

Mergers & Acquisitions — A snapshot

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Summary

- **The Consolidation Standard—determining who consolidates is just the beginning**
- **Consolidation principles**
- **What changed?**
- **Shared power**
- **How does transition work?**
- **Newly consolidated businesses**
- **Newly deconsolidated businesses**
- **Beyond the numbers**
- **Conclusion**

The Consolidation Standard—determining who consolidates is just the beginning

The Consolidation Standard¹ is effective as of January 1, 2010 for calendar year end companies and the impact will soon be reported in the first quarter reporting cycle. As a result of applying the new guidance, certain entities may need to be consolidated while other entities may need to be deconsolidated. Determining who consolidates is just the beginning. There are several other accounting considerations that could follow—such as acquisition accounting for newly consolidated entities, potential changes to impairment tests, and how to measure the impact of deconsolidation of an entity under the M&A Standards².

This volume of *Mergers & Acquisitions—A snapshot* discusses accounting considerations related to the M&A Standards as a consequence of adopting the Consolidation Standard.

¹Accounting Standard Codification 810 incorporates FAS 167, *Amendments to FASB Interpretation No. 46(R)*, which is the U.S. Standard on consolidation ("Consolidation Standard").

²Accounting Standards Codification 805 (which incorporates FAS 141(R), *Business Combinations*), is the U.S. Standard on M&A, and Accounting Standards Codification 810-10-40 (which incorporates FAS 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment to ARB No. 51*) (collectively the "M&A Standards") is the US Standard on deconsolidation.

Consolidation principles

A company generally consolidates an entity if it has control of a majority of the voting interests of the entity. In these cases, control of the voting interests provides the company with the ability to direct significant decisions that impact the entity. Typically, a company's voting interest aligns with its economic interest in the entity. However, control over an entity does not always occur through a majority of voting shares. For example, an entity that is thinly capitalized, an entity where the equity investors lack decision making powers, or where the equity investors do not participate in the profits and losses of the entity are all situations where control is not obtained simply by holding a majority of voting shares. These entities are considered variable interest entities (VIEs).

What changed?

The guidance has changed for assessing who consolidates VIEs. The prior assessment was primarily a quantitative evaluation based on economic risk and rewards, while the new assessment is a qualitative analysis of who actually has control over the significant decisions of the VIE. Since the new guidance is based upon control, the assessment of who consolidates a VIE is now more closely aligned to the voting interest assessment.

Determining who consolidates a VIE under the Consolidation Standard is based on two requirements—who has the power over key decisions, and do they have skin in the game. If one party has both, then that party consolidates the entity.

Power is based on who controls the decisions that most significantly impact the economic activities of the entity. What does this mean? If, for example, the entity manufactures, distributes and markets a product, then decisions around manufacturing, distribution and marketing may significantly drive the operating results of the entity. If a party has control over these activities of the entity, that party would have the power over the entity. On the other hand, if different parties have control over these activities, the party with the "most" power, in the aggregate, would have power over the entity. Lastly, if the board makes decisions over all significant activities and the board is not controlled by one party, then power is shared. For these entities, the analysis will likely involve significant judgment.

Skin in the game is the potential to receive significant benefits or absorb significant losses of the entity. If a company has an equity interest in an entity that is more than insignificant, it likely has skin in the game. If a company does not have an equity interest, it could still meet this requirement by having an interest in the entity that could receive significant benefits or absorb significant losses, such as a loan to the entity or an option to purchase equity of the entity. In most cases, this requirement will be met and judgments about who will consolidate an entity will be focused on who has the power to direct significant activities of the VIE.

Shared power

No one consolidates a VIE if power is shared, as long as the parties are unrelated. The definition of a related party has changed in the new guidance. Previously, transfer restrictions requiring an owner to obtain consent from other owners to transfer its equity interest caused the owners to be related parties. In that case, if the related party owners held a majority of the economic risk and rewards, the owner most closely associated with the VIE was required to consolidate it. However, under the new guidance, mutual transfer restrictions do not automatically result in the owners being related parties. As a result, no one owner may be required to consolidate the entity. As mutual transfer restrictions are common in joint ventures, this change will likely cause a number of joint ventures to be deconsolidated.

The following example highlights the concept of shared power among unrelated parties.

Shared power

Facts

Company X and Company Y each purchase a 50% common stock investment in a venture. Each party has one representative on the board. Decision making at the board requires the consent of both parties. The venture has \$100 million of external bank debt, which Company X guarantees. The venture is a VIE since it was insufficiently capitalized at inception. Transferring its equity investment by either party requires consent of the other party.

Conclusion under the prior guidance

Company X and Company Y are deemed related parties since transfers of equity interests require consent of the other party. Therefore, assuming that Company X and Company Y, as a group, would absorb the majority of the risks of the entity, either Company X or Company Y would consolidate the venture. Applying the related party guidance, Company X would have consolidated the venture as it is most closely associated with the entity.

Conclusion under the new guidance

Company X and Company Y are not related parties since the transfer restrictions apply to both companies (i.e., more than one party). Decisions around activities that most significantly impact the venture's operations are made by the board, which require mutual consent of both parties. Therefore, power is shared. Upon adoption of the new guidance, Company X would deconsolidate the venture and account for its investment under the equity method of accounting. Company Y would continue to apply the equity method of accounting for its investment.

How does transition work?

All relationships between a company and a VIE must be evaluated from inception of the relationship under the new guidance. No grandfathering of prior structures is permitted. This means analyzing relationships with entities that were VIEs under the old guidance, as well as entities that may now qualify as VIEs.

If a relationship with an entity is accounted for differently under the Consolidation Standard, then there are two transition options available in adopting the new guidance: 1) adjust retained earnings as of the earliest period presented ("earliest period option"), or 2) adjust opening retained earnings in the year of adoption ("current period option"). Under either option, adjustments for newly consolidated entities or retained interests (including equity interests) in deconsolidated entities must be rolled forward to the date of adoption as if the new guidance had always been effective.

Adjusting opening retained earnings in the year of adoption may be less time consuming and complex. However, adjusting retained earnings as of the earliest period presented will provide comparative, and likely more meaningful, results for financial statements users.

If it is impracticable at the adoption date for a company to determine the carrying value of an entity as if the new guidance had always been effective, a newly consolidated entity or a retained interest in a deconsolidated entity can be recorded at fair value on the date of adoption. However, this option is not expected to be used frequently.

Newly consolidated businesses

As a result of the new guidance, companies will need to apply acquisition accounting to newly consolidated businesses. The business combination standards in effect on the date the entity would first be consolidated are applied as if the acquisition occurred on that date. For example, if the company's relationship with the business began in 2007, then the prior acquisition accounting guidance would generally be applied, except that any noncontrolling interest would be recorded at fair value as required under the prior VIE guidance. However, if the company's relationship with the business began in 2009, then the M&A Standards would be applied. Regardless of the guidance applied, acquisition accounting judgments need to be made on the consolidation date, including valuing assets and liabilities, determining noncontrolling interests, and recording goodwill.

Next, assets and liabilities recorded at the consolidation date will need to be rolled forward to the date of adoption of the Consolidation Standard. This means more than just carrying forward previous activity during the roll forward period to determine the carrying amounts of the assets and liabilities of the entity at adoption. For example, stepped up asset values will lead to recording higher depreciation and amortization expenses related to depreciable assets. Goodwill impairment tests will also need to be performed at least annually and long-lived asset impairment reviews will be required if certain events have occurred. Given the decline in the economy in recent years, these impairment assessments could result in losses being recorded during the roll forward period.

The following example illustrates a change in who consolidates an entity and related accounting considerations during the roll forward period.

Newly consolidated business

Facts

Company A and Company B, calendar year end companies, each have a 50% common stock investment in Venture C. Venture C is considered a business. Since Venture C was insufficiently capitalized at inception on December 31, 2006, it is a VIE. Company B has a contract to perform all of Venture C's manufacturing and sales and marketing activities. In addition, Company A guarantees Venture C's external debt.

Conclusion under the prior guidance

Company A consolidated Venture C, as it was exposed to a majority of the risk of loss through its equity investment and debt guarantee.

Conclusion under the new guidance

Manufacturing and sales and marketing activities most significantly impact Venture C's operations. Company B has the power over these activities through its contractual arrangements with Venture C. Company B also has skin in the game, since it has a 50% common stock interest. Therefore, Company B should consolidate Venture C, and Company A should deconsolidate it under the new guidance as of December 31, 2006.

Acquisition accounting at inception

Company B will change from applying the equity method of accounting to consolidating Venture C on December 31, 2006. The previous acquisition accounting guidance would be applied to determine the amounts to be consolidated (except for noncontrolling interest being recorded at fair value) since the M&A Standards were not effective on that date. This will likely result in the recognition of stepped up asset values (e.g., intangible assets) and goodwill at inception.

Roll forward period

Company B will roll forward Venture C's accounts from December 31, 2006 to the date of adoption, January 1, 2010. The results during the roll forward period include amortization expense of stepped up asset values as well as any goodwill impairment losses. The net assets consolidated at inception are adjusted for activity during the roll forward period to arrive at the carrying value of the net assets of the entity at the adoption date.

Impact of adoption

If the current period option is elected, the difference between the carrying value of the net assets and the equity method investment would be recorded to retained earnings on January 1, 2010. However, if the earliest period option is elected, operating activities during the roll forward period, including amortization expense and impairments, if any, would be recorded in 2007, 2008 and 2009 to adjust the financial statements for each period.

Newly deconsolidated businesses

If a VIE is required to be deconsolidated, and the current period option is elected, then the retained earnings adjustment is the difference between 1) any retained equity interest, rolled forward to the adoption date of the new guidance, and 2) the carrying value of the net assets deconsolidated on the adoption date. On the other hand, if the earliest period option is elected, then the retained earnings adjustment is calculated as of the earliest period presented, rather than as of the adoption date. If deconsolidation occurs after inception of the relationship, determining whether the interest retained should be at carrying amount or fair value at the deconsolidation date will depend on whether the M&A Standards were in effect at that date. The M&A Standards require a retained equity interest retained to be recognized at fair value at the deconsolidation date, while the previous standards did not.

The next step will require the equity method investment to be rolled forward to the date of adoption, which may include the following accounting considerations:

- **Equity earnings or losses**—Adjust the equity method investment to record the investor's proportionate share of the investee's earnings or losses.
- **Change in equity interest**—Account for changes in the investor's ownership interest of the entity when there are purchases or sales of shares of the entity.
- **Impairment**—Consider the need for other-than-temporary impairments of the equity method investment. This may be different than impairments recognized previously when the entity was consolidated.
- **Basis differences**—Account for differences between the investor's share of the investee's net assets and the amount paid for the interest.
- **Contractual arrangements**—Account for contractual arrangements between the investor and the investee that would have previously been eliminated in consolidation.

The following example discusses how Company A would account for its deconsolidation of Venture C.

Newly deconsolidated business

Deconsolidation at inception

Company A will change from consolidation to the equity method of accounting for its 50% ownership in Venture C on December 31, 2006. Company A elected the current period option to adjust retained earnings in the year of adoption.

Roll forward period

Company A will record 50% of Venture C's earnings or losses during the roll forward period. Basis differences between Company A's share of Venture C's net assets and the amount paid for the investment will be amortized, as appropriate, in applying the equity method of accounting. Any other-than-temporary impairments of the equity method investment and any contractual arrangements with Venture C could impact the accounting during the roll forward period.

Impact of adoption

The impact of adoption is the difference between the net assets deconsolidated and the equity method investment rolled forward to the adoption date. However, if the earliest period option was elected, equity method earnings or losses during the roll forward period, as well as amortization of basis differences and other-than-temporary impairments, if any, would be recorded in 2007, 2008, and 2009 to adjust the financial statements for each period.

Deconsolidation after inception

If the above fact pattern was changed such that deconsolidation did not occur at inception, but rather occurred as a result of an event in 2009 when the M&A Standards were in effect, the equity method investment would have been recorded at fair value instead of at cost at that date. Company A would apply equity method accounting to its investment in Venture C during 2009 to determine the impact of adoption of the Consolidation Standard.

Beyond the numbers

Adoption of the new guidance impacts more than just the numbers. It may impact financial statement reporting and disclosures, data gathering processes, internal controls, debt covenant compliance and compensation arrangements.

Communicating these changes to the company's stakeholders is important. Adjusting internal processes to ensure compliance with the new guidance, such as ongoing monitoring of who consolidates an entity, will be critical. Additionally, ensuring that contractual arrangements contemplate changes in financial metrics caused by new accounting standards may prevent potential issues down the road. For example, upon adoption of the Consolidation Standard, covenants within debt and lease agreements may be violated due to the consolidation or deconsolidation of a VIE.

Conclusion

The new guidance has significantly changed the accounting for VIEs. As a result, more entities generally will be consolidated and certain structures, such as joint ventures, may be deconsolidated. For newly consolidated entities—accounting considerations will need to be examined, including acquisition accounting at the date of consolidation and impairment assessments during the roll forward period. For entities being deconsolidated—calculation of the impact upon deconsolidation will depend on which standards were effective at the time of deconsolidation as well as activity during the roll forward period, including any potential impairments. Bottom line? The adoption of the new guidance may be more challenging than initially expected. Determining who consolidates the VIE is just the beginning!

PwC has developed the following business combinations and noncontrolling interests publications.

- *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 U.S. 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
- *DataLine 2009-34: Accounting for Contingent Consideration Issued in a Business Combination*—for accounting professionals and deal makers
- *DataLine 2010-01: Accounting and Reporting for Decreases in Ownership of a Subsidiary—A Scope Clarification*—for accounting professionals and deal makers

PwC has developed the following publications related to variable interest entities.

- *FAS 167 Company Action Plan—Consolidation of Variable Interest Entities*—an executive brochure on the adoption considerations of the new guidance
- *Guide to Accounting for Variable Interest Entities*—for accounting professionals and deal makers
- *DataLine 2009-30: FAS 167—New Consolidation Guidance for Variable Interest Entities*—for accounting professionals and deal makers
- *DataLine 2009-29: FAS 166—New Guidance for Transfers of Financial Assets*—for accounting professionals and deal makers
- *DataLine 2009-53: FASB Proposes Amendments to FAS 167, and a Deferral for Certain Investment Funds* —for accounting professionals and deal makers

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