COMPLIANCE WEEK

FASB Approves Merger Accounting Overhaul

By Tammy Whitehouse — December 11, 2007

A suite of new accounting rules spelling out how to account for mergers, acquisitions, and partial interests in other entities is finally on the books, culminating years of effort and giving financial reporting executives plenty to think about.

The rules are another giant leap toward fair value accounting and require new uses of fair value measurement when booking business combinations or partial interests in other operations. They are also a significant milestone in establishing a single global accounting language, since international rules, which will look a great deal like the U.S. ones, are expected shortly.

The Financial Accounting Standards Board last week published Financial Accounting Standard No. 141R, *Business Combinations,* and FAS 160, *Noncontrolling Interests in Consolidated Financial Statements.* The Board's goal was to simplify the accounting for business combinations and improve the reporting of noncontrolling or minority interests in financial statements.

They are also the first standards issued by FASB explicitly intended to converge with international rules, although the International Accounting Standards Board has delayed publishing its final standards and will include some differences between the two boards on several key elements. IASB says it still needs to finish some steps specific to its rulemaking process, and it expects to publish its new rules—revised versions of International Financial Reporting Standard No. 3, *Business Combinations,* and International Accounting Standard No. 27, *Consolidated and Separate Financial Statements*—in January.

Stefanie Tamulis, project manager at FASB, says FASB decided it wanted to get moving rather than wait for IASB. "When IASB decided they weren't going to be able to issue until January, our Board said we'd like to get this out to constituents as soon as possible," she explains.

FAS 141R and 160 take effect for financial statement periods beginning after Dec. 15, 2008, so calendar-year companies will implement in 2009. Early adoption is not permitted, Tamulis notes, because investors prefer the comparability that comes with adoption *en masse*.

FASB says FAS 141R will increase consistency in the accounting and financial reporting of business combinations in two ways: by establishing the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed in a business combination; and by requiring more disclosure to reflect the nature and financial effect of the business combination. FAS 160, meanwhile, will require companies to record noncontrolling or minority interests in other enterprises as equity in consolidated financial statements.

Greg Forsythe, a director at Deloitte Financial Advisory Services, says the new standards usher in some significant changes in accounting for business combinations and partial interests in other entities. For example, FAS 141R requires an acquisition to be measured at fair value on the date of the acquisition, where historically measurement might have occurred at some reasonable time before or after the terms of an acquisition are announced. Acquisition costs (fees for attorneys, financing, accounting, auditing, and the like) must now be expensed as incurred rather than capitalized as part of the acquisition, he adds.

STANDARD EXCERPT

Below are excerpts of FAS 141R, Business Combinations.

The date on which the acquirer obtains control of the acquiree generally is the date on which the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

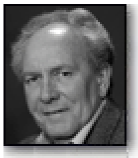
As of the acquisition date, the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in the following two paragraphs.

To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements, at the acquisition date. For example, costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree’s employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its postcombination financial statements in accordance with other applicable generally accepted accounting principles (GAAP).

In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 57–59 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable GAAP.

The acquirer’s application of the recognition principle and conditions may result in recognizing some assets and liabilities that the acquiree had not previously recognized as assets and liabilities in its financial statements. For

Ernie Baugh of the auditing firm Mayer Hoffman McCann says that requirement is proving contentious.



Baugh

"I don't know that companies are as worried as the advisers are," he says. "All of those things used to be included in the cost of the acquisition, written off over a period of years, if they didn't wind up in goodwill. Now they will be expensed immediately. Those costs will be more highly scrutinized. It can be a significant factor in an acquisition. You're talking about expensive people."

example, the acquirer recognizes the acquired identifiable intangible assets, such as a brand name, a patent, or a customer relationship, that the acquiree did not recognize as assets in its financial statements because it developed them internally and charged the related costs to expense.

Source

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Forsythe said the new rules also call for significant change to the reporting of contingencies, or prospective liabilities for which the outcome is uncertain. "Now they will be recorded at fair value at the acquisition date and will be remeasured going forward through the profit-and-loss statement each period," he says.

Greg Rogers, with the law firm Guida, Slavich & Flores, says that change around contingencies in particular is a "sleeper" of an issue right now. He wonders if companies grasp what it will mean for future acquisitions, especially given that it can sweep in contingencies related to environmental liabilities.

John Formica, a partner with PricewaterhouseCoopers, says the new rules introduce a new theory about how partial interests in other entities should be reflected in consolidated financial statements. "Noncontrolling interests are deemed to be equity holders and are therefore reported as equity in the consolidated financial statements," he says. "Under today's accounting, a minority interest is recorded on an area of the balance sheet called mezzanine, and now it will come out of mezzanine and into equity. That changes presentation on the balance sheet with related changes in the income statement."

That question of how to report partial interests is one of the key differences between FASB and IASB views. FASB rules say when a company acquires a controlling interest in an outside entity but not the *entire* entity, it must reflect the entire entity at fair value, Tamulis says. IASB, however, is expected to say acquiring companies can choose to reflect only their proportional interest.

"I don't think the controlling interest issue will be resolved anytime soon," Tamulis says. "It's not a candidate for convergence."

Formica says he initially believed the changes to the presentation of noncontrolling interests on the income statement—including that net income will now include earnings attributable to both the controlling and noncontrolling interests—might be confusing to investors, but he says the disclosure requirements included in the standard should help clarify things.

“Net income today won’t be comparable to net income under the new standard,” he explains. “But the disclosure requirements will make clear those earnings that are attributable to the noncontrolling interests as well as the controlling interests. Earnings attributable to the controlling interests will be comparable to net income reported under today’s accounting and will be used to calculate earnings per share. So earnings per share will be determined on the same basis as it is calculated today. The clarity of disclosures will be important, so investors will get it.”

Forsythe

Another key provision of the new standards, Forsythe says, is a change in the reporting of contingent consideration, which is the part of a purchase price that is contingent on the future financial performance of the acquired business. Currently, payouts based on contingent consideration are reported as they are paid, Forsythe says; under new rules, they will be reported upfront as present values of expected future payment amounts.

Although she acknowledges some discomfort still remains in the market over the new requirements, Tamulis is satisfied with the outcome. “This results in a much better representation of what you acquired,” she says.

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