

# 2007 AICPA National Banks & Savings Institutions Conference

FAS 141(R)

Phillip L. Weaver

November 2007

## Disclaimer

- As of November 12, 2007, the Financial Accounting Standards Board (“FASB”) had not issued FAS 141R.
- Therefore, the slides included in this presentation are current as of November 12, 2007 and are subject to change pending the FASB’s issuance of the final standards.

## Overview

- Joint Project with International Accounting Standards Board (“IASB”)
  - Viewed as the first convergence standard, but some differences remain
- Second phase of FASB’s overall project on business combinations
- FASB will issue two standards:
  - FAS 141R, *Business Combinations, a replacement of FAS 141*
  - FAS 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- IASB will also issue two standards:
  - IFRS 3R, *Business Combinations*
  - IAS 27R, *Consolidated and Separate Financial Statements*

## Key Objectives & Current Status

- Key Objectives:
  - Improve certain purchase accounting rules by increasing (1) transparency of business combinations to users of financial statements and (2) consistency with the Conceptual Framework
  - Move closer to the fair value model
  - Greater convergence with international reporting (IFRS)
- The two Boards plan to issue simultaneously – standards are ready to be released
  - Deliberations are complete and we believe no further points to debate or votes to be taken
- Current projected issuance is middle of November 2007\*
  - \*subject to change

# FAS 141R and IFRS 3R

## Proposed effective date and transition

### **US – FAS 141R**

- Fiscal years beginning after December 15, 2008

### **IFRS – IFRS 3R (requires that IAS 27R be adopted at the same time)**

- Fiscal years beginning after January 1, 2009

## Impacts to Companies

- May require development of complex valuation techniques
  - Fair value items that have not historically been valued in the past
- More use of fair value estimates at both the date the deal closes and post-deal
- Introduces unpredictability in estimating the ultimate purchase price
- Greater volatility / unpredictability of earnings
  - Potentially reduces ability to predict the accretion/dilution that will result from the deal reliably
  - Unpredictability of the effect on ratios / performance measures
- Dramatic changes in accounting and presentation for transactions with minority interests

## FAS 141R: Fundamental Principle

### ***Current practice***

- The acquisition is recorded using a cost accumulation approach
  - Focused primarily on total costs incurred by acquirer to purchase the target

### ***New standard***

- Acquired business should be recorded at fair value
  - Focus on the entire business at fair value without regard to costs incurred by the acquirer
  - Best evidence of fair value is fair value of all the consideration transferred
  - Definition of fair value is FAS 157 - focus on market participant and exit price
  - Buyer specific uses for target would not be considered by marketplace participants in valuing assets and liabilities

### ***Deal implications***

- New fair value provisions will require the development of complex valuation techniques to fair value items that have not historically been fair valued

### ***IFRS convergence***

- US GAAP = IFRS, except for fair value concept -- IFRS generally uses entry price
  - Current IASB fair value project may or may not eliminate this difference

## New Definition: Business

**A business is an integrated set of activities and assets that are capable of being conducted and managed for the purpose of providing either**

**i) a return to investors OR**

**ii) dividends, lower costs, or other economic benefits**

- Nullifies definition in EITF 98-3
- Changes from previous definition include:
  - Removes “self-sustaining” requirement
  - Assess from perspective of hypothetical acquirer
  - Presume a business if “going-concern” element is present
  - Development stage enterprises can now qualify as businesses even if they have not commenced planned principal operations
- New definition will likely increase the number of entities that qualify as a business

## Definition: Business Combination

### *Current practice*

- Control over a business obtained through a transaction involving an acquisition of the net assets or equity interests

### *New standard*

- Expands current definition to include gaining control through other means, including:
  - By consolidating via FIN 46(R) or EITF 04-5
  - By lapsing or removing participating rights (EITF 96-16)
  - By contract (EITF 97-2)
  - In staged acquisitions (i.e. step acquisitions)
- Specifically excludes:
  - Forming joint ventures
  - Combining businesses already under common control
  - Combinations between not-for-profit organizations

## Definition: Business Combination

### *Deal implications*

- More transactions would require fair value assessment and purchase price allocation

### *IFRS convergence*

- US GAAP = IFRS, except for combinations of not-for-profit organizations which are included in scope under IFRS

# Measurement date

## *Current practice*

- EITF 99-12: Generally, measure publicly traded equity securities used as consideration to acquire target at the “announcement date”
  - Announcement date model: Date when substantive agreement is reached that commits both parties and fixes the number of shares or the exchange ratio
- Generally, all other consideration transferred is measured at closing date or consummation date

## *New standard*

- Nullifies EITF 99-12 and requires that all consideration be measured at the **acquisition date**
  - Acquisition date is the date when control is obtained
  - Simplifies the accounting for equity securities
- Purchase price and goodwill impairment risk is not known until day the acquisition is closed
- Possible impairment and bargain purchase scenarios

## Measurement date

### *Deal implications*

- Potential for volatility to post-deal results
- Deal price will have time to reflect market reaction
- Creates uncertainty in estimating acquisition price
- May mitigate future impairment charges in declining markets
- May add to purchase price and goodwill in growing markets
  - Increasing future impairment risk in cyclical or volatile markets
- Consider agreements (caps and floors) to protect against volatility

### *IFRS convergence*

- US GAAP = IFRS

# Measurement period

## *Current practice*

- One-year “allocation period” provided to record estimates related to preacquisition contingencies
  - Generally, information needed to record amounts was not available and adjustments were accounted for prospectively

## *New standard*

- Establishes a provisional account for estimates for which not all necessary information is known at acquisition date related to:
  - Acquisition-date fair value of acquiree
  - Acquisition-date fair value of acquirer’s interest in acquiree
  - Acquisition-date fair value of consideration transferred for the acquiree
  - Acquisition-date values of assets acquired and liabilities assumed
- Relates to new information related to facts that existed at the acquisition date
- Disclose provisional accounts in financial statements

# Measurement period

## *New standard (continued)*

- Retroactively recognize adjustments made during the measurement period to the provisional values as if the accounting had occurred on the acquisition date
  - Prior period financial statements revised in subsequent filing for changes in depreciation, amortization, and other income

## *Deal implications*

- Changes in accounting estimates are not visible in an earnings forecast
  - Changes in recasted financials may have dilutive or accretive impact
- Plan ahead to obtain information to make estimates rather than using a rule of thumb

## *IFRS convergence*

- US GAAP = IFRS

# Transaction costs

## *Current practice*

- Direct external costs (eg. professional fees, such as banking, legal and accounting fees) are considered cost of acquiring the business
- Indirect costs expensed as incurred (eg. internal M&A group)

## *New standard*

- Represent period costs – charge to expense as incurred
- Not considered a component of the fair value of the target acquired

## *Deal implications*

- Decreases balance sheet and may reduce goodwill and related impairment risk
- Accretion/dilution: Reduced acquirer income before and after close
- Demonstrate to stakeholders/analysts that costs will have future value

## *IFRS convergence*

- US GAAP = IFRS

# Restructuring costs

## *Current practice*

- Capitalize in opening balance sheet certain restructuring reserves (eg. exit costs, relocation, plant shut-down, employee termination) of target-related restructuring activities
- Restructuring activities may occur over several years, but generally costs do not impact earnings

## *New standard*

- Nullifies EITF 95-3 and does not allow restructuring costs to be recorded as assumed liabilities
- Expense all acquisition-related restructuring costs that do not meet the recognition criteria of FAS 146
- Post business combination, follow current GAAP including FAS 146

# Restructuring costs

## *Deal implications*

- Affects operating results in post acquisition periods
- Decreases balance sheet and reduces goodwill and related impairment risk
- Accretion/dilution: Reduced acquirer income after close
- Demonstrate to stakeholders/analysts that costs will have future value

## *IFRS convergence*

- US GAAP = IFRS
  - Except for consequential differences in measurement concepts in IAS 37 vs. FAS 146

# Contingent consideration

## *Current practice*

- Earn-outs generally not accounted for until contingency was settled or resolved and then recorded as part of the purchase price

## *New standard*

- Considered a component of the fair value of the target
- Initial recognition: Fair value at the acquisition date
  - Record the “stand-ready” obligation – generally does not represent the amount that will ultimately be paid
  - Probability-weighted DCF or other complex valuation techniques may be required
  - Classify as a liability, derivative instrument or equity
  - Expense earn-outs tied to future services as compensation (no change to current practice)

# Contingent consideration

## *New Standard (continued)*

### ➤ Subsequent measurement:

- If equity, no subsequent remeasurement required
- If derivative, follow FAS 133 and related guidance
- If liability, mark-to-market through earnings each reporting period

### ➤ Paradoxical accounting results

- If the acquiree meets performance milestones, buyer must pay the earnout and incur an additional cost
- Failure to meet performance target would result in income recognition
- Incentive to overvalue contingent consideration and/or potential for abuse

### ➤ Earnouts that are written-off could trigger goodwill impairment

- Ironic outcome given that earnouts are often intended to avoid overpaying for a target

# Contingent consideration

## *Deal implications*

- Increases initial purchase price
  - Potential for more goodwill
- Accretion/dilution is unpredictable due to “day 2” mark-to-market and any goodwill impairment risk

## *IFRS convergence*

- All contingent consideration initially recognized at fair value
- No subsequent remeasurement of contingent consideration classified as equity

# Contingent consideration

## *Significant remaining differences between US GAAP and IFRS*

- Classification of obligation to pay contingent consideration as debt or equity follows respective GAAP. As a result:
  - Classification under US GAAP and IFRS could differ for the same transaction
  - Thus, differences in subsequent accounting will also occur
  
- Differences in subsequent measurement and recognition of gains or losses
  - Under US GAAP, all contingent consideration classified as a liability is remeasured at fair value through P&L
    - unless it is a hedging instrument through OCI
  - Under IFRS, contingent consideration classified as a liability is remeasured based on the applicable IFRS standard
    - eg. IAS 37 and IAS 39

# Acquired contingencies

## *Current practice*

- Recognized if probable and reasonably estimable (FAS 5) at the time of acquisition

## *New standard*

- Initially recognize all contractual contingencies at fair value
- Initially recognize non-contractual contingencies if they meet a “more likely than not” threshold
  - More likely than not usually interpreted as greater than 50% chance of occurring
  - More likely than not that the contingency gives rise to an asset or liability
    - Not necessarily the likelihood that a company may elect to settle the contingency
- Subsequent measurement
  - Contingent liabilities: measure at the **higher** of
    - Acquisition-date fair value
    - FAS 5 amount
  - Contingent assets: measure at the **lower** of
    - Acquisition-date fair value
    - The best estimate of a future settlement amount

# Acquired contingencies

## *Deal implications*

- Prior to settlement, recorded liability can only be increased not decreased (dilutive impact)
  - Settlement at a lower value is accretive
  - Opposite is true for contingent assets
- Accretion/dilution
  - Unpredictable due to “day 2” mark-to-market and any goodwill impairment risk that results from recording more liabilities
- Impact dependent on nature of contingency
  - Presents valuation challenges in any event

## *IFRS convergence*

- All contractual contingent liabilities initially recognized at fair value
- Same subsequent measurement except for consequential differences arising from references to different standards (IAS 37 vs. FAS 5)

## Acquired contingencies

### *Significant remaining differences between US GAAP and IFRS*

- Recognition of non-contractual contingent liabilities
  - Under US GAAP, all contractual contingencies recognized; non-contractual contingencies recognized only if “more likely than not”
  - Under IFRS, all contingencies recognized (regardless of probability)
  
- Recognition of contingent assets
  - Under IFRS, recognition of contingent assets is prohibited

## IPR&D

### *Current practice*

- Measure at fair value and expense IPR&D assets in purchase accounting unless the assets have an alternative future use

### *New standard*

- Initially capitalize acquired IPR&D asset at fair value
  - Subsequent expenditures would not be capitalized
- IPR&D in an asset purchase (under revised definition) would be expensed
- Classify as indefinite lived intangible asset until R&D phase is completed or project is abandoned
  - Expense IPR&D asset if project is abandoned
  - Assign amortization life once R&D phase complete (e.g. FDA approval obtained)

# IPR&D

## *New standard (continued)*

- Test for impairment while classified as indefinite lived intangible asset
  - Impairment based on IPR&D's fair value - no other assets to "shield" potential impairment
  - Increased emphasis on complex/subjective fair value measurement techniques

## *Deal implications*

- Initially the one-time charge was easily explained to stakeholders
- Accretion/dilution:
  - Dilutive effect through amortization (if successful)
  - Dilutive if unsuccessful or abandoned through impairment or write-off
- Timing of dilution is uncertain and may be more difficult to explain when impaired or abandoned
- Recognition at fair value provides for additional valuation opportunities

## *IFRS convergence*

- US GAAP = IFRS
  - \*Note – impairment testing under IFRS could lead to a different result

# Share-based awards

## *Current practice*

- Treated as a modification under FAS 123(R)

## *New standard*

- Consistent with the fair value premise in FAS 123(R)
- Vested Awards
  - If fair value of replacement awards greater than the fair value of old awards, the incremental portion is recorded as compensation expense
  - If fair value of replacement awards is less than the fair value of old awards, the difference is recorded as part of purchase accounting

# Share-based awards

## *New standard (cont.)*

- Unvested Awards
  - Allocate FV of replacement award between past and future services based on past service period relative to total service period
  - Past service portion is part of purchase consideration
  - Remaining portion is compensation expense over remaining service period
  
- Compensation expense recorded immediately if buyer accelerates the vesting of an award that would not otherwise vest at the combination date
  - Compensation expense equal to the fair value related to the accelerated vesting

## *IFRS convergence*

- US GAAP = IFRS

# Bargain Purchase

## *Current Practice*

- Reduce long-term assets for excess of fair value of net assets over consideration paid
- If amounts remain after reducing certain assets, record extraordinary gain

## *New standard*

- Record entire excess of fair value of net assets over purchase consideration as an extraordinary gain
  - Extraordinary gain recorded only after a reassessment of the purchase price allocation
  - Reduction of assets is inconsistent with model to record assets at fair value

## *Deal implications*

- More scrutiny on valuations when a bargain purchase arises

## *IFRS convergence*

- US GAAP = IFRS, except for presentation
  - Gain not recorded as “extraordinary” under IFRS

# Income taxes

## *Current practice*

- Release acquisition date valuation allowances against goodwill, then intangibles, then the income statement
- Reflect any changes in the acquirer's pre-existing tax balances in the purchase date balance sheet
- Recognize tax benefit of excess tax goodwill in the year taken on the return

## *New standard*

- All changes in valuation allowances and tax uncertainties after the FAS 141R effective date would be subject to FAS 141R, even if the respective transaction was before the effective date

# Income taxes

## *New standard (continued)*

- Deductible goodwill with an original tax over book basis will result in an initial DTA -- determined in an iterative computation
  
- Changes in valuation allowances and tax uncertainties:
  - First year: adjust changes in valuation allowance against goodwill
    - where goodwill is reduced to zero, reduce income tax expense
  
  - Thereafter: adjust valuation allowance changes through income tax expense
    - Recognize any changes in the acquirer's pre-existing tax balances in the income statement or equity
    - Treat tax benefit of excess tax goodwill as a deferred tax asset

# Income taxes

## *Deal implications*

- Changes in valuation allowances and other tax reserves made after the measurement period are charged to earnings
  - Increased income statement volatility
  - Important to consider the volatility in the expected effective tax rate in the accretion/dilution analysis
- Buyers may receive tax indemnifications
  - FAS 141R allows for assets to be recorded and may reduce volatility, but is not reported as an adjustment to income tax expense and is not reflected in the effective tax rate
- Changes outside the 12 month window will have an impact on the tax expense and eventually the effective tax rate

## *IFRS convergence*

- Generally US GAAP = IFRS
  - IFRS does not have the concept of valuation allowances (net presentation)
  - Therefore, the reduction of a valuation allowance under US GAAP = recognition of additional DTA under IFRS

## US GAAP vs. IFRS

### *Other remaining differences between US GAAP and IFRS*

- Different definitions of fair value could lead to different amounts for assets or liabilities initially recognized at fair value
  - Differences in fair value should be rare for non-financial instruments
  
- Accounting for some assets and liabilities occurs according to respective GAAPs, and as a result, creates differences
  - applies to assets and liabilities not initially measured at fair value
  - eg. taxes, employee benefits, share-based payments