What you need to know about the new accounting standards affecting M&A deals*

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Executive summary

Overview

For many companies, mergers and acquisitions (M&A) are a key strategic driver of shareholder value. While, in theory, accounting considerations should not affect the decision to buy or sell a business, accounting and reporting concerns often impact many decisions made in the evaluation of a deal, including decisions about how to communicate the transaction to a company's stakeholders.

Important changes in the accounting for M&A transactions have occurred. In the fourth quarter of 2007, the U.S. Financial Accounting Standards Board (FASB) released new standards dealing with the accounting and reporting for M&A and the related topic of consolidations.[1] The International Accounting Standards Board (IASB) is expected to issue its related standards in the first quarter of 2008. Because most companies use either the standards of the FASB or the IASB for financial reporting, the accounting for M&A will be impacted worldwide.

The last time standard setters changed the accounting for M&A, the immediate impact was dramatic—no more pooling-of-interests, no more goodwill amortization. Those changes significantly altered how some acquisitions were structured. In comparison, the new standards may seem less dramatic. But they will influence deal negotiations and deal structures, affect how companies model and evaluate the impact of an acquisition, and change how companies communicate with stakeholders about deals.

While certain aspects of the accounting for M&A will be simpler, the new standards introduce new accounting concepts and create certain accounting complexities. Further, the expanded use of fair value accounting will inherently create valuation complexities. Several of the changes have the potential to generate greater earnings volatility in connection with and after an acquisition.

Here are just some of the key changes:

- Transaction costs and restructuring charges will be expensed.
- The accounting for certain assets acquired and liabilities assumed in an acquisition will change significantly. Some notable examples: acquired in-process research and development (IPR&D) assets will now be capitalized; certain contingent assets and liabilities will be recognized at fair value; and allowances for loan losses on the acquisition date will be eliminated.
- Earn-out arrangements (contingent consideration), depending on how they are structured, will be measured at fair value until settled, with changes in fair value recognized each period in earnings.
- In partial acquisitions, when control is obtained, the acquiring company will recognize and measure at fair value 100 percent of the assets and liabilities, including goodwill, as if the entire target company had been acquired.
- Companies will no longer recognize gains or losses on the sale of shares of a subsidiary when control is retained.
- Companies will be under increased pressure to finalize the acquisition accounting in the first reporting period after the deal. Material adjustments made during the measurement period to the initial acquisition accounting will be recorded back to the acquisition date. This will cause companies to revise previously filed financial statements when reporting comparative period financial information in subsequent filings.

Even companies with no merger activity on the horizon may be affected by the new standards as the financial reporting for minority interests will undergo a major change. This will likely cause performance measures, financial ratios, and consolidated equity balances to change, and companies will need to evaluate the impact of these changes particularly on existing contractual arrangements, such as debt covenant calculations.

The changes in these standards are pervasive. Management will need to revisit the customary practices it uses to evaluate potential acquisitions and to communicate to stakeholders its performance and financial results subsequent to an acquisition. In doing so, companies should note that the new standards are to be applied to acquisitions that close in years beginning after December 15, 2008 (2009 for calendar-year-end companies). Although early adoption of the standards is prohibited, we recommend that companies assess the broader impact of the standards now, as it could affect their thinking on potential transactions.

This publication highlights and explores the major provisions of the standards and their implications. A summary of how these provisions compare with parallel provisions of prior standards is presented in the appendix.

1 The standards represent the first joint effort by the FASB and the IASB to develop converged standards. FAS 141(R) is the U.S. standard on M&A; FAS 160 is the U.S. standard on consolidations.

The impact on deals

We do not anticipate that the new standards will impact deal flow. That dynamic is influenced by broader macro-economic factors. However, the changes introduced by the new standards will affect how companies account for and report M&A activity.

The new standards will:

Influence acquisition negotiations and deal structures

- The use of earn-outs may become less frequent due to the earnings volatility that results from changes in their fair value, while obtaining seller indemnifications may become a greater part of the negotiation process.
- The use of equity securities to pay for deals may be viewed as less attractive, as the new standards require the value of the securities to be measured at the close of the transaction rather than when the transaction is announced. Thus, pricing of deals for accounting purposes will not be known until closing.
- Acquirers will need to consider the accounting implications of strategies involving acquisitions of less than 100 percent of the target company.
- The greater use of fair value measures and other estimates inherent in acquisition accounting may have the unintended consequence of causing the timing of deals to change. Closing a transaction early in a quarter will provide more time to refine acquisition accounting estimates and thus reduce the possible need to revise previous financial statements.

Affect the financial projections used to model the acquisition

- Private equity investors and corporate management will need to modify their exit strategy and accretion/dilution models to reflect the earnings impact that will result from the new standards.
- Pervasive changes in a number of areas, including the expensing of deal costs and restructuring charges, will impact earnings and affect other modelling considerations.
- Operating metrics such as gross margins, operating earnings, EBITDA, and debt/equity ratios will change, particularly for partial acquisitions.

Influence how, when, and what companies communicate to stakeholders

- Companies may need to explain the nature of deal-related costs that will now directly impact the bottom line, as well as changes in the purchase price based on the closing-date value of equity securities issued in a deal.
- The rationale and assumptions supporting the fair value measures for certain balance sheet items will likely need to be discussed.
- The reasons for the revision of prior-period financial statements for material adjustments to the acquisition accounting will need to be clearly communicated to stakeholders.
- Finally, the new consolidation standard will result in a host of new disclosures about transactions with minority shareholders and certain non-recurring gains or losses.

The impact of fair value

The standard setters approached revising the accounting for business combinations with the view that an acquired business, as well as the underlying assets and liabilities, should be recorded at fair value. Under the previous standard, certain assets and liabilities of an acquired business were recorded at fair value, while others were not.

The use of fair value in the new standards will change current practice in the following ways:

- Transaction costs, such as deal costs and restructuring charges, will no longer be capitalized as part of the acquisition. The principle behind the change is that these costs are not part of the *fair value* of the business acquired, but rather a *cost* of acquiring the business.
- Most assets and liabilities will be recorded at their fair values on the date of acquisition. This would include contingencies and earn-out arrangements (contingent consideration). Most asset reserves will be eliminated, as the acquired assets will be recorded at their fair values. Acquisitions that result in a "bargain purchase" from an accounting standpoint will no longer reduce asset values and will result in an operating gain under the new standards.
- Even in a partial acquisition, the acquiring company will recognize and measure at fair value 100 percent of the assets and liabilities of the target, including 100 percent of goodwill. This means that minority interests will also be recorded at fair value rather than historical cost.
- Similarly, in a step acquisition, once control is obtained the entire business will also be recorded at fair value on that date. This includes the investor's prior investment in the subsidiary, resulting in a gain or loss on the transaction date. Subsequent transactions with minority shareholders will not result in a gain or loss, or a change in the recorded amount of assets and liabilities, unless control is lost.

The measurement principles for applying fair value to assets and liabilities are also changing. No longer will buyers be able to determine the fair value of acquired assets by reference to the intended use of an asset. The standard requires that the buyer value assets by using marketplace assumptions rather than the assumptions the acquirer used to arrive at the purchase price. As a result, higher values could be placed on assets that the buyer might have no intention of using or plans to phase out. This would cause higher depreciation and amortization (or impairment) charges in future periods.

These changes have many practical implications. Clearly, valuation issues will be in the forefront, particularly for assets and liabilities that require more subjective valuation techniques. The valuation of more complex items, such as contingencies and earn-out arrangements, is new, and valuation models and practices are likely to evolve over time. The application of the marketplace approach to fair value will also require modifications in traditional valuation practices. Lastly, the use of fair value measures will affect the comparability of financial information among companies and may make it more difficult to predict earnings in future periods.

What you need to know about the new accounting standards affecting M&A deals

Discussing the implications

The new financial reporting relationship

Partial acquisitions and noncontrolling interests

Stepping back to see the bigger picture

Discussing the implications

The following provides more detail on the implications of the new standards for M&A deals.

Deal costs

Deal costs typically include direct payments to investment bankers, advisors, attorneys, appraisers, and accountants. Under previous accounting, such costs were capitalized as part of the purchase price. These costs will now be expensed as incurred. As a result, reported earnings in periods prior to the closing will be reduced. Beyond this immediate impact on earnings, there are several further implications:

- In the future, some companies may want to delay initiating thorough due diligence and incurring related deal costs until there is a higher degree of certainty that the transaction will actually occur.
- High deal costs in the period preceding an acquisition could warrant an explanation to the market, which would signal the existence of ongoing M&A activity.

Companies will need to carefully assess the accounting for deal costs for acquisitions that are in process in late 2008. If the deal closes in 2008, these costs will be capitalized as part of the acquisition. If the deal does not close in 2008, the costs will need to be expensed.

Restructuring activities

The new standards generally preclude acquirers from recording a liability related to a planned restructuring of the acquired company's operations. As a result, the cost of these restructurings will be charged to earnings in the post-acquisition period. Under previous accounting, the cost of an acquirer's planned restructuring of the acquired company's operations was recorded as a liability, as part of the accounting for the acquisition, resulting in higher goodwill.

Under the new standards, the cost to restructure the operations of the acquired company as a result of the deal can be recognized as part of acquisition accounting only if certain conditions are met. These conditions are similar to those that must be met to recognize a liability for restructuring activities outside an acquisition. That is, the acquirer's restructuring plan must be in place on the date of the acquisition. For example, the plan would need to be approved, the benefit arrangements communicated to employees, and the facilities abandoned before a liability could be recorded.

For most acquisitions, these conditions set a very high hurdle for an acquirer to clear on the acquisition date, and we expect such situations to be rare. As a result, the costs for these restructuring activities will be recorded in earnings after the transaction's closing date.

This treatment eliminates the anomaly that arose under the previous accounting, whereby the accounting for restructuring costs depended on whether the restructuring was of the acquirer's or the acquired company's operations. From an accounting standpoint, it will now make no difference which facilities will be shuttered or whose employees will be severed (those of the acquired company or those of the buyer) to achieve the synergies expected from the transaction.

Because these restructuring costs will now be charged to earnings, they may receive increased scrutiny from stakeholders. Companies may, therefore, come under increased pressure to demonstrate the link between the restructuring activity and anticipated synergies; thus management will want to ensure that the benefit of the acquisition is communicated clearly to stakeholders.

Acquired contingencies

In a significant change from prior practice, acquired contingent assets and liabilities (e.g., litigation, environmental issues, or possible product recalls) will be recorded at fair value as of the acquisition date, if certain conditions are met. The guidance introduces new complexities, as acquiring companies must determine the nature of the contingency (that is, whether the contingency is contractual or non-contractual) and the likelihood of occurrence. Under the new standards, the threshold for recognizing acquired contingencies on the acquisition date is lower than is required when companies account for contingencies outside an acquisition.

Subsequent changes in the recorded amount of an acquired contingent liability will not be recognized unless there is new information about its outcome, and the amount determined under other applicable accounting guidance is higher than the original fair value amount. If so, an adjustment to increase the liability will be recorded in earnings. Similarly, subsequent changes in the recorded amount of a contingent asset will not be recognized unless there is new information about its outcome, and the best estimate of its future settlement amount will be lower than the original fair value. In this case, a charge to earnings will be recorded to decrease the asset.

	Acquisition date	Subsequent accounting periods
Contractual	All at fair value	No change in the recorded amounts, unless there is new information about its outcome, and amounts under existing standards would be higher (liabilities) or the estimated settlement amount would be lower (assets), until resolved
Non-contractual	If "more likely than not," record at fair value; otherwise do not recognize	

The accounting by the buyer for seller indemnifications has also changed. If the buyer is able to obtain seller indemnifications for certain contingencies (e.g., environmental matters or tax exposures), the indemnification will be recognized and measured as a contingent asset in the same way as the related contingent liability. This means that these accounts will generally move in tandem and any impact on earnings will be offset, although not always within the same income statement caption.

Recording contingencies at fair value will entail a highly complex valuation process. Further, companies will need to track acquired contingencies separately from other contingencies to effectively assess whether the amount of the contingency under other applicable accounting standards would be higher (for a liability) or lower (for an asset) than the fair value amount determined on the acquisition date. In addition, the new standards require companies to provide more disclosures about acquired contingencies, including the nature and amount of the contingencies as well as the potential range of outcomes. While the new standards will not change the acquirer's economic exposure to contingencies, companies will want to ensure that the legal and financial due diligence processes appropriately consider the existence and nature of acquired contingencies. Further, the representations and warranties provisions of the purchase and sale document may be expanded to minimize exposures to contingencies.

Earn-outs (contingent consideration)

Under the previous accounting, earn-outs were generally considered part of the cost of the acquisition and did not need to be accounted for until the contingency was resolved. Under the new standards, earn-outs and other forms of contingent consideration will be recorded at fair value on the acquisition date, regardless of the likelihood of payment. Subsequent changes in the fair value of most contingent consideration arrangements will be recorded in earnings. However, if the contingent consideration meets the requirements for classification as equity, it would not be adjusted in subsequent accounting periods for changes in fair value.

The impact of the new requirements is worth illustrating. Assume that a buyer agrees to pay the seller additional cash consideration if certain performance targets are met in the three years following the acquisition. Upon acquisition, the buyer records a liability representing the fair value of the obligation to make the additional payment. In each reporting period during the three-year earn-out, the fair value of the obligation is adjusted through earnings until the commitment is settled. As the likelihood of meeting the performance targets increases, the fair value of the contingent consideration also increases, resulting in an additional liability and additional expense. The reverse is also true: Failure to meet the targeted performance milestones under an earn-out will result in income, but may also trigger the need for an impairment analysis of goodwill. Many believe that these results are counter-intuitive.

Given the impact on earnings, the buyer may want to consider alternative deal structures, including one that would allow the contingent consideration to be treated as equity. If this is the preferred alternative, buyers will also need to consider the dilutive impact of the equity earn-out arrangement. In certain circumstances, however, buyers may seek to avoid earn-outs altogether and settle the final purchase price when the deal closes. This strategy will likely affect deal negotiations.

In-process research & development (IPR&D)

In-process research and development will continue to be measured at fair value on the acquisition date; however, these assets will no longer be written off to earnings immediately after the acquisition. Instead, they will be capitalized and recorded as intangible assets on the acquisition date, subject to impairment until completion. If the projects are completed, the IPR&D assets will be amortized through earnings. If the projects are abandoned, the IPR&D assets will be written off. The new standards have not changed the accounting for research and development expenditures that are incurred after the acquisition, including those for completing the acquired IPR&D projects. These costs generally continue to be expensed as incurred.

Here's an example: Under previous accounting, a pharmaceutical company's acquisition of a biotech company with new drugs under development would likely have resulted in the recording of an immediate, non-recurring, and easily explainable write-off of the value ascribed to the IPR&D. Under the new accounting, the value of the drugs under development will be capitalized on the acquisition date and reported as intangible assets. If the drugs to which the IPR&D relates are successful, the assets will be amortized in future periods. The IPR&D assets associated with unsuccessful drugs will need to be written off in periods subsequent to the acquisition. Further, assessing IPR&D assets for impairment will be a challenge because research and development projects evolve over time and may be combined with other projects, thereby losing or blurring their individual identities and complicating valuation.

The accounting for IPR&D in an acquisition of assets for accounting purposes has not changed. In some circumstances, it may be worthwhile for companies to consider acquiring just the desired assets rather than the entire business. The FASB is considering amending the accounting for IPR&D purchased in an asset acquisition to conform it to the accounting for IPR&D acquired in an acquisition of a business. Until then, buyers that acquire just the desired IPR&D asset, rather than the entire business, will immediately write off the asset.

Effective tax rate volatility

In the past, adjustments to acquisition-related tax reserves were generally made by adjusting goodwill. Those adjustments were made irrespective of the time that had elapsed since the acquisition. For example, if after the acquisition, the IRS examined tax periods of the target company preceding its acquisition, the results of the examination would almost always be recorded as an adjustment to goodwill, regardless of when the examination was completed. Under the new standards, such adjustments will generally be recorded in earnings subsequent to the acquisition, directly impacting a company's effective tax rate.

Further, the new accounting for changes in tax reserves will apply to all acquisitions, including those consummated in periods prior to the effective date of the standard. Therefore, adjustments made to these accounts after the effective date of the standard will be charged to earnings, while adjustments made to these accounts prior to the effective date will affect goodwill.

The new standards require similar changes in the accounting for post-acquisition adjustments to deferred tax valuation allowances of the acquired company, which could also impact a company's effective tax rate. This provision will also apply to previous acquisitions. In the past, when a valuation allowance of the acquired company established in the acquisition accounting was released, the adjustment reduced goodwill (possibly other non-current intangible assets). Under the new standards, the subsequent reduction of a valuation allowance of the acquired company recorded in the acquisition accounting will typically be reported in earnings.

There may also be instances when an acquisition results in a change in assessment of the recoverability of the buyer's pre-existing deferred tax assets. For example, if income of an acquired company is expected to offset the buyer's existing operating losses, the corresponding reduction in the buyer's previously recorded valuation allowance will be reported in earnings. Previously, the reduction of the buyer's valuation allowance reduced goodwill as part of the acquisition accounting. Therefore, irrespective of whether a reduction of the valuation allowance of the buyer is recorded at the date of the acquisition or in post-acquisition periods, the reduction will be reported in earnings.

Post-acquisition effective tax rates may also be impacted by other provisions in the standards. For example, in the acquisition of stock of another company (a non-taxable transaction), deal costs and earn-outs will often be treated as part of the cost of the acquired entity for tax purposes. This means that these costs will become part of the tax basis of the shares, and they will not result in a tax deduction until or unless the shares of the entity are subsequently sold. Thus, no current or deferred tax benefit would be recognized for those payments. The pre-tax expenses for these items without a related tax benefit will result in an increase in the company's effective tax rate for that reporting period. That is, the charge to earnings for an increase in the value of an earn-out arrangement after the acquisition will create an expense for financial reporting purposes that is not deductible for tax purposes.

Companies may want to enhance their due diligence procedures to more precisely identify and measure the significant tax uncertainties of the target at the acquisition date to mitigate the potential for significant volatility in its effective tax rate in the future.

Valuation date

The standards introduce a new accounting consideration for companies that plan to issue equity as a component of the purchase price. The value of equity securities issued as part of the purchase price will be measured on the closing date of the transaction, rather than on the announcement date. Fluctuations in the acquirer's stock after the announcement date and before the closing date will therefore impact the amount of the purchase price for accounting and reporting purposes. Companies may feel pressure to compress the period between the announcement date and the closing date to limit the risk of major variations in the stock price. In addition, while most deal structures include price protections in the event of wide swings in stock price, management may want to consider negotiating features in the acquisition agreement to narrow the range of stock price variability that would trigger the protection provisions.

Adjustments to acquisition accounting

Another significant change from prior financial reporting practices relates to adjustments made to the acquisition accounting after the transaction. Companies will have a period of time after the acquisition (similar to the time permitted under previous requirements) to true-up acquisition accounting estimates. However, the new standards require the revision of prior-period financial statements to record material adjustments of estimated amounts in the acquisition accounting as of the acquisition date. This contrasts with previous accounting in which these types of adjustments were generally reflected in the period of change.

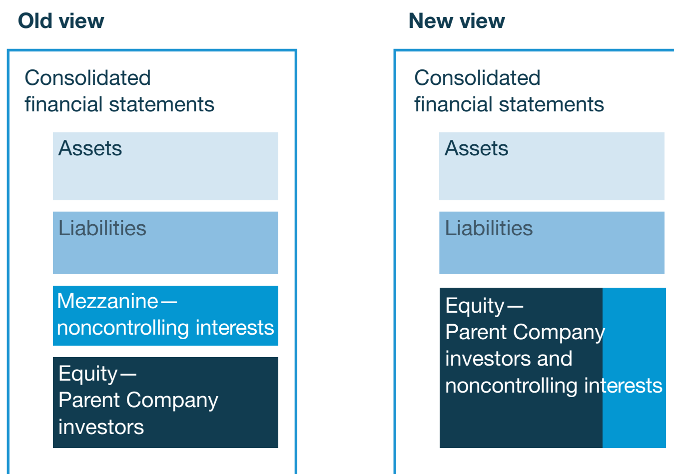
Nearly every organization will be impacted by this requirement, due to the pervasive use of estimates. The requirement is likely to increase the pressure on due diligence to provide the information necessary to make accurate estimates and thereby minimize the need to revise prior-period financial statements in subsequent filings. Further, management may want to give careful consideration to the timing of a deal's closing date. A closing date in the beginning of a quarter will provide more time to finalize the accounting for the transaction prior to reporting quarterly results.

The new financial reporting relationship

The new standards change the nature of the financial reporting relationship between the parent and minority shareholders in a consolidated subsidiary (the standards refer to minority shareholders as noncontrolling interests).

The standard setters have adopted the view that the consolidated financial statements should be presented as if the parent company investors and the other minority investors in partially owned subsidiaries have similar economic interests in a single entity. Therefore, minority shareholders are now viewed as having an interest in the consolidated reporting entity. As a result, the investments of these minority shareholders, previously recorded between liabilities and equity (the "mezzanine"), will now be reported as equity in the parent company's consolidated financial statements. The following exhibit illustrates this change.

The reporting entity: view of consolidated financial statements



Since the noncontrolling interests are now considered equity of the entire reporting entity, transactions between the parent company and the noncontrolling interests will be treated as transactions between shareholders, provided that the transactions do not create a change in control. This means that no gains or losses will be recognized in earnings for transactions between the parent company and the noncontrolling interests, unless control is achieved or lost. These new principles fundamentally change not only the presentation, but also the accounting for noncontrolling interests in the consolidated financial statements. Although the change makes certain aspects of the accounting for transactions between shareholders simpler, like step-acquisition accounting, other aspects of the new financial reporting relationship will be highly complex, for example, determining the fair value of the noncontrolling interests on the acquisition date.

Another implication of reporting noncontrolling interests as a component of equity is that companies that have been reporting more than their proportionate share of a partially owned subsidiary's losses will now report higher earnings because the noncontrolling interests will be allocated their share of the losses even if their equity balance is in a deficit position.

This new accounting will be required for all companies that have partially owned subsidiaries on the effective date of the standard. This means that there will be different accounting for these transactions before and after January 1, 2009. For example, if management was contemplating acquiring additional equity interests in a partially-owned subsidiary, the acquisition would be accounted for as an additional cost of the subsidiary (i.e., a step acquisition) before January 1, 2009. After that date, the same transaction would be accounted for as an equity transaction, with the difference between fair value and carrying value recorded in equity. Likewise, if management is considering the sale of an interest that would not result in a change of control, it may want to complete the transaction before the effective date of the standards. In doing so, the company would record a gain or loss, rather than recording it as an equity transaction. Communications to stakeholders will need to be clear about the implications of these types of transactions.

Partial acquisitions and noncontrolling interests

The following provides more detail on the implications of the new financial reporting relationship.

Goodwill on partial acquisitions

In a partial acquisition, or step acquisition in which a company acquires a controlling interest through a series of transactions, the acquirer will generally record all assets, including 100 percent of goodwill, and all liabilities at fair value on the date control is obtained. This applies to single-step acquisitions of a controlling interest, as well as to transactions in which acquiring control requires multiple steps over time. Under the previous accounting, the buyer would have recorded the acquired portion of the net assets at fair value (including goodwill on a pro rata basis) and retained the book value for the noncontrolling (minority) interests. This approach resulted in goodwill being recorded for the acquired interest only.

Transactions with minority shareholders

Acquiring minority shareholder interests when there is no change in control

The purchase of additional interests in a partially owned subsidiary will be treated as an equity transaction if there is no change in control. If the parent company purchases additional shares of stock in the partially owned subsidiary, and the fair value of the interest acquired exceeds its carrying value, the adjustment will reduce the parent company's equity. This in turn may impact the equity-based operating metrics and financial ratios of the parent company.

For example, let's assume that a parent company that owns 60 percent of the voting equity interests of a subsidiary acquires an additional 10 percent from the minority shareholders for $100 million. Further, assume that the carrying value of that interest is $65 million. Since there was no change in control, the parent company would record an adjustment (in this case a decrease) to its equity for the difference between the fair value of that interest of $100 million and the related carrying value of $65 million, or $35 million. Under previous accounting guidance, this difference would have been recorded as an additional cost of the acquisition, likely resulting in more goodwill. Thus, if a company is assessing its strategic alternatives concerning the outstanding interests of minority shareholders, it should consider the impact of the new accounting on balance sheet ratios and performance metrics.

Transactions	Previous accounting	New accounting
Holds 60%	Fair-value 60% and consolidate; minority interest of 40% recorded at carryover basis on the acquisition date	Fair-value 100% of assets and liabilities and consolidate on the acquisition date
Acquires additional 10% (now 70%)	Fair-value additional 10%	Equity transaction

Parent company sale to third parties (or its interests are diluted) when there is no change in control

Transactions such as the sale of subsidiary stock by the parent or the issuance of stock by the partially owned subsidiary, which under previous accounting generally resulted in gains or losses, will now be recorded in stockholders' equity as long as there is no change in control of the subsidiary.

If a company is contemplating the sale in the near term of a portion of an existing subsidiary that would not result in a change of control, management may want to consider the timing of the transaction, since gains or losses will no longer be recognized after the effective date of the standard.

Transactions	Previous accounting	New accounting
Holds 80%	Fair-value 80% and consolidate; minority interest of 20% recorded at carryover basis on the acquisition date	Fair-value 100% of assets and liabilities and consolidate on the acquisition date
Dispose of 20% (now 60%)	Record gain or loss on disposition	Equity transaction

Step acquisitions: acquiring shareholder interests when there is a change in control
If the parent company obtains control by increasing its ownership from, say, 40 percent to 65 percent, the parent would adjust its initial investment (i.e., the 40 percent) to fair value by recording a gain or loss based on the difference between the fair value and the carrying value of the investment. The remeasurement guidance is likely to have more of an impact on the recognition of gains, since companies are required to periodically evaluate their investments for impairment. The acquiring company will need to consider the earnings impact of recording the investment at fair value and the manner in which the transaction is communicated to stakeholders. For example, if there had been a diminution in the value of the shares of the investment, management might believe it's the right time to take a larger stake in the company, even though doing so could trigger a loss (if the loss was not previously recognized) on its current holdings.

Transactions	Previous accounting	New accounting
Holds 40%	Equity method investment recorded at cost on the acquisition date	Equity method investment recorded at cost on the acquisition date
Acquires additional 25% (now 65%)	Fair-value additional 25% and consolidate; minority interest of 35% recorded at carryover basis	Fair-value 100% of assets and liabilities and consolidate; record holding gain or loss on original 40%

Parent company sale to third parties (or its interests are diluted) when there is a change in control
Transactions between the parent company and third parties (noncontrolling interests) that result in a change of control will generate gains or losses to be recorded in earnings. If a company sells shares of its subsidiary such that it no longer controls the subsidiary, the company would (i) recognize a gain or loss in earnings on the shares sold and (ii) adjust the retained equity investment to fair value, with any difference from its carrying value recognized as a gain or loss in earnings. Transparent reporting of these transactions will be required through robust disclosures in the financial statements.

Transactions	Previous accounting	New accounting
Holds 80%	Fair-value 80% and consolidate; minority interest of 20% recorded at carryover basis on the acquisition date	Fair-value 100% of assets and liabilities and consolidate on the acquisition date
Dispose of 60% (now 20%)	Record gain/loss on shares sold	Record gain/loss on shares sold and gain/loss to revalue remaining interest (i.e., the 20%) to fair value

New look for the income statement

In addition to the changes in the balance sheet, there is also a change in what is presented in the income statement. Net income will include both the parent's and the minority shareholders' share of earnings. That differs from today's presentation in which net income represents only the parent's share. To provide consistency with past reporting, there is a new category called "net earnings attributable to the parent company," which will be similar to net income under the prior standards. Despite this change, earnings per share will still be determined on the basis of net earnings attributable to the parent company's shareholders, consistent with previous calculations.

Although not a new look, the presentation of gross margins and operating earnings for companies that enter into a partial acquisition is likely to look different in amount when compared to amounts determined under previous practice, due to the recording of 100 percent of the acquired assets at fair value.

Stepping back to see the bigger picture

The effective dates of the new standards on accounting for M&A and on consolidations provide companies time to assess the strategic implications for a variety of significant issues. These issues encompass the impact of the new standards on deal structure, deal assessment, financial modelling, and post-transaction financial reporting and communications, as well as the earnings impact that will occur both before and after an acquisition.

Management will need to provide additional information to investors so that they may clearly understand the impact of acquisitions on reported results. This will be more important under the new accounting standards because the reporting of pre- and post- acquisition expenses, transactions with minority shareholders, and the information in financial statements will differ from what investors are used to seeing.

In light of the very real impact that these new standards have on acquisition strategy and financial reporting, the message is clear. The changes are far reaching—they will affect old deals, deals in the pipeline that are expected to close both before and after 2009, and the presentation of consolidated financial statements. Senior executives and directors need to understand the key features of the new standards and will want to assess their impact now on deal strategies.

We welcome the opportunity to dialogue with you on any of the matters discussed here.

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Appendix: A quick look at key features of the new standards

A quick look at key features of the new standards

Deal costs and restructuring costs

New accounting	Previous accounting
New accounting Transaction costs and costs to restructure the acquired company will generally be expensed.	**Previous accounting** Transaction and costs to restructure the acquired company were typically recorded as part of the cost of the acquisition.
Impact These costs will now affect earnings.	

Acquired contingencies

New accounting	Previous accounting
New accounting Upon acquisition, certain contingent liabilities of the target (e.g., litigation, environmental issues, or possible product recalls) will be measured at fair value. After the acquisition, if new information is available, contingent liabilities will be measured at the higher of their acquisition-date fair value or the amount determined under existing guidance for non-acquired contingencies.	**Previous accounting** Contingent liabilities were typically recorded when payment was deemed to be probable and the amount was estimable.
Certain acquired contingent assets will be measured at fair value. In subsequent periods, if new information is available, contingent assets will be measured at the lower of their acquisition-date fair value or the estimated amount to be realized.	Contingent assets typically did not meet the recognition criteria and were seldom recorded.
Impact The recognition criteria have been changed and, as a result, more contingent assets and liabilities will be recorded.	

Earn-outs (contingent consideration)

New accounting	Previous accounting
New accounting Earn-outs and other forms of contingent consideration (i.e., additional payments dependent on the outcome of future events) will be recorded at fair value on the acquisition date, regardless of the likelihood of payment. Subsequent changes in fair value for certain earn-outs will directly impact earnings.	**Previous accounting** Earn-outs were recorded when the contingency was resolved and were considered part of the cost of the acquisition.
Impact Previously recorded as adjustments to goodwill, changes in the fair value of these arrangements will now affect earnings.	

In-process research and development (IPR&D)

New accounting	Previous accounting
New accounting Acquired IPR&D will be measured at fair value and recorded as an asset on the acquisition date.	**Previous accounting** IPR&D was measured at fair value and expensed immediately upon acquisition as a one-time charge to earnings.
Impact Post-deal earnings will be affected by either the amortization or the impairment of the IPR&D asset.	

Accounting for tax adjustments

New accounting	Previous accounting
New accounting Changes to acquisition-related deferred tax asset and income tax reserves made after the acquisition will generally impact income tax expense.	**Previous accounting** These adjustments were commonly treated as an adjustment to goodwill.
Impact These tax items will now affect earnings.	

Valuation date

New accounting	Previous accounting
New accounting Equity securities issued as part of the purchase price will be measured on the closing date of the transaction.	**Previous accounting** Equity securities were generally measured when the deal was announced.
Impact The purchase price will be impacted by movements in stock price between the announcement date and the closing date.	

Partial acquisition and minority interests

New accounting	Previous accounting
New accounting Noncontrolling interests will be recorded in equity in the consolidated financial statements.	**Previous accounting** Called minority interests, these amounts were generally recorded on the balance sheet between liabilities and equity (the “mezzanine”).
Impact No gains or losses will be recognized in earnings for transactions between the parent company and the noncontrolling interests, unless control is achieved or lost.	

Goodwill on partial acquisitions

New accounting	Previous accounting
New accounting Even when less than a 100% controlling interest is acquired, 100% of the net assets of the acquired business, including 100% of goodwill, will be recorded at fair value.	**Previous accounting** Only the acquired controlling interest was recorded at fair value, while the remaining interests retained their pre-acquisition book values.
Impact This change will likely result in higher asset values and affect future operating metrics and financial ratios, although net income attributable to the parent company remains unchanged.	

Adjustments to acquisition accounting

New accounting	Previous accounting
New accounting Adjustments to acquisition-date accounting estimates will be accounted for as adjustments to prior-period financial statements.	**Previous accounting** These types of adjustments were reflected in the period of change; previous financial statements were not reopened.
Impact Enhanced due diligence procedures may be needed to obtain greater assurance about the accuracy of accounting estimates on the acquisition date to avoid changes to previously released financial information.	

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