FAS 141R: Valuing Contingent Assets and Liabilities
Mastering New Valuation Standards for Mergers, Acquisitions and Combinations

A Live 100-Minute Audio Conference with Interactive Q&A

Today's panel features:
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Thursday, August 6, 2009
The conference begins at:
1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

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FAS 141R: Valuing Contingent Assets and Liabilities Teleconference
Aug. 6, 2009

Statements 141(R) and 160 - New Accounting For Business Combinations And Non-Controlling Interests
Implementation Issues

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Agenda

Overview

Statement 141R – Implementation Issues

Statement 160 – Implementation Issues
Overview

- Both standards became effective for calendar year-end companies as of 1/1/09

- Light M&A deal volume has led to limited “live” examples

- Too early to tell how practice is evolving, if at all, to the new rules

- 141R concepts are “creeping” into other areas of accounting

- FASB/EITF/SEC have been addressing implementation issues
Statement 141R – Business Combinations

- Identifying transactions within its scope
- Determining purchase price
- Measuring assets acquired and liabilities assumed
141R – Definition Of A Business

Requirement…
• SFAS 141R expanded the definition of a business such that (1) it need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes, and (2) outputs are not required for an integrated set of activities and assets to qualify as a business

Issues…
• What is getting swept in now that might not have in the past?
• Since SFAS 141R says a business “need not include all of the inputs and processes,” does that imply that the business needs to at least have some?
• What are the implications of this expanded definition to other pieces of literature?

Implementation guidance…
• Development stage enterprises, real-estate properties, individual retail stores or branches may all be swept in under the revised definition
• While IFRS 3(R) is similar, some disagreement exists between US GAAP and IFRS practitioners on the extent of inputs and processes needed
• More entities may qualify for the FIN 46R business scope exception
• SFAS 142 reporting units may need to be reassessed
  – Could lead to different goodwill allocations (e.g. divestitures, impairments)
141R – Contingent Consideration

**Requirement...**
- SFAS 141R requires that the fair value of amounts to be issued be included in initial purchase price. If the arrangement qualifies for equity treatment, no additional adjustment required. If the arrangement qualifies for liability treatment, amount needs to be “marked” through the income statement until ultimately settled.

**Issues...**
- How do you actually qualify for equity treatment?
- Is there a way to provide the seller with downside protection without jeopardizing equity treatment?
- If equity treatment is not obtained, where does the “mark” get recorded?
- How is the fair value of contingent consideration determined?

**Implementation guidance...**
- Obtaining equity treatment is not as easy as settling, or having the option to settle, in stock
  - Is the arrangement a liability under SFAS 150?
  - Is the arrangement indexed to the entity’s own stock (EITF 07-5)?
  - Does the arrangement meet all of the criteria for equity classification (EITF 00-19)?
- Share price guarantees and/or puts added pressure on the SFAS 150 analysis
- Gains/losses should be treated as operating for purposes of the statements of operations and cash flows
- A discounted cash flows model is ordinarily applied to valuing contingent consideration
141R – Deal Fees

Requirement…
• SFAS 141R requires that direct and incremental costs (i.e., professional fees) be expensed as incurred

Issues…
• How should a buyer account for fees paid to an investment banker for both advisory services and underwriting in connection with a business combination or asset acquisition?
• How should a buyer account for deal costs incurred prior to adoption that will ultimately relate to transactions closing subject to SFAS 141R?

Implementation guidance…
• When an investment banker is providing, in addition to transaction advisory services, underwriting services associated with the issuance of debt or equity securities, total fees incurred should be allocated on a relative fair value basis for purposes of accounting for debt/equity issuance costs separate of deal costs
  – Reminder: Debt issuance fees are still capitalized and equity issuance fees are still offset against equity
• SEC has indicated that it will accept any of the following three alternatives for pre-adoption deal costs:
  – Capitalize deal fees in the current year only if it is probable the acquisition to which they relate will close prior to the adoption of SFAS 141R,
  – Capitalize all deal fees in the current year; immediately expense any deferred deal fees relating to deals in-process upon adoption of SFAS 141R, or
  – Capitalize all deal fees in the current year; retrospectively adjust historical financials for a change in accounting principle affecting deal fees relating to deals in-process upon adoption of SFAS 141R
141R – Compensation

Requirement…
• SFAS 141R requires that – in the absence of a contractual requirement in the target’s share-based compensation plans to do so – the acceleration of vesting of a share-based compensation award in a business combination (i.e., the exchange of unvested awards of the target for either vested awards of the buyer or cash) will result in an incremental charge in the buyer’s post-combination income statement.

Issues…
• How do you decipher between pre-existing arrangements and new arrangements?
• What about split payments (e.g., 50% if there is a change in control, and 50% 1-year after a change in control)?

Implementation guidance…
• The acquirer must evaluate each arrangement to determine whether it is compensation expense rather than a payment for past services and meets the criteria for being part of the business combination transaction.
• Factors that an entity may consider when making these determinations include (but are not limited to):
  – What is the purpose of the payments?
  – Who initiated the arrangement and who primarily benefits from it?
  – When was the arrangement entered into?
**141R – Indemnifications**

**Requirement…**
- FAS 141R requires an acquirer recognize an indemnification asset at the same time that it recognizes the indemnified item, measured on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts.

**Issue…**
- How should cash or shares escrowed at closing for (1) standard reps and warranties and/or (2) specific indemnities be accounted for?
- How should an issuer reflect subsequent changes in a tax-related indemnification asset in the income statement?

**Implementation guidance…**
- If the amounts in escrow are for standard reps and warranties, the entire escrow amount would typically be recorded as purchase price since most standard reps and warranties are expected to settle without claim.
- If the amounts in escrow are related to a specific indemnification (i.e., explicitly referenced in the purchase agreement):
  - Record the entire escrow amount as part of the purchase price.
  - Record a liability related to the indemnified item at fair value or otherwise depending on the applicable guidance (i.e., FAS 5 and FIN 48), and a corresponding asset for the same amount.
- While adjustments to income tax contingencies are a component to current tax expense (benefit), adjustments to the related indemnification asset should be recorded outside of income tax expense (benefit).
141R – Fair Value Of Liabilities

Requirement…
- FAS 141R requires that most liabilities be fair valued

Issues…
- What is the appropriate discount rate to use for acquired debt?
- What happens to any differences between the fair value assigned in purchase accounting (i.e., as determined by a discounted cash flows or other valuation model) and the ultimate payout amount?

Implementation guidance…
- Discount rate should be reflective of the terms of the deal
  - Asset purchase – Rate of buyer
  - Stock purchase – Rate of target, but need to consider “guarantees” – both explicit and implicit
- For debt items recorded at fair value, discounting will result in future accretion through interest expense
- For non-debt items recorded at fair value (e.g., warranties and liability classified contingent consideration), discounting will result in future accretion expense through operating income
- Pre-acquisition contingencies accounted for in accordance with SFAS 5, rather than at fair value, would be exempt from this issue
- Amounts may need to be modeled and planned for
141R – Defensive Intangible Assets

**Requirement...**
- SFAS 141R requires an acquirer to recognize an acquired asset and measure it at fair value in accordance with SFAS 157, even if it decides not to use that acquired asset

**Issues...**
- What is a defensive intangible asset?
- How is a defensive intangible asset recorded?
- How is the useful life of a defensive intangible asset determined?

**Implementation guidance...**
- EITF 08-7 was issued to clarify the accounting around defensive intangible assets
- A defensive intangible asset is an asset an entity does not intend to actively use but intends to hold or “lock-up” to prevent others from obtaining access to the asset
  - Defensive assets can include assets that the acquirer will never actively use, as well as assets that will be used by the acquirer during a transition period when the intention of the acquirer is to discontinue the use of the assets
  - Defensive assets have value to market participants
- A defensive value asset should be recognized as a separate unit of accounting and not added to the value of a buyer’s pre-existing assets
- A defensive value asset should be assigned a useful life that reflects the entity’s consumption of the expected benefits related to that asset
  - Useful life is determined by estimating the period over which the defensive intangible asset will diminish in fair value
• SFAS 141R’s tax changes apply to all deals – not just prospective deals

• SFAS 141R requires retrospective adjustment of financial statements for changes in estimates used in acquisition method of accounting; while not a “restatement,” this can still be a painful process, especially if involved in a registration process or maintain active “open” registration statements (e.g. S-8)

• Recording receivables at fair value, instead of “present values of amounts to be received determined at appropriate interest rates, less allowances for uncollectibility…” has proved challenging for banking industry

• The fair value of a noncontrolling interest cannot ordinarily be implied from the price of the acquired interest

• Judgment must be applied in determining whether escrowed share arrangements, whereby the shares are released upon the satisfaction of a contingency, are compensatory (EITF Topic D-110)

• EITF 09-2 tentatively concludes SFAS 141R’s IPR&D accounting is to be applied to asset acquisitions

• EITF 08-6 concludes that entities accounting for equity method investments should (1) determine the initial carrying value of an equity method investment by applying Appendix D of SFAS 141R (i.e., deal fees may be capitalized), and (2) account for subsequent share issuances of the investee as if the equity method investor had sold a proportionate share of its investment (i.e., any gain or loss is recognized in earnings)
  - Note: The Task Force considered whether to provide guidance on how the difference between the investor's carrying value and the investor's share of the underlying equity of the investee should be allocated, but decided not to address this issue. Practice should continue to follow the one-line item purchase price allocation required by APB 18
Statement 160 – Non-Controlling Interests

- Identifying transactions within its scope
- Resolving conflicts with pre-existing guidance
160 – Partial Sales Of Subsidiaries

Requirement…
• SFAS 160’s deconsolidation provisions, including the requirement to remeasure any retained non-controlling interest to fair value, apply to a “subsidiary”

Issues…
Does this requirement apply to:
• The sale of a subsidiary that does not meet the definition of a business?
• The exchange of a group of assets that constitutes a business in exchange for an equity interest in the purchaser or the transferred business?
• The sale of a subsidiary to an equity method investee?
• The contribution of a subsidiary to a joint venture?
• The sale of a subsidiary that is in-substance real estate?

Implementation guidance…
Under proposed guidance from the FASB:
• SFAS 160 would be modified such that it would only apply to subsidiaries that are businesses
• EITF 01-2 would be modified such that the exchange of a group of assets that constitute a business (e.g., a carve-out) for an equity interest should follow the provisions of SFAS 160 (i.e., full versus partial gain)
• SFAS 160 would apply when a subsidiary is transferred to an equity method investee
• SFAS 160 would apply to the formation of a joint venture
• Sales of interests in a subsidiary that is in-substance real estate would be accounted for in accordance with SFAS 66 and related literature
160 – Contingent Consideration

Requirement…
• SFAS 160 requires that the fair value of “any consideration received” be included in the gain or loss on deconsolidation of a subsidiary

Issues…
• Does that mean that contingent consideration received by a seller is no longer subject to the “gain contingency” guidance in SFAS 5?
• If “yes,” what is the seller’s accounting on Day 2 if the contingent consideration arrangement does not meet the definition of a derivative?

Implementation guidance…
• Yes. Need to record full fair value of what was received on Day 1, including fair value of contingent consideration arrangement
• Day 2 accounting has been added to the EITF’s agenda (EITF 09-4)
  – Certain Task Force members also recently suggested that EITF 09-4 should also include a reconsideration of the seller’s initial accounting for the contingent consideration arrangement. Further discussion is expected
160 – Changes In A Parent’s Ownership Interest

**Requirement…**
- SFAS 160 requires that changes in a parent’s ownership interest, while the parent retains its controlling financial interest, are accounted for as equity transactions

**Issues…**
- How does this guidance interact with SAB Topic 5H, *Accounting For Sales Of Stock By A Subsidiary*?
- What is the treatment of transaction costs?
- What amounts, other than equity, must be reallocated between the controlling and non-controlling interest?

**Implementation guidance…**
- SEC has rescinded SAB Topic 5.H, which permitted gain recognition on the sale of subsidiary stock
- A parent’s direct costs to purchase and sell interests in a subsidiary should generally be recorded as an adjustment to APIC (assuming parent retains control)
- Parent must reallocate accumulated other comprehensive income and goodwill impairments between the controlling and non-controlling interests
160 – Other Observations

• Net income is bifurcated between the controlling and non-controlling interests as follows:

  Net Income xxx
  Less: Net income attributable to the non-controlling interest (xx)
  Net Income attributable to XYZ Company (i.e., Registrant) XXX

  – EPS is calculated using “Net income attributable to XYZ Company”
  – Cash flow statement begins with “Net Income,” as paragraph 6 of SFAS 95 was not modified

• Income should be allocated regardless of whether losses, prior to the adoption of SFAS 160, had been allocated to the controlling interest because the non-controlling interest had been reduced to zero; the controlling interest is not able to recoup previous, non-pro rata allocations of losses
Appendix –
Significant Changes Under 141R
## Appendix: 141R – Significant Changes

<table>
<thead>
<tr>
<th>Issue</th>
<th>SFAS 141</th>
<th>SFAS 141 (R)</th>
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</thead>
<tbody>
<tr>
<td>Measurement date for acquirer’s equity securities</td>
<td>A reasonable period of time before and after terms are agreed to and announced</td>
<td>Fair value at acquisition date</td>
</tr>
<tr>
<td>Restructuring and exiting costs</td>
<td>Liability recognized in the business combination</td>
<td>Post combination expenses</td>
</tr>
<tr>
<td>Adjustments to certain income tax balances</td>
<td>Adjustments generally recorded to goodwill</td>
<td>Adjustments recorded to income tax expense</td>
</tr>
<tr>
<td>Indemnification assets</td>
<td>No guidance on point; diversity in practice</td>
<td>Recognize and measure based on the related liability</td>
</tr>
<tr>
<td>Negative goodwill</td>
<td>Pro-rata reduction of certain long-lived assets (extraordinary gain)</td>
<td>No reduction of assets, record as gain</td>
</tr>
<tr>
<td>IPR&amp;D</td>
<td>Value in purchase accounting – immediately expense</td>
<td>Value in acquisition method accounting – do not expense</td>
</tr>
</tbody>
</table>
## Appendix: 141R – Significant Changes (Cont.)

<table>
<thead>
<tr>
<th>Issue</th>
<th>SFAS 141</th>
<th>SFAS 141 (R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition Costs</td>
<td>Capitalized and generally recorded as a component of goodwill</td>
<td>Expense as incurred</td>
</tr>
<tr>
<td>Contingent</td>
<td>Generally record when contingency is resolved</td>
<td>Record fair value at acquisition date – liabilities remeasured to fair value each period</td>
</tr>
<tr>
<td>Consideration</td>
<td></td>
<td></td>
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<tr>
<td>Reacquired Rights</td>
<td>Generally recorded at fair value</td>
<td>Record at fair value for the remaining contractual term (i.e., ignore renewals)</td>
</tr>
<tr>
<td>Measurement Period</td>
<td>Generally recorded prospectively</td>
<td>If material, retrospective application required</td>
</tr>
<tr>
<td>Adjustments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Definition of a</td>
<td>Must have inputs, processes, AND outputs.</td>
<td>Inputs, processes, and outputs not necessarily required</td>
</tr>
<tr>
<td>Business</td>
<td></td>
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<tr>
<td>Noncontrolling</td>
<td>Historical cost</td>
<td>Fair value</td>
</tr>
<tr>
<td>Interest</td>
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FAS 141R: Valuing Contingent Assets And Liabilities Teleconference

Aug. 6, 2009

Business Combinations and Non-Controlling Interests – FSP FAS 141(R)-1

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Agenda

Acquired Contingencies
- Overview
- Initial recognition and measurement
- Subsequent measurement
- Valuation
- Disclosures

Loss Contingencies Disclosure Project
- History
- Project status and next steps
Acquired Contingencies

Overview

• FSP FAS 141(R)-1* was issued on April 1, 2009

• Amends and clarifies accounting for acquired contingencies

• Issued as a result of significant concerns from preparers, legal counsel, auditors, etc.

• Same effective date as FAS 141(R)*

• Carries forward the guidance in FAS 141 without significant revision

* ASC 805
Acquired Contingencies (Cont.)

Overview (Cont.)

Exposure Draft
Fair value

FAS 141

Fair Value if determinable

FSP FAS 141(R)-1

Preliminary Deliberations
Fair Value

FAS 141(R)

• Fair value
• Higher of fair value or FAS 5 amount
Acquired Contingencies (Cont.)

Initial Recognition And Measurement

• On the acquisition date:
  - Record at fair value, if determinable
  - If not determinable, record if probable and reasonably estimable
  - If above criteria are not met:
    ▪ An asset or a liability can not be recorded
    ▪ Acquirer should account for such assets or liabilities under FAS 5*

* ASC 450
• More acquired contingencies (e.g., warranties) will likely be measured at fair value

  - Availability of reliable information

  - Existence of a long track record of history

  - Market transactions
Acquired Contingencies (Cont.)

Initial Recognition And Measurement (Cont.)

- FASB expects fair value of most legal contingencies will not be determined on acquisition date
- Legal contingencies particularly difficult to record at fair value
  - Unpredictability of litigation
  - Lack of prior experience due to the unique nature of each lawsuit
  - Fair value estimates could change dramatically as new developments occur
  - Unlikely that fair value estimates will be predictive of the ultimate outcome in many cases
- Likely that more contingent liabilities will likely be recorded than contingent assets
Acquired Contingencies (Cont.)

Subsequent Measurement (Cont.)

- Measured and accounted for using a systematic and rational basis, depending on the nature

- Judgment will be required

- Companies need to develop policies for transitioning from initial measurement at fair value to subsequent measurement at amounts other than fair value
Acquired Contingencies (Cont.)

Subsequent Measurement (Cont.)

- For example, warranty obligations subsequent accounting may be similar to guarantees.

- Guarantees are initially recognized at fair value under FIN 45*

- Reduced, by a credit to earnings, as guarantor is released from risk under guarantee.

- Release from risk typically recognized over term of guarantee.

* ASC 460
Acquired Contingencies (Cont.)

Valuation

- Limited practical experience and guidance

- FAS 141(R) does not change valuation techniques that are used to value these assets and liabilities
Acquired Contingencies

Disclosures

• The following disclosures shall be included in the business combination footnote:
  - Acquired contingencies recognized at the acquisition date
    - Nature of the contingencies
    - Amounts recognized and measurement basis applied
  - For contingencies not recognized at the acquisition date
    - Disclosures required by FAS 5, if occurrence of the contingencies are deemed reasonably possible
      - Nature of the contingencies
      - Estimate of range of outcomes, or
      - If no estimate can be made, disclose that fact
  - An acquirer may aggregate disclosures for assets or liabilities arising from contingencies that are similar in nature
Loss Contingencies Disclosure Project
Loss Contingency Disclosures Project

History

• In 2008, the FASB issued an exposure draft

  - Investor concerns that current disclosures are inadequate and untimely

  - Not recognition/ measurement

  - Expanded disclosures

  - Enable investors and other users of corporate financial statements to assess the likelihood, timing and amount of future cash flows associated with loss contingencies
Proposed disclosures would have:

• Required enhanced quantitative and qualitative disclosures (e.g., gross amount of claim or estimate of the maximum exposure to loss)

• Required a reconciliation of loss contingencies in the aggregate, at the beginning and end of the period

• Enhanced disclosures for insurance and indemnification arrangements

• Provided a limited prejudicial exemption
Loss Contingency Disclosures Project (Cont.)
History (Cont.)

• Comment period ended on Aug. 8, 2008

• Significant interest from broad range of constituents
  - 240 comment letters
  - Substantial majority not supportive of proposal
  - FASB has delayed the proposal’s effective date
Loss Contingency Disclosures Project (Cont.)

Project Status And Next Steps (Cont.)

- Update since exposure draft
  - Evaluation of comment letters
  - Field testing complete
  - Roundtable discussions - March 6, 2009 including users, preparers, ABA, regulators, auditors, FASB, IASB

- Next steps
  - Re-deliberations in Q3
  - Update project plan and timetable to be developed
  - Effective date not expected prior to the end of 2009
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Contingent Litigation Liabilities Under FSP 141R-1

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Recognition Of Contingent Litigation Liabilities Under FSP 141R-1

- Criteria if liability cannot be determined during measurement period
  - Information before the end of the measurement period indicates that it is probable that a liability had been incurred at the acquisition date
  - The amount of the liability can be reasonably estimated
- Similar to traditional FAS 5 standard
- Specifically adopts guidance from FAS 5 and FASB Interpretation No. 14
Legal View

- Most litigation should not result in recognition of a liability under FAS 5 (or FSP 141R-1) due to uncertainties of litigation
- ABA policy for responses to auditor letters
  - In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer than an unfavorable outcome is either “probable” or “remote”
    - Probable – an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight
    - Remote – an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight
  - For this limited purpose, the ABA’s definitions of “probable” and “remote” differ from FAS 5
Legal View (Cont.)

- Range
  - The amount or range of potential loss will *normally* be as *inherently impossible to ascertain*, with any degree of certainty, as the outcome of the litigation.
  - Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight (emphasis added).

- Practical concern with abandoned FAS 5/141R exposure draft: The ABA policy would not allow attorneys to provide information to companies/auditors that auditors might conclude is necessary to give a clean opinion.
Reasons For Not Expanding Disclosure By Companies/Attorney

- Difficulty predicting litigation outcomes
- Facts can be misleading (e.g. claim amounts)
- Road map for opposing litigants and counsel
- Attorney-client privilege
- Attorney work product
Attorney-Client Privilege And Attorney Work Product

- Attorney-client privilege protects confidential communication between an attorney and client made for the purpose of obtaining professional legal advice and assistance.
- Attorney work product doctrine protects documents and theories prepared by an attorney in the course of an investigation if litigation is pending or is anticipated.
- If privilege or doctrine is waived, applicable information becomes discoverable by adversary in litigation.
Attorney-Client Privilege And Attorney Work Product (Cont.)

- Disclosure to third parties, including auditors, waives privilege
- Disclosure to adversary in litigation, including in public company financial statements, waives work product doctrine
- No clear consensus regarding whether disclosure to auditors waives work product doctrine, but majority of cases say it does not
What Is To Come?

- FASB disclosure project

- Round table held on March 6, 2009
  - Two general approaches to disclosure: Predictive or additional facts
  - Minutes suggest participants still struggled trying to balance the issues noted earlier
Click here for the text of FSP FAS 141R-1:


Click here for the text of FAS 141R:


Click here for the text of FAS 160: