

QuickBrief!

...timely news on accounting and operational issues

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Retail & Consumer



Proposed Business Combinations Accounting Standards: Impact on Retail and Consumer Companies

The Financial Accounting Standards Board (FASB) will soon begin redeliberating two exposure drafts (EDs) that it issued last year that propose new accounting for business combinations and noncontrolling interests. One of the EDs proposes revising FASB Statement No. 141, Business Combinations (the proposed FAS 141(R)). The other (the Consolidations ED) proposes a new accounting standard that would incorporate consolidation guidance contained in Accounting Research Bulletin No. 51, Consolidated Financial Statements, and would provide new guidance on accounting for minority interests. Both proposals are far reaching and would affect all industries, including the retail and consumer products (Retail & Consumer) industry sectors. PricewaterhouseCoopers' DataLine 2005-26: *FASB Issues Exposure Drafts On Accounting For Business Combinations And Noncontrolling Interests*, discusses these rules in general. This *QuickBrief* addresses certain provisions of proposed FAS 141(R), and to a lesser extent the Consolidations ED, that we think will be most significant to Retail & Consumer companies.

Deal Costs and Restructuring Charges

One of the changes in proposed FAS 141R will require expensing acquisition-related transaction and restructuring costs. The expensing of acquisition-related transaction costs would be a significant change to current practice.

In addition, the expensing of restructuring charges will be significant to retail companies in particular since it is common to close a number of stores after an acquisition where locations overlap. Consumer products manufacturers will have similar issues when rationalization of capacity in manufacturing or distribution operations is anticipated as part of an acquisition.

Contingent Consideration

Another proposed change will require contingent consideration and contingent assets and liabilities to be recorded at their fair values on the acquisition date, with changes in fair values generally being recorded through earnings each reporting period thereafter. These and other proposed changes will increase income statement volatility in subsequent periods due to changes in fair values. To implement these changes, Retail & Consumer companies will need to develop valuation models for their initial and ongoing accounting for contingent assets and liabilities as well as contingent consideration.

Deal structures involving contingent consideration are often used when the fair value of a business is subject to significant uncertainty or when the buyer and seller cannot agree on the purchase price. Under the proposal, the buyer would be required to estimate the fair value of the contingent consideration even if the parties to the transaction have been unable to agree on the fair value of the acquired business.

Contingent consideration is commonly used in connection with Retail & Consumer business acquisitions. An example might include a situation where the initial purchase price in a retail acquisition is based on a low-end assumption regarding future cash flows of the acquired stores, with additional consideration contingent upon more favorable results. Estimating the fair value of the contingent consideration will require significant judgment and will likely require the use of multiple and/or complex valuation techniques. The acquirer's decisions regarding the existing brand/banner(s) -- whether to retain, alter, disband, or replace -- can be a significant component in the valuation of contingent consideration. For example, an initial decision to retain the existing banner of a store would yield a certain estimate of contingent consideration value. A subsequent decision to replace the banner with the acquirer's banner may actually decrease sales in the short-term, which would yield a decrease in the fair value of the contingent consideration.

The proposed accounting will also have what may appear to be a counter-intuitive effect on the subsequent financial reporting. That is, better-than-expected results from an acquired business may increase the expected contingent payment, resulting in charges to income, while worse-than-expected results may reduce the contingent payment, resulting in income statement gains.

Definition of a Business

The proposed rules would modify the current definition of a business in Emerging Issues Task Force Issue 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets* or of a Business (EITF 98-3). This definition of a business is an important element of the proposed guidance, because the accounting for business combinations can differ significantly from the accounting for an asset acquisition. Specifically, there are two key differences in the accounting for these transactions under the proposed rules:

1. Intangible assets acquired in an acquisition that do not qualify as a business, must be recognized in accordance with FASB Statement No. 142, *Goodwill and Other Intangible Assets* (FAS 142). Therefore, goodwill will not be recognized in an asset acquisition, but rather excess purchase consideration over fair value will be required to be allocated to identifiable assets. The proposed definition of a business will not require that the integrated set of activities and assets which comprise a business be self-sustaining. Instead, the integrated set of activities and assets need only be "capable" of being conducted and managed for the purpose of providing a return to investors, or lower costs or other economic benefits. With respect to the change in definition of a business, the changes are likely to increase the number of transactions that will be deemed to be acquisitions of businesses -- which under the old guidance, would have been treated as asset acquisitions -- particularly for retail companies. Under current practice, individual retail stores or groups of stores may not have met the definition of a business because they were operated as part of a larger division, region, or marketing area. As a result, they may have been treated as asset acquisitions rather than acquisitions of businesses eligible for business combination accounting. Since the proposed rules key on how a group of stores "could" be operated, it is likely that most store acquisitions will be treated as business combinations under the proposed guidance.

2. Most contingent consideration arrangements related to an asset acquisition and contingencies acquired in an asset acquisition will be accounted for in accordance with FASB Statement No. 5, *Accounting for Contingencies* (FAS 5), not in accordance with proposed FAS 141(R). Asset acquisitions will not be subject to the requirement to (i) initially record contingent consideration and acquired contingencies at their fair values and (ii) report subsequent changes in fair values through earnings each reporting period.

Bargain Purchases

A “bargain purchase” occurs when the fair value of a business acquired exceeds the fair value of the consideration paid. In these situations, the acquirer must review the procedures that were used to estimate the fair value of the acquired business and, if applicable, the consideration exchanged, to ensure that the valuations reflect all available evidence of fair value. Under the proposed guidance, when the fair value of the acquired interest exceeds the fair value of the consideration paid, the excess is first used to reduce goodwill that would have otherwise been recognized. If the goodwill is reduced to zero, any excess that remains should be recorded as a gain in the acquirer’s income statement. This differs from current practice under which the excess would first reduce certain non-current assets of the acquired business on a pro rata basis, with any remaining amount being recorded in the income statement as an extraordinary gain.

Minority Interests as Equity

The proposed accounting model for non-controlling (minority) interests in a subsidiary reflects the FASB’s view that shareholders of subsidiary companies own an equity interest in the consolidated net assets of the entity. Minority interests would be presented as a separate component of equity on the consolidated balance sheet rather than the current practice of presentation as a “mezzanine” item. This proposal would cause a significant change in consolidation procedures, effectively making it necessary for entities to adopt the “economic unit” approach for their consolidated financial statements. That approach recognizes that holders of non-controlling interests of a subsidiary are owners of a residual interest in a component of the consolidated entity. Although the face of the balance sheet will disclose the portion of the net assets that is attributable to the shareholders of the parent company and the portion that is attributable to non-controlling interests, consolidated equity will generally be increased by this change and balance sheet ratios will also be affected. Obtaining control of an equity investee will trigger full fair value accounting under this model, which will result in recognizing a holding gain or loss on a previously acquired non-controlling interest. This accounting model would also result in gain or loss recognition when a parent company obtains control of another entity without increasing its equity interest in that entity – for example, if minority veto rights lapse or upon the initial consolidation of an entity under FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*. Although minority interests have generally not played a significant role in recent retail acquisition activities, the increasing number of strategic investors could cause minority interests to become more commonplace as sophisticated financing structures may increase.

