# Business Combinations and Consolidations . . . the new accounting standards*

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# Business Combinations & Consolidations… the new accounting standards

A condensed summary of the significant provisions and implications of two new accounting standards on the accounting for business combinations and consolidated financial statements (FAS 141R and FAS 160) is provided below.† The standards will have a pervasive impact on accounting practices that have been well understood for many years. The changes introduced by the new standards are likely to affect the planning and execution, as well as the accounting and disclosure, of merger transactions. The changes will almost certainly affect how those transactions are communicated to stakeholders. For these reasons, understanding their impact is critical for finance leaders, deal makers, and senior executives.

FAS 141R continues the evolution toward fair value reporting and significantly changes the accounting for acquisitions that close beginning in 2009, both at the acquisition date and in subsequent periods. The standard introduces new accounting concepts and valuation complexities, and many of the changes have the potential to generate greater earnings volatility after the acquisition.

### Scope

**New Provision:** Definitions of a business and a business combination will be expanded.

**Implication:** More transactions and events will qualify as business combinations and will be accounted for at fair value under the new standard.

### Fair Value

**New Provision:** All business combinations (whether full, partial or step acquisitions) will result in all assets and liabilities of an acquired business being recorded at their fair values, with limited exceptions.

**Implication:** Determining fair values of assets and liabilities based on market participant assumptions as opposed to company specific assumptions may present new valuation challenges. In partial acquisitions, recording all assets at their full fair values will likely affect companies' future operating metrics due to increased amortization, depreciation, or future impairment charges—even though net income will still be allocated between the parent's interests and noncontrolling interests. In step acquisitions, previous investment interests held prior to obtaining control will also be recorded at fair value, with any gain or loss recognized in earnings.

### Contingent Consideration

**New Provision:** Earn-outs and other forms of contingent consideration will be recorded at fair value on the acquisition date.

**Implication:** Measuring contingent consideration at fair value may require the use of complex valuation techniques that are highly subjective and based on a variety of assumptions. Contingent consideration arrangements that qualify as liabilities will result in fair value adjustments in subsequent periods, which will directly impact earnings, rather than additional purchase price.

### Contingencies

**New Provision:** Certain acquired contingencies will be recorded at fair value at the acquisition date. In subsequent periods, those contingent liabilities will be measured at the higher of their acquisition date fair value or the amount determined under the existing guidance for non-acquired contingencies. Contingent assets will be measured at the lower of their acquisition date fair value or the estimated amounts to be realized.

**Implication:** Measuring contingencies at fair value may require the use of complex valuation techniques that are highly subjective and based on a variety of assumptions. Judgment will be required in determining which contingencies will be recognized at fair value and which will be accounted for in the same way as non-acquired contingencies.

### Acquisition Costs

**New Provision:** Acquisition costs will generally be expensed as incurred.

**Implication:** The expensing of acquisition costs will lead to lower earnings, primarily in pre-combination periods.

### Restructuring Costs

**New Provision:** Restructuring costs generally will be expensed in periods after the acquisition date.

**Implication:** The expensing of restructuring costs will result in increased charges to earnings, likely over several reporting periods, as the new business is integrated.

† The two standards represent the first joint effort by the U.S. Financial Accounting Standards Board and the London-based International Accounting Standards Board to develop converged standards. FAS 141R and FAS 160 were issued in the fourth quarter of 2007. Both standards will generally be effective for acquisitions that close beginning in 2009.

FAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests (NCI) and classified as a component of equity. This new consolidation method will significantly change the accounting for transactions with minority-interest holders. Additionally, financial statement presentation, operating metrics, and financial ratios at the date of acquisition and in subsequent periods will be affected.

### In-Process Research & Development

**New Provision:** In-process research and development (IPR&D) will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date.

**Implication:** IPR&D charges will impact future earnings when the IPR&D asset is amortized or impaired in subsequent periods rather than expensed at the acquisition date. Assessing IPR&D intangible assets for impairment will prove challenging as projects evolve over time.

### Measurement Date

**New Provision:** Fair value of the purchase price, including the issuance of equity securities, will be determined on the acquisition date.

**Implication:** This change will simplify the accounting because equity securities will no longer be measured at the announcement date. However, the new provisions may introduce volatility and uncertainty in estimating the final purchase price due to market price changes between the announcement date and the acquisition date.

### Income Taxes

**New Provision:** Changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period will impact income tax expense.

**Implication:** Similar to changes in other assets and liabilities in a business combination, changes in these tax items after the measurement period will be recognized in earnings rather than as an adjustment to the cost of the acquisition.

### Noncontrolling Interests (NCI) Presentation

**New Provision:** NCI will be recognized in the equity section, and losses in excess of the NCI's equity interest will continue to be allocated to NCI.

**Implication:** The new presentation will generally increase consolidated equity balances and will impact balance sheet metrics and financial ratios.

### Transactions with NCI

**New Provision:** Purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. Upon a loss of control, the interest sold, as well as any interest retained, will be measured at fair value, with any gain or loss recognized in earnings.

**Implication:** Assets and liabilities will not change for subsequent purchase or sale transactions with NCI as long as control is maintained. Differences between the fair value of consideration paid or received and the carrying value of NCI will be recognized as an adjustment to the parent interest's equity. Accordingly, such transactions may also impact balance sheet metrics and financial ratios.

### Transition

**New Provision:** The new standards will be effective for annual periods beginning after December 15, 2008, with early adoption prohibited.

**Implication:** The new business combinations standard will be applied prospectively, while most classification and presentation provisions of the NCI standard will be applied retrospectively.

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