10Minutes on Mergers and Acquisitions*

What you need to know about emerging topics essential to your business. Brought to you by PricewaterhouseCoopers.

November/December 2007

A new scorecard: sizing up the changes

Highlights

- A pair of new accounting and reporting standards, impacting M&A, will go into effect for US companies in 2009.
- The new standards, applicable to both US and international companies, will increase transparency and global comparability.
- The new scorecard doesn't change the rationale for doing a particular deal, but it will impact how deals are designed and reported.
- Communication with investors will be key to easing the transition.
- Planning now improves the ability to adapt existing processes and practices.

Recently released accounting standards introduce pervasive changes to how companies track and report M&A. Two deserve particular attention: expensing transaction and restructuring costs, and the broader use of fair value concepts. These two changes will significantly impact financials, both at the time of the deal and after, as they will dilute earnings and reduce earnings predictability.

Key practical impacts

1. Expensing transaction and restructuring costs increases transparency and also dilutes earnings.
2. Remeasurement of certain fair-valued items, particularly earn-outs, will trigger earnings volatility.
3. Due diligence will require greater precision, especially with regard to financial projections and deal accounting.
4. Operating and financial performance metrics could be impacted by the changes.
5. The content presented in shareholder communications may need to be reassessed.

*connectedthinking

PricewaterhouseCoopers

At a glance

Key changes

- expensing of all transaction costs
- expensing of most restructuring costs
- earn-out arrangements may have to be remeasured at fair value
- acquired in-process R&D will no longer be expensed at acquisition
- equity securities issued as part of the purchase price will be measured on the closing date, not at announcement
- minority interest earnings will no longer be excluded from net income

Key challenges

- ensuring investors understand the impact of the new standards on how operating performance is reported
- providing investors with deeper explanations for the costs and benefits of the deal
- considering deal design to address the impacts on earnings
- forecasting the performance measures of the deal
- transitioning financial and tax reporting processes

01

A new scorecard for today's global markets

M&A activity is critically important to growing, entrepreneurial companies and to investors interested in those companies. It's a key driver of shareholder value.

The US standard setter has recently released new standards on mergers and acquisitions and consolidations that will impact how companies report M&A activity. These new standards will be applied to acquisitions that close in years beginning after December 15, 2008.

While the new standards encourage greater transparency and global comparability, the right direction for today's global markets, not everyone applauds the results. A natural consequence of improved transparency and comparability is the introduction of a new level of earnings volatility and uncertainty.

The good news is that the scorecard doesn't change the rationale for doing a particular deal, nor does it stand in the way of doing deals. It does, however, have important implications for how deals are designed and reported.

Working toward global synergies

	US—FASB		Global—IASB (Pending)
Mergers and Acquisitions	Financial Accounting Standards FAS 141 (R)	=	International Financial Reporting Standards IFRS 3 (Revised)
Consolidations	Financial Accounting Standards FAS 160	=	International Financial Reporting Standards IAS 27 (Revised)

02

Expensing deal costs will impact earnings in the short term

Transaction costs typically include direct payments to investment bankers, advisors, attorneys, appraisers, and accountants. These costs will now be expensed and reported earnings in periods prior to closing will be reduced. Although most of these costs will only affect the first year, they may have a noticeable impact on earnings and on financial projections used to model the deal.

Perhaps even more significant: most of the restructuring costs intended to achieve synergies (such as closing acquired plants, severance for acquired employees, parachutes for target company executives) will also be expensed after the deal. This additional visibility becomes especially sensitive if the benefits are not realized as predicted.

This treatment may strike some as inconsistent: “I’m expensing everything today, but it will take a few years to get to the synergies. Is that fair?” Perhaps not, but there are advantages. Expensed deal costs are generally viewed as only a short-term drain on earnings. In addition, all competitors, domestic and international, will use the same scorecard, making for a level playing field.

Companies will now need to explain the nature and amount of deal-related costs because those costs will directly affect the bottom line. One thing is definite: investor expectations will need to be managed.

03

Increased earnings volatility is an added challenge

Most senior executives want to see earnings growth with no surprises. However, the new M&A standards aim to give investors and other stakeholders a clearer view into the impact of the deal, no matter what the effect on the P&L.

One of the most significant changes is a broader use of fair value measurements—actual or estimated market values at a given date. Most amounts of the acquired business will be recorded at fair value on the date of acquisition. While the majority of these values will be stable from that point forward, others (such as earn-out arrangements, acquired contingencies, and in-process research and development assets) may need to be remeasured in later reporting periods. That remeasurement shows up in earnings.

The greater use of fair value measures may have the unintended consequence of causing the timing of deals to change. The rationale and assumptions supporting fair value measures reported in the financials will need to be honed. Closing a transaction early in a quarter will provide more time to refine fair value acquisition estimates. This will reduce the possible need to revise previously reported financial information in subsequent filings, as required by the new standards when accounting estimates change.

There is an additional source of volatility. Share price swings will create uncertainty because equity issued will be valued at closing, not announcement. The ultimate purchase price could vary significantly from the announced price.

Collars are often used in equity deals and are now likely to become tighter and even more common. Time will tell, but the attractiveness of using equity as currency in transactions may diminish, and deal-makers may consider compressing the period between announcement and closing.

Companies will now need to be prepared to explain changes in financials brought about by this volatility.

How best to prepare

Before the standards take effect

- Ensure that your leadership team, including the board, is familiar with the changes in the M&A standards.
- Review your deal pipeline to assess whether any transaction should be accelerated, restructured, or delayed as a result of the new standards.
- Keep in mind a timing issue: transaction costs for deals in process in late 2008 will be capitalized if the deal closes in 2008, but will need to be expensed if the deal closes after 2008.
- Assess due diligence protocols to enhance the precision of financial projections and accounting estimates.
- Evaluate financial reporting processes and practices to address transition issues resulting from the new standards.
- Understand the changes to tax reporting that will increase the volatility of the effective tax rate, particularly for acquired tax positions.

When the standards are operational

- More transparent reporting and greater earnings volatility will need clear explanation to investors. The economics are no different than in the past, but the presentation will be.
- Communications about deals will need to be more detailed, especially concerning costs incurred to achieve the benefits driving the overall vision for the transaction.
- Consider the use of cash versus equity payments in deal structures, since equity may create purchase price uncertainty.
- Determine if the use of earn-outs will meet your strategic objectives, including the choice between cash and equity earn-out arrangements.
- Assess whether the new transparency of deal costs will accelerate the need to discuss M&A activity with investors and other stakeholders.

For further information on the impact of the new M&A standards, please see our executive overview paper, available in print and online, at: www.pwc.com/10minutes.

Upcoming 10Minutes topics:

Tax reform on the horizon
As the race for the White House heats up, tax reform is once again on the candidates' minds. This time, there is a new and compelling issue: US competitiveness in world markets. Tax reform can help—but how? 10Minutes identifies the key aspects of the debate.

Creating a change-ready organization
To succeed in an interconnected world, business needs to be agile and flexible. Balancing what must be standardized and what must be dynamic is the trick. 10Minutes explores the concept of a business agility blueprint that enables an enterprise to anticipate and embrace change.

How "fair value" can affect your bottom line
Fair value, or marking assets and liabilities to market, is an idea on the march. It's showing up in many new accounting standards, and it has bottom-line impact. 10Minutes will discuss the things you need to know without the technical jargon.

The SEC complexity agenda
SEC Chairman Christopher Cox has vowed to simplify the US financial reporting system. Is there a viable solution? Will it include a movement toward principles-based standards? A change in the definition of materiality? Changes in the legal and regulatory environments? Or all of the above and more? 10Minutes clarifies what it means for companies.

New concepts for financial reporting
The basic formats for the income statement and balance sheet have remained all but unchanged for decades. They are the foundation of public reporting and investor financial analysis. Today, the standard setters are considering major changes to both form and content. What may have seemed set in stone is in reality set to change. 10Minutes provides an update on the state of play.

How PwC can help

To have a deeper discussion about the new M&A standards and their impact on your business, please contact:

Dennis Nally
US Chairman and Senior Partner
PricewaterhouseCoopers LLP
Phone: 646-471-7293
Email: dennis.nally@us.pwc.com

Michael Burwell
US Transaction Services Leader
PricewaterhouseCoopers LLP
Phone: 646-471-9570
Email: michael.j.burwell@us.pwc.com

Tell us how you like 10Minutes and what topics you would like to hear more about. Just send an email to: 10Minutes@us.pwc.com

© 2007 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a Delaware limited liability partnership) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity. *connectedthinking is a trademark of PricewaterhouseCoopers LLP (US).