

VALUATION observations



SFAS No. 141(R): The Next Frontier in Business Combinations

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In late 2007, the Financial Accounting Standards Board (FASB) released a revision to its standard pertaining to business combinations, SFAS No. 141. Effective for deals closing December 15, 2008 and later, SFAS No. 141(R) brings about several changes to the original statement, many of which have a material impact on the recognition and valuation of the assets acquired by a company.

SFAS Nos. 141 vs. 141(R)

The objective of the FASB, in enacting these changes, is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its reports about a business combination and its effects. To accomplish these goals, the revised statement establishes principles and requirements for how the acquirer:

- a) Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquire;
- b) Recognizes and measures the goodwill

acquired in the business combination or a gain from a bargain purchase;

- c) Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.ⁱ

Although the new statement retains many of the fundamental requirements of SFAS No. 141, the following represent some of the potentially impactful divergences in SFAS No. 141(R) from the original statement:

Transaction Costs. Under SFAS No. 141, costs incurred by the acquiring company associated with the transaction are added to the purchase price, likely resulting in higher goodwill. With the implementation of SFAS No. 141(R), the acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received.ⁱⁱ This practice lends itself to the principle that only assets should be recorded for a combination (since transaction costs are unrelated to the acquired assets).

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Contingent Consideration. Buyers and sellers often differ as to the value of a business based on a company's future earnings capacity. One manner in which parties will try and bridge this gap is to enact contingent consideration or "earn-out" arrangements, in which the buyer agrees to pay an additional amount or the seller agrees to refund part of a purchase price depending on certain performance targets. Under SFAS No. 141, most contingent consideration arrangements are ignored in the calculation of the purchase price. If the agreed upon performance targets are met, the contingency amount is recorded as additional goodwill. Consistent with its goal of having more accurate representations of asset values on company financial statements, SFAS No. 141(R) requires contingent consideration that is classified as an asset or liability to be re-measured to fair value at each reporting date until the contingency is resolved.ⁱⁱⁱ These contingencies will be marked-to-market until they are resolved, at which time the gain or loss will be recorded on the income statement.

Bargain Purchase. In the event that an acquirer purchases a business for less than the aggregate fair value of the purchased assets, the old standard requires that the "negative goodwill" differential be treated as, and be recorded as, a pro-rata reduction in non-current assets acquired. Under SFAS No. 141(R), all acquired assets are recorded at their fair values, regardless of the purchase price. Any

excess (i.e., if the sum of fair values exceeds the purchase price) is recorded as a gain on the income statement (net of deferred taxes) on the acquisition date.^{iv} The new method for recording assets acquired in a bargain purchase more accurately represents the assets at the company's disposal, as they are recorded at fair value, illustrating the FASB's enhanced focus on fair value versus historical cost accounting for business combinations.

In-Process R&D. Under the previous standard, buyers must assign values to in-process research and development ("IPR&D") assets for recording the acquisition and then immediately write them off. However, in doing so, the balance sheet is devoid of potentially relevant information about assets that may have been used to justify the purchase price. The application of SFAS No. 141(R), in accordance with SFAS No. 142: *Goodwill and Other Intangible Assets*, requires the classification of research and development intangible assets as indefinite-lived until the completion or abandonment of the associated research and development efforts.^v The newly recorded assets are not written off or amortized, but are subject to impairment testing under SFAS No. 142 (until completion).

Measurement Date and Period. Under the original standard, the values of certain components of a business (particularly

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stock) are measured at the announcement date, or the date when the agreement is reached. SFAS No. 141(R) states that the acquisition date is the date on which the acquirer obtains control of the acquiree. The date in which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree, or the closing date.^{vi} Additionally, under the original standard, the acquiring company assigns provisional values to the acquired assets and has up to one year to adjust these values. The statement does not, however, indicate whether these adjustments to equity should be reported as income or be applied retroactively to equity. SFAS No. 141(R) clarifies this ambiguity to a degree, allowing a measurement period of up to one year to adjust values as of the acquisition date, but requiring a restatement of prior period financial statements in the event of a material change to the fair values.

Goodwill Measurement. According to the old standard, the acquiring company must consider the aggregate fair values of the appropriate share of acquired intangible assets. The difference between this amount and the purchase price is recorded as goodwill (no goodwill is attributed to the non-controlling interest). Under this method of goodwill measurement, there is little effort made to assess the existence or actual value of goodwill. Rather, residual value is thrown into the goodwill account such that the

balance sheet will balance. While 141(R) does not abandon the use of the residual goodwill measurement approach, because acquirers will now be required to record additional assets and liabilities such as IPR&D and contingent consideration at fair value, it is likely that the residual goodwill amounts recorded will much more closely approximate the actual value of the goodwill acquired in a transaction.

Step or Partial Acquisitions. In a partial or step acquisition, where a transaction itself is not a controlling interest transaction, but results in the acquirer owning a controlling interest, the new standard requires that the acquirer records, at the date of acquisition, 100% of the fair values of the acquired company's entire set of assets and liabilities (including goodwill). In step acquisitions, where control is achieved through a series of transactions, the acquirer shall re-measure its previously held equity interest in the acquiree at its acquisition-date fair value and recognize the resulting gain or loss, if any, in earnings.^{vii} Any transaction in which the acquirer purchases a minority interest after control is obtained is accounted for as an equity transaction. This is in contrast to the previous standard, in which the acquirer preserves the original book value of each investment in the series of transactions that resulted in a change of control and once control is obtained, the book values of the previous investments

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are added together to determine the total consideration. The issue with this practice is that the aggregate sum of the book value of the investments will likely not approximate fair value, an issue which is resolved with the revised statement.

Calculating the Impact

To review the effect that these changes will potentially have on financial statements, we look at an example. In this example, a company is acquired for \$50.0 million in cash consideration and \$7.5 million of earnings-based contingent consideration (for purposes of our analysis, assume the fair value of contingent consideration has already been calculated). Also, assume the acquiring company incurred expenses totaling \$750,000 in connection with the acquisition. The fair value of the acquired assets is determined to be \$49.0 million. Under the original SFAS No. 141, transaction costs are included in the purchase price, while contingent consideration is excluded and recognized in the year in which the contingency is settled. Under SFAS No. 141(R), acquisition costs are expensed at the time of purchase and the determined fair value of contingent consideration is included in the purchase price. Taking into account the fair value of \$49.0 million for the acquired assets and the respective values of contingent consideration and transaction costs incurred, the application of SFAS No. 141(R) results in a recorded goodwill amount of \$8.5 million versus \$1.75 million under the old standard, as outlined in the accompanying table.


Purchase Price Analysis		
	141	141(R)
Cash Payment	\$ 50,000,000	\$ 50,000,000
Contingent Consideration	-	7,500,000
Acquisition Expenses	750,000	-
Total Purchase Price	50,750,000	57,500,000
Fair Value of Acquired Assets	49,000,000	49,000,000
Recorded Goodwill	\$ 1,750,000	\$ 8,500,000

Acquisition Implications

As is outlined in the above example, the implementation of SFAS No. 141(R) has the potential to materially affect post-transaction financial statements. In effect, the changes will often result in higher goodwill balances, as contingent consideration will be included in the purchase price and step transactions will be recorded at fair value. There will also be more disclosures about goodwill, as management will have to describe the economic factors that validate recorded goodwill (i.e., expected synergies, value of the assembled workforce, etc.). With these higher goodwill balances and more disclosures about goodwill, there are likely to be more goodwill impairment charges taken in the years subsequent to the transaction. With more details and more disclosures and the possibility of being perceived as "wrong" about the transaction price, management is likely to become more involved with the due diligence process in addition to the preparation of the purchase price allocation. With the implementation of its revised statement,

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the FASB has enacted standards that will ultimately lead to increased disclosure and financial statement accuracy in the realm of business combinations. 

ⁱ	Financial Accounting Standards Board, Summary of Statement No. 141 (revised 2007)
ⁱⁱ	Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 141 (revised 2007), Paragraph 59
ⁱⁱⁱ	Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 141 (revised 2007), Paragraph 65 (b)
^{iv}	Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 141 (revised 2007), Paragraph 36-38
^v	Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 141 (revised 2007), Paragraph 66 (a)(2)
^{vi}	Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 141 (revised 2007), Paragraphs 10-11
^{vii}	Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 141 (revised 2007), Paragraphs 47-48

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