Strafford

presents

FAS 141R: Valuing Contingent Assets and Liabilities

Mastering Valuation Standards for Mergers, Acquisitions and Combinations

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
William T. Berry, Jr., Partner, **Cherry, Bekaert & Holland**, Richmond, Va.
Mark T. Plichta, Partner, **Foley & Lardner,** Milwaukee, Wis.
Jay Seliber, Assurance Partner, **PricewaterhouseCoopers,** San Jose, Calif.
Rick Martin, Vice President of Technical Accounting, **Pluris Valuation Advisors**, New York
David Gaynor, Vice President, **Pluris Valuation Advisors**, New York

Tuesday, July 27, 2010

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FAS 141R: Valuing Contingent Assets and Liabilities Webinar

July 27, 2010

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Today's Program

- Key Background (*Bill Berry*) — Slides 6 through 17
- Contingent Litigation Liability Considerations (*Mark Plichta*) — Slides 18 through 39
- Practical Issues, Part I (*Jay Seliber*) — Slides 40 through 47
- Practical Issues, Part II (*Rick Martin and David Gaynor*) — Slides 48 through 58

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Key Background

Bill Berry, Cherry, Bekaert & Holland

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New Standard (FAS 141R)

- **Effective with deals closing on/after Jan. 1, 2009**
- **Very low deal volume during 2009**
- **Issues just now surfacing, will continue to accelerate**
- **Rules expected to continue to evolve**
  - Should consider impact as negotiations proceed
- **For deals closing prior to Jan. 1, 2009, use prior guidance**
  - Even where contingencies and other open matters are resolved in 2009 and later

Primary Differences – (And There Are Many More)

Old FAS 141	New FAS 141R
Accounting valued from buyer's perspective	Accounting valued at market's perspective
Strict definition of a business scoped out some acquisitions	Inputs, processes and outputs not required to fall into business combination guidance
Post-closing adjustments generally recorded prospectively	Post-closing adjustments require retrospective accounting

Primary Differences (Cont.)

Old FAS 141	New FAS 141R
Accounting valued from buyer's perspective	Accounting valued at market's perspective
Amounts paid (including direct transaction costs) are allocated to acquired assets and liabilities	Fair value of acquired assets and liabilities (regardless of cost, or lack thereof) is recorded
"Negative goodwill" reduced other long-term assets before hitting P&L	"Negative goodwill" immediately recognized as gain in P&L

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Primary Differences (Cont.)

Old FAS 141

- Minority interests often recorded at historical basis when less than 100% purchased

New FAS 141R

- All assets/liabilities recorded at fair value, even if not all acquired

  … "minority interest" is new "non-controlling interest" under FAS 160 – recorded at new basis (fair value)

Primary Differences (Cont.)

Old FAS 141

- Direct costs were capitalized as goodwill
- Planned restructuring costs were often recorded as liability at closing (increased goodwill)

New FAS 141R

- Direct costs are expensed at closing
- Planned restructuring costs are period costs (may result in "day one" expense)

Primary Differences (Cont.)

Old FAS 141

- Income tax valuation reserves – reduction (even post-acquisition) reduces goodwill

New FAS 141R

- Income tax valuation reserves – any changes affects current income tax provision (at the date of adjustment)

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Primary Differences (Cont.)

Old FAS 141	New FAS 141R
Earn-outs (contingent consideration) recorded as paid	Earn-outs estimated and recorded at closing with subsequent adj's to the P&L
Contingent gains/losses generally not recorded unless FAS 5 recognition was met	Contingent gains/losses recorded at fair value at closing, subsequent adj's to the P&L

… to be discussed at greater length, in following

Effects On Negotiations

- **Buyers are becoming increasingly creative.**
  - "Bargain purchase" valuations require more scrutiny.
  - Deal costs allocated to debt or equity.
  - Sellers are encouraged to initiate buyer's planned restructurings.
  - Value of earn-outs are being paid at closing.
    - (Often at a negotiated reduced amount)
  - Other initiatives tailored to keep costs out of post-closing P&L

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Some New Problems …

- **"Acquisition of the competition"**
  - Acquired assets may have "no value" to buyer, but
  - FAS 141R requires "market-based" fair value to be recorded, and
  - This may result in "day one" charge off of recorded intangibles
- **How do you fair value acquired debt?**
  - Discounted at buyer's or seller's rate?
  - May result in additional non-cash interest costs/income
- **Contingencies are difficult to fair value**
  - Considerable judgment
  - Concerns of legal counsel, audit firms and others
  - *Details to be discussed in greater detail, in following*

Some More Problems …

- **How do you fair value non-controlling interests?**
  - Is this the same as the acquired interests?
- **Many special industry issues**
  - Loans and loan loss reserves in banking industry
  - Income tax treatments in connection with valuation reserves
  - Retrospective adjustments are unfavorable to public companies
- **Debt covenants and other projections being missed**
  - Buyers were not aware of implications

And, Even More Problems …

- **Guidance continues to evolve**
  - Like most new standards with broad application

- **Given absence of acquisition activity, transition has been slow to develop**
  - Many accountants have not yet applied new standard

- **Companies can have mixed accounting**
  - Old standard applies to transactions closed before 1/1/2009
  - Some post-closing and contingency adjustments may still be recorded.
  - New standard dovetails old accounting; applies to transactions closed on and after 1/1/2009

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Contingent Litigation Liability Considerations

Mark Plichta, Foley & Lardner

Litigation Contingencies Under FAS 141R Generally

- Generally, would have expanded disclosure by companies and their attorneys
- Resulted in great controversy
- Short-term fix: Superseded by FSP 141R-1
- Long-term fix: FASB contingency litigation disclosure project
  - ASC 805 disclosure would be expanded consistent with new ASC 450 disclosures

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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 audit letters (treaty)

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Recognition Of Contingent Litigation Liabilities Under FSP 141R-1

- Fair value at acquisition date, if determinable
- Criteria if acquisition date fair value 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

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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.

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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.

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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.

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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 says it does not

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FASB Contingency Disclosure Project

- March 6, 2009 roundtable
- Board meetings on Oct. 2, 2009 and April 14, 2010
- Exposure draft issued July 20, 2010

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FASB Disclosure For Contingencies Project – March 6, 2009 Roundtable

- Two general approaches to disclosure: Predictive or additional facts
- Minutes suggest participants still struggled trying to balance the issues noted earlier

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FASB Disclosure For Contingencies Project – Oct. 2, 2009 Board Meeting

- Three broad principles
  - Disclosures about litigation contingencies should focus on the contentions of the parties, rather than on predictions about the future outcome.
  - Disclosures about contingency should be more robust, as the likelihood and magnitude of loss increase and as the contingency progresses toward resolution.
  - Disclosures should provide a summary of information that is publicly available about a case and indicate where users can obtain more information.

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Exposure Draft

- Objective: Disclose qualitative and quantitative information about loss contingencies to enable financial statement user to understand:
  - The nature of the loss contingencies
  - Their potential magnitude
  - Their potential timing (if known)

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Exposure Draft (Cont.)

- Disclosure threshold
  - Maintains the existing requirement to disclose asserted claims and assessments whose likelihood of loss is at least reasonably possible
  - Disclosure of certain remote loss contingencies (due to their nature, potential magnitude or potential timing) may be necessary to inform users about the entity's vulnerability to a potential severe impact.

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Exposure Draft (Cont.)

- Whether to disclose remote loss contingencies - considerations
  - The potential effect on the entity's operations
  - The cost to the entity for defending its contentions
  - The amount of efforts and resources management may have to devote to resolve the contingency
  - The plaintiff's amount of damages claimed, by itself, does not necessarily determine whether disclosure about a remote contingency is necessary.
  - The entity should not consider the possibility of recoveries from insurance or other indemnification arrangements.

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Exposure Draft (Cont.)

- Qualitative disclosures
  - Disclose qualitative information to enable users to understand the loss contingency nature and risks
  - During early stages of asserted litigation contingencies, disclose at a minimum, the contentions of the parties. In subsequent reporting periods, disclosure should be more extensive as additional information about a potential unfavorable outcome becomes available. If known, disclose the anticipated timing of, or the next steps in, the resolution of individually material asserted litigation contingencies.

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Exposure Draft (Cont.)

– For individually material contingencies, the disclosure should be sufficiently detailed to enable financial statement users to obtain additional information from publicly available sources such as court records. For example, an entity should disclose the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding, and its current status.

– When disclosure is provided on an aggregated basis, disclose the basis for aggregation and information that would enable financial statement users to understand the nature, potential magnitude and potential timing (if known) of loss.

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Exposure Draft (Cont.)

- Quantitative disclosures – contingencies that are at least reasonably possible (not remote)
  - Publicly available quantitative information; for example, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses
  - An estimate of the possible loss or range of loss and the amount accrued, if any
  - If the possible loss or range of loss cannot be estimated, a statement that an estimate cannot be made and the reasons therefore
  - Other non-privileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss

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Exposure Draft (Cont.)

– Information about possible recoveries from insurance and other sources only if, and to the extent that it has been provided to the plaintiff, it is discoverable either by the plaintiff or by a regulatory agency, or it relates to a recognized receivable for such recoveries. If the insurance company has either denied or contested the entity's claim for recovery, then the entity should disclose that fact.

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Exposure Draft (Cont.)

- Quantitative disclosures – remote contingencies that meet the disclosure threshold
  - Publicly available quantitative information; for example, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses
  - Other non-privileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the loss
  - Information about possible recoveries from insurance and other sources only if, and to the extent that it has been provided to the plaintiff, it is discoverable either by the plaintiff or by a regulatory agency, or it relates to a recognized receivable for such recoveries. If the insurance company has either denied or contested the entity's claim for recovery, then the entity should disclose that fact.

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Exposure Draft (Cont.)

- Tabular reconciliation
  - For each period for which a statement of income is presented, a **public** entity should disclose reconciliations by class, in a tabular format, of recognized (accrued) loss contingencies to include all of the following:
    - The carrying amounts of the accruals at the beginning and end of the period
    - Amount accrued during the period for new loss contingencies
    - Increases for changes in estimates for loss contingencies recognized in prior periods
    - Decreases for changes in estimates for loss contingencies recognized in prior periods
    - Decreases for cash payments or other forms of settlements during the period

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Exposure Draft (Cont.)

– All loss contingencies recognized in a business combination should be included in the reconciliation but shown separately if they have a different measurement attribute (for example, fair value vs. probable loss amount)

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Reasons For Not Expanding Disclosure By Companies/Attorney – Revisited

- 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 audit letters (treaty)

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Practical Issues, Part I

Jay Seliber, PricewaterhouseCoopers

Agenda For This Section

- Valuing contingencies
  - Legal
  - Environmental
  - Warranty
- Due diligence trends
- Indemnifications
- Tax contingencies
- Dealing with subsequent information

Valuing Contingencies

- Legal
  - Guidance in ASC 805 largely reverted to language in “old” FAS 141
  - Measured at fair value at the acquisition date if fair value is reasonably estimable
  - If fair value is not reasonably estimable, follow ASC 450 or other applicable GAAP
    - Generally record when probable and reasonably estimable
  - 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
- Environmental
  - Recorded at fair value
  - Target generally recorded at gross undiscounted cost
    - Can result in lower value in purchase accounting
  - Fair value will need to consider what a third party would charge to assume obligation

Valuing Contingencies (Cont.)

- Warranty
  - Recorded at fair value
  - Target generally recorded at cost to fulfill
    - Can result in higher value in purchase accounting
  - Could result in a profit element being recorded over time

- Other
  - Earn-outs assumed in a merger will be accounted for the same as earn-outs arising from the current acquisition.
    - Consider settling a target's earn-outs prior to completing the merger

Due Diligence Trends

- Scope of due diligence
  - Lengthier and more detailed diligence process
  - More detailed valuations during diligence may mitigate the risk of recasting prior periods for changes to estimates.
  - Valuations also necessary in assessing amounts that will amortize against income in the future, potentially impacting accretion/dilution analysis
  - Greater focus on tax matters due to post-acquisition treatment of adjustments
  - Longer time to close
  - Earn-out structures have been reconsidered

- Integration planning
  - Acquisition strategy needs to be quickly converted into integration strategy.
  - Early integration planning being built into diligence process
  - Greater need for the M&A integration process to quickly capture deal value and track progress
  - Tracking and reporting synergies are more important than ever.

- Early involvement/expertise of accounting, valuation and legal experts

Indemnifications

- New concept under GAAP

• Under ASC 805, in cases where a seller indemnifies a buyer for a potential contingency or a liability up to a certain threshold, the buyer should recognize an indemnification asset (as it also recognizes a liability in purchase accounting for the related exposure).

• Subsequent accounting for the indemnification asset should follow the approach utilized for the associated liability (e.g., marked-to-market through P&L if liability is marked-to-market through P&L).

•The indemnification asset is only written off if collected or sold, or the right to it is lost.

• P&L impact of indemnification asset and related liability may or may not offset (e.g., income tax contingencies).

• Consider collectability as well as any caps on indemnification.

- Indemnification and survival period in private deals is buy-side friendly (>10%, 12-24 months).

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Tax Contingencies

New guidance applies to tax matters associated with prior mergers as well

- All changes in valuation allowances and tax uncertainties of the target will affect income tax expense and therefore the effective tax rate, unless occurring within the measurement period.
- Changes in acquirer's pre-existing tax balances recorded in income statement
- Similar to changes in other assets and liabilities in a business combination, changes in these tax items after the measurement period will be recognized in earnings rather than as an adjustment to the cost of the acquisition.

Income tax indemnifications

- Income tax and other indemnifications are recognized and measured according to contractual terms using the same assumptions and on the same basis used to measure the liability for the indemnified amount ("mirror image" receivable). However, the use of a similar basis may still result in the indemnity asset not being equal to the liability. For example, the fair market value of the asset may be different than the fair market value of the liability, due to credit risk or other collectability considerations.
- Recorded "gross" on balance sheet and income statement
  - Can result in mismatch in line items
  - Subsequent changes to tax uncertainty liabilities would affect the income tax provision; however, corresponding changes in indemnification receivables would be recorded in pre-tax income.

Dealing With Subsequent Information

- Changes arising in valuation of assets and liabilities during the “measurement period” are reflected retrospectively back to the acquisition date.
- Changes arising after the “measurement period” are recorded in the income statement.
- The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed a year from the acquisition date.
- New information that gives rise to a measurement period adjustment should relate to events or circumstances existing at the acquisition date.
- Distinguishing between measurement period adjustments and income statement entries is not easy. Consider:
  - Timing of information
  - Nature of information
  - Precision of item

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Practical Issues, Part II

Rick Martin and David Gaynor, Pluris Valuation Advisors

– Contingencies: A Refresher –

Topic	141	141R	Comments
Transaction Costs	Added to the cost of the business No longer included in the purchase price	Expensed as incurred	
Contingent Consideration	Recorded when determinable	Estimated at fair value on acquisition date Subsequent changes in value affect future earnings "If a contingent consideration is tied to future employment and the payments are automatically forfeited if employment ends, then the contingent consideration is considered compensation for post combination services." A87a.	Need to calculate the fair value of the contingent consideration at the transaction date and in future periods Certain contingent consideration may be compensation for post-combination services
Bargain Purchase	Pro-rata reduction of certain acquired assets	Acquired assets are stated at fair value Then a gain is recognized on the income statement	No longer adjust the value of certain acquired assets for negative goodwill
Contingent Assets and Liabilities	Not recognized at fair value in purchase accounting	Is the fair value readily determinable or not?	

– Valuing A Contingent Consideration: Issues –

- ***Is the future payment(s) employee compensation or a contingent consideration?***

- ***ASC 805-10-55-24/25 provides guidance, and the decision is based upon:***
  - ***Continuing employment***
  - ***Duration of continuing employment compared with future payout timeframe***
  - ***Level of compensation***
  - ***Incremental payments to employees***
  - ***Number of shares owned***
  - ***Linkage to valuation***
  - ***Formula for determining consideration***
  - ***Other agreements and issues***

– Valuation Of A Contingent Consideration: Example From ASC 805-10-55-34 –

- Target hired a new CEO under a 10-year contract that contains a clause in which Target pays the CEO $5.0 million if it is acquired before the contract expires.
- Target is acquired eight years later.
- CEO was still employed as of the date of acquisition and will receive payment under the pre-existing contract.

In this example, since the Target entered into the employment agreement prior to the acquisition, and the purpose of the employment agreement was to hire a CEO, there is NO evidence that the agreement was arranged to provide benefits to the acquirer. Therefore, the $5.0 million is considered a contingent consideration and is included in the purchase price.

– Valuation Of Defensive Intangible Assets –

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

- ***An example of a defensive intangible asset would be if Coca Cola acquired Pepsi and decided to not utilize the Pepsi formula. That "developed technology" is a defensive intangible asset that needs to be valued under SFAS 141R.***

- ***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 intangible assets can include not only assets that the acquiring company will never actively use, but also assets that will be used by the acquirer during a transition period with the intention of discontinuing the use of that asset after the completion of the transition period.***

- ***A market participant would place value on this asset as they would more than likely utilize the asset. Thus, the valuation of defensive assets is required under SFAS 141R.***

– 141 Vs. 141R Case Study –

Company A acquires Company B for $200 million

- Company B is a direct competitor of Company A.
- The deal is structured as a stock deal and closes on 12/31/09.
- In addition to the purchase price, Company A agrees to pay Company B up to $20 million over the next four years if certain EBITDA goals are met.
- Company B is currently involved in a trademark infringement litigation. The fair value is readily determinable.

Company B's identifiable intangible assets

- Trademark
- Customer relationships
- Technology: Company A plans on discarding this asset immediately after the acquisition, preferring to utilize its own developed technology.
- IPR&D

– 141 Vs. 141R Case Study (Cont.)

Valuation of a contingent consideration –

Earn-out valuation example:

- Company A acquires Company B and agrees to pay Company B up to $20 million in earn-out if Company B meets specific EBITDA goals by 12/31/13.

Assumptions:

- The fair value of the earn-out on the acquisition date (12/31/09) is $10 million.
- Fair value of the earn-out on 12/31/10 is $9 million
- Fair value of the earn-out on 12/31/11 is $12 million
- Fair value of the earn-out on 12/31/12 is $14 million
- Fair value of the earn-out on 12/31/13 is $15 million

– Case Study –

(Calculation of total consideration)

Account	141 Allocation	141R Allocation	Comments
Purchase Price	$ 20,000,000	$ 20,000,000	
Transaction Costs	1,000,000	-	Transaction expenses are no longer capitalized.
Earnout	-	10,000,000	Reflects the fair value from the prior example. This was not valued under 141 due to the uncertainty surrounding achieving the targeting EBITDA levels.
Total Consideration	**$ 21,000,000**	**$ 30,000,000**	

– Case Study –

(Determination of asset values)

Account	141 Allocation	141R Allocation
Working Capital	$ 2,500,000	$ 2,500,000
Fixed Assets	5,000,000	5,000,000
Trademark	1,000,000	1,000,000
Customer Relationships	1,500,000	1,500,000
Developed Technology (Defensive Asset)	??	2,000,000
IPR&D	1,750,000	1,750,000

– Case Study –

(141 vs. 141R Summary)

Account	141	141R
Purchase Price	$ 20,000,000	$ 20,000,000
Transaction Costs	1,000,000	-
Earnout	-	10,000,000
Total Consideration	**$ 21,000,000**	**$ 30,000,000**
Working Capital	$ 2,500,000	$ 2,500,000
Fixed Assets	5,000,000	5,000,000
Trademark	1,000,000	1,000,000
Customer Relationships	1,500,000	1,500,000
Developed Technology (Defensive Asset)	-	2,000,000
IPR&D	1,750,000	1,750,000
Contingent Litigation Liability	-	(2,500,000)
Goodwill	**$ 9,250,000**	**$ 18,750,000**

– Post-Transaction –

(Earn-out valuation impact)

FV of Earnout	Balance Sheet	Activity
$10 million	$10 million in additional liability Increase in acquisition price by $10 million	$10 million liability
$9 million	N/A	$1 million of income
$12 million	N/A	$3 million of expense
$14 million	N/A	$2 million of expense
$15 million (the value of the settlement of the earnout)	N/A	$1 million of expense $15 million cash payment