October 2008

# Mergers & Acquisitions —A snapshot

## Change the way you think about tomorrow's deals

**Stay ahead of the new accounting and reporting standards for M&A**

**Highlights**

- **Valuation date**
- **Transaction and restructuring costs**
- **Contingent consideration**
- **In-process research and development**
- **Assets that are not intended to be used**
- **Partial acquisitions and noncontrolling interests**

## How timing your transactions in light of the new standards will impact your business and communication with stakeholders

The deadline for the new merger and acquisition (M&A) standards[1] is quickly approaching. For most companies, the standards will take effect for M&A deals that close on or after January 1, 2009.[2] Recognizing that the new guidance will dramatically change the way companies negotiate and account for M&A, we've written this publication, the first in what we expect will be a series of such publications as the new standards are implemented. This series will help you keep abreast of emerging issues resulting from the new standards, as well as provide you with new ideas on modifying current strategies and employing new ones for future deals.

This first installment of *Mergers & Acquisitions—A snapshot* focuses on how the accounting treatment for M&A transactions will depend considerably on whether the deal closes before or after the effective date of the new standards—there will be a significant difference between the accounting for deals closing before the standards take effect (i.e., in 2008) and those closing after that (i.e., in 2009). Where commercially feasible, some companies may want to change the timing in which a deal will close to achieve a company's desired financial reporting treatment for their particular transaction.

1 FAS 141(R), Business Combinations (FAS 141(R)), is the new US standard on M&A, and FAS 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment to ARB No. 51 (FAS 160), is the new US standard on consolidations.

2 FAS 141(R) is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. FAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Early application of both standards is prohibited.

# Although the underlying economics (e.g., cash flows) of a business combination may be no different if the deal closes in 2008 or 2009, the financial reporting for that transaction will differ dramatically

**Valuation date may add volatility in the purchase price.**

The standard introduces 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 once the new standard becomes effective. Previously, equity securities were generally measured when the deal was announced.

| Timing of acquisition | Implications |
|---|---|
| 2008 | Fluctuations in the acquirer's stock after the announcement date and before the closing date will usually not impact the amount of the purchase price for accounting and reporting purposes. |
| 2009 | Fluctuations in the acquirer's stock after the announcement date and before the closing date will impact the amount of the purchase price for accounting and reporting purposes.<br><br>Bargain purchase and overpayment scenarios may become more likely. Overpayment scenarios would increase goodwill impairment risk.<br><br>More caps and floors may be utilized in the acquisition agreement to protect the acquirer from stock price volatility and its impact on the purchase price. |

**Transaction and restructuring costs will have an earnings impact.**

Transaction and restructuring costs are integral to almost all M&A transactions and are often material to the acquirer.

Before the new standard, most transaction costs were recognized in goodwill as part of the purchase price, and restructuring costs associated with the transaction were generally recognized as a liability on the acquisition date. Each was considered part of the cost of the M&A transaction. Once the new standard goes into effect, transaction and restructuring costs will be recognized separately from the M&A transaction and generally expensed as incurred.

The question arises as to how a company should account for acquisition costs incurred prior to the effective date of the new standard for an M&A transaction that will not close until after the effective date of the new standard. The new standard does not specifically address this transition issue. A company can choose to expense transaction costs as incurred, capitalize transaction costs as incurred but retrospectively expense such costs upon adoption of the new standard or capitalize such costs and expense them in the interim period in which the new standard is adopted. Companies should disclose the selected method to account for such costs and apply it consistently.

| Timing of acquisition | Implications |
|---|---|
| 2008 | There will be no earnings impact in either the precombination or postcombination periods.<br><br>More goodwill will be recognized. |
| 2009 | There will be lower earnings in both the precombination and postcombination periods.<br><br>Less goodwill will be recognized.<br><br>High deal costs in a reporting period preceding an acquisition could warrant an explanation to the market, signaling ongoing M&A activity.<br><br>The earnings impact of restructuring charges will likely force more companies to demonstrate the link between the restructuring activity and the anticipated synergies. |

**Contingent consideration must be recognized at fair value on the acquisition date.**

Under the previous accounting, contingent consideration (e.g., earn-outs) were generally accounted for as part of the cost of the acquisition once the earn-out was resolved. Under the new standard, 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 contingent consideration arrangements will be recorded in earnings, unless the contingent consideration is classified as equity or qualifies as a hedging instrument.

| Timing of acquisition | Implications |
|---|---|
| 2008 | When contingent consideration is paid, it generally will be recognized as additional goodwill and therefore has no earnings impact in the postcombination period. |
| 2009 | Generally, more goodwill will be recognized on the acquisition date. Earnings will be more volatile for contingent consideration that is classified as a liability, since it will be adjusted to its fair value through earnings each reporting period until resolved.<br><br>Valuations to determine the fair value of contingent consideration on the acquisition date and in the postcombination period may require complex valuation techniques. |

**In-process research and development (IPR&D) will have an earnings impact in the postcombination period.**

IPR&D will continue to be measured at fair value on the acquisition date; however, these assets will no longer be written off to earnings upon the acquisition. Instead, IPR&D will be capitalized and recorded as an intangible asset on the acquisition date, subject to impairment testing until completion. If the projects are completed successfully, the IPR&D assets will be amortized through earnings. If the projects are abandoned, the IPR&D assets will be written off at that time.

| Timing of acquisition | Implications |
|---|---|
| 2008 | Companies expense IPR&D on the date of acquisition, resulting in a one-time charge to earnings, and no charge against future earnings in the form of amortization and/or impairment charges.<br><br>There will be less direct linkage in the financial statements between (1) the acquired IPR&D and (2) the anticipated synergies. |
| 2009 | Capitalizing IPR&D on the acquisition date will impact future earnings, because such assets will be amortized or impaired in subsequent periods.<br><br>There will be greater need to demonstrate the link to stakeholders between (1) the acquired IPR&D and (2) the anticipated synergies.<br><br>Assessing IPR&D assets for impairment will be challenging because research and development projects evolve over time and may be combined with other projects, thus losing or blurring the assets' individual identities and complicating valuation. |

**Assets that are not intended to be used will have an earnings impact in the postcombination period.**

An acquirer may, for competitive purposes or other reasons, choose not to use an acquired asset or may intend to use the asset in a way that is not its highest and best use (i.e., use it differently from how other market participants would). The new standard specifies that the acquirer's intended use of an asset does not affect its fair value. Previously, if an acquirer based an asset measurement on the aquirer's intended use, the measure of the asset's value may have resulted in a lower value or no value at all. For example, an entity may have acquired a trade name that it planned to use for only a short time, which may have led to little or no value being assigned to it. However, if the entity considered how market participants would use the asset, a higher value might be assigned if market participants would have continued to use the asset.

| Timing of acquisition | Implications |
|---|---|
| 2008 | By assigning little to no value to assets that are not intended to be used, companies will have less depreciation in the postcombination period.<br><br>Measuring assets not intended to be used based on their intended use results in the recognition of more goodwill on the acquisition date.<br><br>There will be less direct linkage in the financial statements between (1) the acquired assets that are not intended to be used and (2) their impact on earnings. |
| 2009 | Assets that are not intended to be used on the acquisition date will impact future earnings as such assets are amortized or become impaired in subsequent periods.<br><br>Using market participants' highest and best use as the measurement basis for assets that are not intended to be used is likely to result in the recognition of less goodwill on the acquisition date.<br><br>There will be greater need to demonstrate to stakeholders the link between (1) the acquired assets that are not intended to be used and (2) their impact on earnings. |

# Partial acquisitions and noncontrolling interests

**Full goodwill will be recognized.**

In a partial acquisition in which a company acquires a controlling interest, the new standard generally requires the acquirer to record all assets—including goodwill—and all liabilities at 100 percent of their fair value on the date control is obtained. This is as if the buyer acquired 100 percent of the company. Under the previous accounting, the buyer recorded the acquired portion of the net assets at fair value and retained the book value for the noncontrolling (minority) interest. This approach resulted in goodwill being recorded for the acquired interest only.

The new standard specifies that in a step acquisition the acquirer's previously held equity interest is remeasured at fair value on the date the controlling interest is acquired. Any difference between the carrying value and the fair value of the previously held equity interest is recognized as a gain or loss in the income statement. Under previous guidance, the previously held equity interest would be recognized at its carryover basis.

| Timing of acquisition | Implications |
|---|---|
| 2008 | For partial acquisitions, there will be less goodwill on the acquisition date and less depreciation and amortization in the postcombination period for purposes of determining net income. If assets are impaired in the postcombination period, there will be a potential for less of an earnings impact.<br>Any unrealized gain or loss on previously held equity interests will not be recorded on the acquisition date. |
| 2009 | For partial acquisitions, there will be more goodwill on the acquisition date and more depreciation and amortization in the postcombination period for purposes of determining net income. (However, income attributable to the controlling interest shareholders will not be impacted.) If assets are impaired in the postcombination period, there will be a potential for more of an earnings impact.<br>The recognition of full goodwill and more depreciation and amortization in the postcombination period will impact various balance sheet ratios and performance metrics for companies.<br>Recognizing a gain or loss on the remeasurement of the previously held equity interest will have an earnings impact on the acquisition date. |

**The acquisition of minority shareholder interests when there is no change in control will be an equity transaction.**

Under the new standard, the purchase of additional interests in a partially owned subsidiary will be treated as an equity transaction if there is no change in control (i.e., no step up in basis of the acquired net assets and no goodwill recognition). Before the new standard, these transactions resulted in the additional interest acquired being recorded at fair value, including the recognition of any goodwill resulting from the transaction.

| Timing of acquisition | Implications |
|---|---|
| 2008 | More goodwill will be recognized on the acquisition date. There will be greater depreciation and amortization expense in the postcombination period, as well as less impact on the parent company's equity balance.<br>Obtaining control prior to the effective date of the new standard means that purchases of noncontrolling interests in future years will not result in additional step up of acquired assets, however, such a transaction may be dilutive to equity. |
| 2009 | If the fair value of the interest acquired exceeds its carrying value, the adjustment will reduce the parent company's equity. If the fair value of the interest acquired is less than its carrying value, the adjustment will increase the parent company's equity.<br>A company's equity-based operating metrics and financial ratios may be impacted.<br>There will usually be less depreciation and amortization expense in the postcombination period. |

**A parent company's sale of subsidiary shares to third parties (or the dilution of its interests) when there is no change in control will be an equity transaction.**

Under the new standard, transactions such as the parent company's sale of subsidiary stock or the issuance of stock by the partially owned subsidiary (which in the past has 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.

| Timing of acquisition | Implications |
|---|---|
| 2008 | Gains or losses will generally be recognized in earnings on the date that the interests are sold. |
| 2009 | Gains or losses will not be recognized until the parent company loses control of the subsidiary. |

**A parent company's sale of subsidiary shares to third parties (or the dilution of its interests) when there is a change in control will have a larger earnings impact.**

Transactions between the parent company and third parties that result in a change in control will generate gains or losses that are to be recorded in earnings. If as a consequence of selling subsidiary shares, a company no longer controls the subsidiary, the company would recognize a gain or loss in earnings on the sold shares and also adjust the retained equity investment to fair value, with any differences from its carrying value recognized as a gain or loss in earnings. Under the previous guidance, companies would recognize a gain or loss in earnings on the sold shares but continue to hold any remaining interest in the equity of the subsidiary at its carryover value.

| Timing of acquisition | Implications |
|---|---|
| 2008 | Gains or losses will usually be recognized on the transaction date for the portion sold.<br><br>For the retained investment, gains or losses on the investment will not be recognized until the retained investment is sold or until the investment becomes impaired. |
| 2009 | Gains or losses are recognized on the transaction date for the portion sold.<br><br>For the retained investment, the gain or loss will be recognized immediately on the transaction date. |

**Expanded definition of a business may impact gains on sale transactions and trigger a goodwill impairment assessment.**

The expanded definition of a business in the new standard may impact the gain or loss on a sale transaction. For example, a transaction that would qualify as a sale of assets under previous guidance but would be a sale of a business under the new standard could require an allocation of goodwill to be included in the carrying amount of the business to be disposed of. The disposal of a business that is only a portion of a reporting unit will require an impairment assessment for the remaining goodwill.

| Timing of acquisition | Implications |
|---|---|
| 2008 | The asset sold might not qualify as a business and therefore no goodwill would be allocated to that asset, with the sale resulting in more gain on the transaction. |
| 2009 | An asset sale may qualify as a sale of a business and would therefore require goodwill to be allocated to the carrying amount of the business that is to be disposed of. The allocation of goodwill to the business sold will trigger the need for a goodwill impairment assessment for any remaining goodwill in the reporting unit. |

# Timing matters

The new M&A standards will influence deal negotiations and deal structures, as well as affect how companies model and evaluate the impact of an acquisition. Although accounting consequences certainly should not be the only factor companies evaluate when negotiating a deal, management will benefit from thoroughly understanding the accounting implications of closing a deal in 2008 versus closing a deal in 2009.

PwC has developed the following other publications related to Business Combinations and Noncontrolling Interests, covering topics relevant to a broad range of constituents.

- *10 Minutes on Mergers and Acquisitions*—targeted to chief executive officers and board members
- *What You Need to Know about the New Accounting Standards Affecting M&A Deals**—designed for senior executives and deal makers
- *Business Combinations and Consolidations…the new accounting standards**—an executive brochure
- *IFRS 3 (Revised) Impact on Earnings—The Crucial Q&A for Decision Makers*—designed for senior executives and deal makers
- *A Global Guide to Accounting for Business Combinations and Noncontrolling Interests—Application of U.S. GAAP and IFRS Standards*—designed for accounting professionals and deal makers
- DataLine 2008–01: FAS 141(R), *Business Combinations*—designed for accounting professionals and deal makers
- DataLine 2008–02: FAS 160, *Noncontrolling Interests in Consolidated Financial Statements*—designed for accounting professionals and deal makers

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