

Mergers & Acquisitions —A snapshot

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Highlights

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Accounting for partial acquisitions and disposals—it's not so simple!*

In an economic environment where many companies are buying and selling portions of businesses, the M&A Standards¹ will have an impact on how companies account for these types of transactions. At first glance, the fundamental concept of “control” that drives the accounting seems easy to understand. If a company gains control, the acquisition is a business combination. If a company loses control, it deconsolidates the subsidiary. If a company maintains control, the transaction is recorded in equity. Simple, right? Not so fast!

This volume of *Mergers & Acquisitions—A snapshot*, will discuss several intricacies in the M&A Standards relating to the accounting for partial acquisitions and disposals that may impact how companies report financial results and communicate to shareholders.

¹ FAS 141(R), *Business Combinations* (Accounting Standards Codification 805), is the US Standard on M&A, and FAS 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment to ARB No. 51* (Accounting Standards Codification 810), is the US standard on consolidations (the “M&A Standards”).

Control matters

It may be helpful to provide a summary of how control matters in the accounting under the old and new guidance. As you will see from the following scenarios, the key determination is whether there has been a change of control.

Scenario	M&A Standards	Old guidance
1. Dispose of 60% of a business and lose control	Record gain/loss on 60% sold and revalue the 40% to fair value (i.e., recognize 100% of gain/loss)	Record gain/loss on 60% sold
2. Dispose of 40% of a business and maintain control	Equity transaction (no gain/loss)	Record gain/loss on 40% sold
3. Own 25% and acquire additional 35% interest of a business and obtain control	Fair value 100% of assets/liabilities and consolidate; record 40% noncontrolling interest at fair value; record gain/loss on revaluation of 25% to fair value	Fair value 35% and consolidate; record 40% minority interest at carryover basis (25% also remains at carryover basis)
4. Control 60% of a business and acquire 40% interest	Equity transaction (no step-up)	Fair value additional 40% as a step acquisition

As demonstrated in these scenarios, under the M&A Standards, a company that loses control of a business but retains an equity investment will now recognize 100% of the gain upon deconsolidation, while a company that disposes of a partial interest but maintains control wouldn't even recognize a gain on the shares sold. A company that obtains control of one of its existing investments will generally recognize a gain, while a company that acquires an additional interest in an entity that it already controls will not. On the other hand, the accounting for the disposals and acquisitions of assets (versus a business) hasn't changed and will continue to follow existing guidance. Therefore, assessing whether a group of assets constitutes a business is critical in determining the accounting for these transactions.

Now, with that as background, let's take a look at some of the challenges companies are facing implementing the M&A Standards for partial acquisitions and disposals.

Form or substance?

Does the legal form of the transaction matter? A company could sell a majority interest in a subsidiary in legal form but is required to continue to consolidate the subsidiary. In this case, a change of control has not occurred and the sale would be accounted for as an equity transaction. The substance is that control has not changed and the accounting follows that determination.

However, sometimes it is not easy to apply the substance of the transaction given the lack of symmetry in terms between the two M&A Standards. One standard applies to the disposal of a "subsidiary", a legal entity, while the other standard applies to the acquisition of a "business", which may not be a legal entity. The question arises as to whether the new guidance applies to the disposal of a business that is not in the form of a subsidiary.

For example, is a company required to apply the M&A Standards in Scenario 1 if the company disposes of a division that is a business but not in a legal subsidiary and obtains a 40% investment in the company that acquired the division? Would the company follow the guidance in the M&A Standards or would the company follow the guidance for the disposal of assets for which the accounting hasn't changed? If a company incorporates a division that represents a business into a subsidiary prior to disposal, should the new guidance apply? The FASB is currently debating this issue. However, if the substance of a transaction is that a company sold a business, we believe the accounting should recognize the substance of the transaction. That is, the M&A Standards should apply. We believe that there should be symmetry between the M&A Standards following the substance of the transaction.

Conflicts in the literature

While the concept of control under the M&A Standards may sound simple to apply, the accounting may conflict with other facets of the accounting literature. Let's explore a few of these conflicts.

Real estate

Accounting for sales of real estate and potential gain recognition under the real estate industry guidance is complex. In some cases, recognition of a sale is precluded and in others gain recognition may be reduced or deferred. If a company sells only a portion of a business that consists primarily of real estate and the criteria for both sale

and gain recognition have been met, then the company could record a partial gain relating to the portion sold in accordance with the real estate industry accounting guidance. This treatment is unlike the all or nothing approach included in the M&A Standards. Therefore, when a company sells a portion of a business that consists primarily of real estate, the question arises whether the company follows the industry guidance specific to real estate or the guidance included in the M&A Standards.

One view is that a company should continue to apply specific real estate industry accounting guidance to sales of interests that are in-substance real estate and that the M&A Standards do not apply to such transactions. The rationale is that the accounting guidance for real estate contains many nuances unique to these transactions, so companies should continue to apply the specific guidance that was intended to handle these types of transactions. Others believe that a company should account for the sale of a business that consists primarily of real estate similar to the sale of businesses in other industries. In that case, the M&A Standards would apply.

While the question is currently being debated by the FASB, we believe that the specialized real estate industry guidance should govern the sale of all businesses that consist primarily of real estate.

The following example highlights the different accounting.

	M&A Standards	Real estate industry guidance
Same facts as Scenario 1 except that the subsidiary consists only of real estate and that the criteria outlined in the real estate guidance for both sale and full accrual gain recognition are met. The company receives \$60 in cash. The book value and fair value of the real estate subsidiary are \$80 and \$100, respectively	Record 100% gain	Record gain on 60% sold
	Proceeds \$60	Proceeds \$60
	Retained investment, fair value 40	Retained investment, book value 32
	Deconsolidation, net assets (80)	Deconsolidation, net assets (80)
	Gain \$20	Gain \$12

Transfer of business to an existing equity investment

Oftentimes, a company will sell a business to an entity in which it has an existing equity investment causing the company to lose control in the former business. Following the old guidance, a company would generally recognize a gain only for the portion of the business that was effectively sold to a third party, unlike the all or nothing approach included in the M&A Standards. So, again we are left with a conflict in the accounting literature. Which guidance do we follow? The FASB is also addressing this question. In the interim, we believe the M&A Standards should govern the sale of a business to an existing equity investment.

The following example highlights the different accounting.

	M&A Standards	Old guidance
A company sells a business with a carrying amount of \$100 to its 25% equity investee for \$500	Record 100% gain	Record gain on 75% sold (i.e., the portion of the business effectively sold to the third party investors)
	Proceeds \$500	Full gain \$400
	Deconsolidation, net assets (100)	75% sold .75
	Gain \$400	Gain \$300

Joint ventures

There is also a conflict between joint venture accounting guidance and the M&A Standards. The term “joint venture” is used loosely in practice, but in a “true” joint venture arrangement, two parties enter into an agreement to operate a business where both parties have joint control. That is, neither party has control. Historically, a company that contributed a business into a joint venture would not recognize a gain. In certain circumstances partial gain recognition was appropriate. In either case, it was not the all or nothing approach prescribed by the M&A Standards.

Is the accounting under the M&A Standards the same for arrangements with joint control as with arrangements which result in the loss of control? While the FASB is addressing this question, we believe when a company contributes a business to a joint venture and loses unilateral control over that business, the M&A Standards should apply, similar to other transactions where there is a loss of control. Therefore, the company would recognize 100% of the gain.

The following example highlights the different accounting.

	M&A Standards	Old guidance
A company contributes a business with a carrying amount of \$100 and fair value of \$500 to a joint venture.	Record 100% gain	The company would either recognize no gain or only 50% of the gain
	Fair value \$500	Full gain \$400
	Deconsolidation, net assets (100)	50% .50
	Gain \$400	Gain \$200

Other issues

Retained investments

The guidance for partial disposals requires that a company record its retained investment in an entity at fair value, but the M&A Standards do not define “retained investment”. The question arises how this ambiguity will impact how much gain to recognize upon disposal.

Let’s go back to Scenario 1 and assume the business being sold was paying rent to the parent of \$1,000 per month which is significantly below market value at the disposal date. After the sale, the lease agreement remains in place. Economically, in the sale transaction, the seller is receiving consideration for 60% of the business sold and for the below market lease agreement.

We believe that the accounting should reflect the economics of both transactions in the seller’s financial statements. That is, the company should recognize the retained equity investment as well as the unfavorable lease arrangement at fair value upon deconsolidation of the business.

Valuation considerations

Valuation considerations may be more complex in connection with partial acquisitions and disposals under the M&A Standards. In some cases, a company may need to apply the M&A Standards even if there is no monetary consideration paid. For example, there may be a change of control because of a change in shareholder rights such that one party obtains control over an entity which in the past it had not controlled. Under the M&A Standards,

the company that gains control would have a business combination and would need to fair value 100% of the assets, liabilities and noncontrolling interest and recognize a gain on its previously held equity interest without the benefit of any monetary consideration being exchanged.

Even when there is monetary consideration, valuation complexities can arise. Lets look at a scenario where a company acquires a 60% interest of a business to illustrate these complexities. Assume the company paid \$60 million in cash for the 60% interest, from which one might infer that the fair value of the 40% is \$40 million (((\$60 million / 60%) X 40%). In many cases, deriving the fair value of the 40% directly from the price paid for the 60% will not be that simple. Why?

Well, first of all, a company will likely be willing to pay a control premium to acquire a controlling interest in another entity, and the control premium would be included in the value of the purchase price paid for its interest. This control premium may not reflect a benefit that would inure to the 40%. This might be the case when the 40% is not expected to benefit from the synergies in the transaction that benefit the 60%. Therefore, it would not be appropriate to simply extrapolate the amount paid to derive the value of the 40%.

Another reason may be simply due to timing. In an all cash deal for a public company, the value of the purchase price for the 60% interest will be determined by market conditions at the date the buyer and seller agree to the deal price, while the value of the 40% will be determined as of the closing date. Market prices will likely change between the agreement date and closing date such that the 40% can not simply be derived from the transaction price for the 60% interest. These are only a couple of reasons why it may not be so simple to value the 40% in this transaction, so it’s wise to consult with a valuation expert in this highly judgmental area.

Moving forward

At first glance, the accounting for partial acquisitions and disposals seems straight-forward, but there are several complexities that make it difficult to implement in practice and explain in communications to shareholders. We have only touched on a few of these complexities, and more will surface in the future. Remember, when determining the appropriate accounting for partial acquisitions and disposals, it may not be so simple!

PwC publications and resources

PwC has developed the following publications related to business combinations and noncontrolling interests, covering topics relevant to a broad range of constituents.

- *10 Minutes on Mergers and Acquisitions*—for chief executive officers and board members
- *What You Need to Know about the New Accounting Standards Affecting M&A Deals*—for senior executives and deal makers
- *Mergers & Acquisitions—A snapshot*—a series of publications for senior executives and deal makers on emerging M&A financial reporting issues
- *Business Combinations and Consolidations...the new accounting standards*—an executive brochure on the new accounting standards
- *A Global Guide to Accounting for Business Combinations and Noncontrolling Interests: Application of US GAAP and IFRS Standards*—for accounting professionals and deal makers
- *DataLine 2008–01: FAS 141(R), Business Combinations*—for accounting professionals and deal makers
- *DataLine 2008–02: FAS 160, Noncontrolling Interests in Consolidated Financial Statements*—for accounting professionals and deal makers
- *DataLine 2008–27: FASB Proposed Amendments To The Accounting For Acquired Contingencies under FAS 141(R)*—for accounting professionals and deal makers
- *DataLine 2008–30: Key Considerations for Implementing FAS 141(R) and FAS 160*—for accounting professionals and deal makers
- *DataLine 2008–35: Nonfinancial Asset Impairment Considerations*—for accounting professionals and deal makers
- *DataLine 2009–16: New Guidance for Acquired Contingencies*—for accounting professionals and deal makers

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John P. McCaffrey
US Transaction Services Leader
(646) 471-1885
john.p.mccaffrey@us.pwc.com

Donna L. Coallier
Transaction Services Partner
(646) 471-8760
donna.coallier@us.pwc.com

Jay B. Seliber
Business Combinations Implementation Leader
(408) 817-5938
jay.seliber@us.pwc.com

Raymond J. Beier
Strategy Analysis Group Leader
(973) 236-7440
raymond.beier@us.pwc.com

John R. Formica Jr.
National Professional Services Group
(973) 236-4152
john.r.formica@us.pwc.com

Lawrence N. Dodyk
National Professional Services Group
(973) 236-7213
lawrence.dodyk@us.pwc.com

