

Ready for the Changes to Business Combination Accounting?

Why are the changes important?

If your company is considering buying another business, you may get more than you bargained for if you close the deal in 2009 or later. What will you get in 2009 if you are not prepared for the changes to business combination accounting? Surprises and likely unpleasant ones at that. As such, you need to make sure you understand the repercussions of these changes when planning for the business acquisitions you may make in 2008 or 2009. In doing so, keep in mind that a difference of one day in the acquisition date could make a world of difference in the accounting for a business combination.

The changes to business combination accounting are noteworthy signs of the accounting world's movement to more accounting at fair value and more alignment with International Financial Reporting Standards.

What has changed?

FASB Statement No. 141 (revised 2007), *Business Combinations*, introduces numerous changes to a buyer's accounting for a business combination that are both significant and, in some cases, controversial. Some of the more profound revisions brought about by Statement 141R that will affect the accounting for most, if not all, business combinations include:

- **Recognizing and measuring all the assets and liabilities of the target, even in a partial acquisition.** Application of Statement 141R results in recognition of 100% of the assets acquired and liabilities assumed, even if less than 100% of the target's ownership interests are acquired by the buyer. In other words, Statement 141R results in the recognition of the target's business as a whole, regardless of whether 51% or 100% (or any percent in between) of the target is acquired. Consequently, the portion of the target that was not acquired (the minority or "noncontrolling" interest) is also recognized causing the buyer to recognize both the goodwill attributable to it as well as the goodwill attributable to the noncontrolling interest. Recognition of 100% of the assets acquired and liabilities assumed and 100% of goodwill represent a profoundly different conceptual model than that captured in the pre-existing guidance.
- **Using a "fair value" model rather than a "cost allocation" model in measuring the assets acquired**

and liabilities assumed. The overall model used to account for a business combination under Statement 141R results in measuring virtually all the assets acquired and liabilities assumed at fair value. The prior guidance only partially relied on fair value measurements and ultimately only used those measurements to allocate the cost of the acquisition to the assets acquired and liabilities assumed.

- **Using a "fair value" model rather than a "carryover basis" (or "book value") model in measuring the nonacquired interest in the target.** The overall model used to account for a business combination under Statement 141R results in measuring the nonacquired (or noncontrolling) interest in the target at fair value. The pre-existing guidance used the book value of the net assets acquired in measuring the noncontrolling interest in the target.



- **Expensing deal costs incurred in connection with a business combination.** Deal costs incurred by the buyer are no longer included in the purchase price of the target when accounting for a business combination. Under Statement 141R, these costs are expensed as incurred and as the related services are rendered, except for those costs incurred by the buyer to issue debt or equity securities. These issuance costs are accounted for under other generally accepted accounting principles (GAAP).

- **Recognizing and measuring the target's preacquisition contingencies.** The guidance in Statement 141R distinguishes between contingencies of the target that are contractual and those that are noncontractual. Those that are contractual are recognized at their fair value at the acquisition date. Those that are noncontractual are only recognized if it is more-likely-than-not that the contingency meets the definition of a liability or an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*. If that threshold is met, the contingency is recognized and measured at its acquisition-date fair value. If that threshold is not met, the contingency is not recognized in the accounting for the business combination. Pre-existing guidance on the subject of the target's preacquisition contingencies relies on a model based predominantly on FASB Statement No. 5, *Accounting for Contingencies*, which uses a "probable" threshold for recognition and a "best estimate" approach for measurement.
- **Recognizing the fair value of earn-outs (i.e., contingent consideration) in the initial accounting for the acquisition.** Statement 141R includes the fair value of earn-outs and other forms of contingent consideration in the consideration transferred for the target at the acquisition date. Under the pre-existing guidance, contingent consideration was typically recognized upon resolution of the contingency and issuance of the consideration. Whether or not the resolution of the contingency affected purchase accounting depended on the nature of the contingency.
- **Eliminating the recognition of liabilities for restructuring costs expected to be incurred as a result of a business combination.** Pre-existing guidance may have resulted in the buyer recognizing a liability in purchase accounting for restructuring costs based on its expectations instead of its obligations. Statement 141R eliminates this possibility given that restructuring costs that are merely expected to be incurred do not represent a liability as defined in Concepts Statement 6. Instead, Statement 141R requires restructuring costs that result from a business combination to be accounted for under other applicable authoritative literature, as appropriate (e.g., FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*). Under Statement 141R, what the buyer plans to do with the target after acquisition does not affect the buyer's accounting for the acquisition.
- **Reflecting in income tax expense the effects of a buyer's decision to reduce its own deferred tax asset valuation allowance due to the business combination.** If a buyer determines that some or all of its previously recognized valuation allowance is no longer needed as a result of a business combination, the effect of reducing (or eliminating) the valuation allowance would almost always be recognized in income tax expense under Statement 141R. Application of pre-existing guidance would have reflected the effect of reducing the valuation allowance in purchase accounting, which could have affected the amount of goodwill or certain noncurrent assets recognized as a result of the business combination.
- **Recognizing a gain from a bargain purchase.** If applying Statement 141R results in negative goodwill, the buyer is required to perform a careful review of the factors that resulted in the negative goodwill. If, after this careful review, negative goodwill still exists, the buyer recognizes a gain from a bargain purchase. This is expected to be rare. Application of pre-existing guidance would have first used negative goodwill to reduce the carrying amount of certain acquired assets on a pro rata basis.

These are only some of the more profound revisions brought about by Statement 141R. There are many other revisions that may be more or less significant to any given organization depending on its specific situation. Other examples are:

- Applying Statement 141R to business combinations involving mutual entities, such as credit unions
- Applying Statement 141R upon the initial consolidation of a variable interest entity
- Applying Statement 141R to business combinations in which no consideration is transferred
- Expanding the definition of what constitutes a business
- Requiring adjustments during the one-year purchase price allocation period (now called measurement period) to be applied retrospectively
- Using the acquisition date as the measurement date for the buyer's equity securities included in the consideration transferred
- Accounting for a step acquisition
- Accounting for in-process research and development
- Subsequent accounting for contingent liabilities and assets recognized in a business combination
- Measuring accounts receivable at fair value (which results in no separate recognition of an allowance account)
- Many more...

Many newer standards require extensive disclosures and Statement 141R is no exception. A substantial majority of the exhaustive requirements are incremental to what was required under pre-existing guidance.

When is adoption required?

The revisions brought about by Statement 141R are effective for business combinations with acquisition dates that occur on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. For example, if the buyer has a calendar year end and the acquisition date for its business combination falls on January 1, 2009 or after, then Statement 141R applies. However, if the acquisition date for its business combination falls on December 31, 2008 or earlier, then Statement 141R does not apply. Early adoption of Statement 141R is prohibited.

The only guidance within Statement 141R that applies to a business combination that occurred prior to the buyer's adoption of Statement 141R relates to income tax accounting. More specifically, if after the effective date of Statement 141R the buyer subsequently changes the valuation allowance recorded for deferred tax assets acquired in a pre-Statement 141R business combination, the effects of those changes should almost always be reflected as an adjustment to income tax expense. In addition, specific guidance was added to FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, to address how changes to acquired income tax positions should be treated by the buyer. This new guidance applies to income tax positions acquired in a business combination that occurred prior to the buyer's adoption of Statement 141R.

What should we do now?

While the new business combination accounting model should not be implemented immediately, it is still useful to understand and appreciate how the accounting for a business combination that occurs after the effective date of Statement 141R will differ from a business combination that occurs before the effective date of Statement 141R. As stated earlier, the difference of one day in the acquisition date could make a world of difference in the accounting for a business combination.

To help you understand the implications of Statement 141R, please contact Boyer & Ritter to arrange a review of your specific situation with one of our audit specialists.

