going forward, FAS 141(R) requires such costs to be recognized separately from the acquisition and to be expensed as and when incurred, resulting in a hit to earnings primarily in periods leading up to completion of the acquisition. Similarly, where as FAS 141 provides for restructuring costs that the acquirer expects but is not obligated to incur to be recognized as if they are a liability assumed at the acquisition date, FAS 141(R) requires the acquirer to recognize and expense those costs separately from the business combination, as and when incurred, resulting in a hit to earnings primarily in post-acquisition periods. Based on these new expense accounting requirements, acquirers will likely become more sensitive to transaction expenses, as well as the timing of their being incurred relative to other dynamics affecting earnings.

Effect on Use of Equity as Purchase Consideration

FAS 141(R) requires that equity securities (e.g., stock) issued by the acquirer as purchase consideration be measured at fair value on the acquisition date. Currently under FAS 141, the value of equity issued by the acquirer as consideration is measured as of the date of announcement of the business acquisition.

The new timing requirement for valuing equity consideration stands to create accounting issues for acquirers issuing equity as purchase consideration where there is gap in time between when the terms of the acquisition are agreed to and when the acquisition actually closes. If the acquirer agrees to issue a specific number of shares on the agreement date and the value of those shares increases between the agreement date and the acquisition date such that the value of the total acquisition consideration exceeds the value of the acquired assets, the acquirer will be required to book this excess as goodwill. This could lead to a post-acquisition requirement to perform a goodwill impairment assessment, which in turn could result in the acquirer being forced to write down some or all of this goodwill, resulting in a hit to earnings.

On the flip side, if the acquirer agrees to issue a specific number of shares on the agreement date and the value of those shares decreases between the agreement date and the acquisition date such that the value of the total acquisition consideration is less than the value of the acquired assets (net of liabilities) – what is referred to under FAS 141(R) as a "bargain purchase", the acquirer will be required to book this excess as a gain in earnings as of the acquisition date. (Currently, FAS 141 requires such a "negative goodwill" amount to be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to the particular assets acquired). While any earnings gain may initially appear as a positive, it is not the type of gain that makes investors or analysts particularly happy since it is merely an accounting rule effect rather than a tangible result of operational performance.

Under these new accounting requirements, acquirers may be less attracted to using equity consideration in business acquisitions. To the extent acquirers continue to use equity consideration, expect increased efforts to limit the time lag between entry into an acquisition agreement and completion of the acquisition, and an increased use of deal terms (collars) providing for pre-closing adjustments to the agreed-upon number of equity securities to be issued as consideration based on changes to fair value of those equity securities prior to closing.

Accounting for Contingencies; Contingent Consideration

The current FAS 141, permits an acquirer to defer recognition of pre-acquisition contingencies until the recognition criteria for FAS 5 (Accounting for Contingencies) are met. FAS 141(R) now requires an acquirer to recognize assets acquired and liabilities assumed arising from contractual contingencies as of the acquisition date, with the valuation of such contingent assets and liabilities to be measured at their acquisition-date fair values. Also under FAS 141(R), an acquirer is required to recognize non-contractual contingencies as of the acquisition date, again measured at their acquisition-date fair values, but only if it is more likely than not that they meet the definition of an asset or a liability under FASB Concepts Statement No. 6 (Elements of Financial Statements).

A contingent liability includes an obligation of the acquirer to make payments based on the outcome of future events, such as earn-out payments. Under FAS 141, contingent consideration paid after closing of an acquisition is treated as an adjustment to the purchase price and is only required to be booked when the contingency is resolved and the consideration is paid or becomes payable. Under FAS 141(R), contingent consideration must be given a fair value as of the acquisition date, notwithstanding the uncertainty as to when or how much (if any) of such contingent consideration may actually be paid. Following closing of the acquisition, if and when new information is obtained with respect to such contingent consideration (i.e., whether it is required to be paid and, if so, how much), the acquirer must evaluate that new information and measure a liability at the higher of its acquisition-date fair value or the amount that would be recognized if applying FAS 5, and measure an asset at the lower of its acquisition-date fair value or the best estimate of its future settlement amount. To the extent the actual contingent consideration is ultimately determined, any difference between the value determined on the acquisition date and the finally determined amount must be recognized in earnings and not as an adjustment to the purchase price.

As a result of the new valuation intricacies and accounting difficulties imposed by FAS 141(R) with respect to contingent consideration, it is expected that earn-outs or other similar forms of contingent consideration, already a somewhat unpopular component of acquisition agreements due to the difficulty in negotiating their terms, will be shunned even further by acquirers.

Conclusion

The stated goal of the new FAS 141(R) is to improve, simplify and converge U.S. and international methods of accounting for business combinations. FAS 141(R) will almost certainly cause acquirers to put additional thought into the timing and structuring of acquisitions, including how much (if any) equity to use as purchase consideration, what sort of collars or other restrictions ought to be used in connection with equity consideration, how much time should be permitted to elapse between announcement and closing of the deal and the desired timing for closing to best dovetail transaction-related accounting issues with operational accounting.

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Garth's practice is concentrated in general corporate and securities law focusing on mergers and acquisitions, corporate finance, fund formation, venture capital, securities regulatory compliance, and commercial agreements. His experience includes representation of clients in a variety of industries including high technology products and services, alternative energy, biotechnology and genome sciences, industrial products, food products, real estate development, and waste management services. Garth's practice includes providing advice to U.S. clients on Canadian corporate and business law matters and advice to Canadian clients on U.S. corporate, business and securities law matters.

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