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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

The conference begins at:

1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

You can access the audio portion of the conference on the telephone or by using your computer's speakers.
Please refer to the dial in/ log in instructions emailed to registrations.

CHERRY BEKAERT& HOLLAND
CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS

Valuable Ideas for Growing Private Businesses — *Summer 2009*

FAS 141R Brings New Accounting Rules for Business Combinations

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In December 2007, the Financial Accounting Standards Board (FASB) issued Statement No. 141R (FAS 141R), *Business Combinations*, which introduced many changes to the way that purchasers must account for business combinations that close on or after January 1, 2009. The changes brought on by FAS 141R are both significant and, in some cases, controversial.

Given the effects of the current economic downturn, there have been very few acquisitions closed during the first half of 2009. However, recent indicators show that the M&A market is picking up and, as the market improves, more business combinations are likely to occur and this guidance will receive renewed attention. Consequently, the implications of completing a transaction under FAS 141R should be factored into any decision to pursue a deal as it can significantly impact the metrics used historically for contingent payments and covenants.

A Broad, Principles-Based Standard
FAS 141R expands the definition of what constitutes a business and impacts the accounting for business combinations of substantially all commercial enterprises, mutual entities (such as credit unions), and, in certain cases, transactions where no financial consideration is transferred. The reach of FAS 141R also extends to the accounting for the initial consolidation of variable interest entities.

FAS 141R requires the acquirer to use a "fair value" approach in measuring the acquired assets and assumed liabilities rather than the "cost allocation" approach of the previous purchase accounting standard. The overall model used to account for a business combination under Statement 141R results in measuring the acquired assets and assumed liabilities at fair value – regardless of the purchaser's cost of the acquisition.

The prior guidance sought to allocate the purchaser's cost, which often led to certain assets being left out of the opening balance sheet when fair value exceeded the cost of the acquisition. As a result of this revision, users will need to adopt the principles and disclosure guidance of FAS 157, *Fair Value Measurements* – another recently issued standard which the accounting profession (and virtually all market participants) has struggled to adopt.

Additionally, FAS 141R eliminated former guidance that required carryover basis when less than 100 percent of an entity was acquired. Under FAS 141R, all assets and liabilities of the entity will be recorded at 100 percent of their fair value regardless of any noncontrolling interests, which were previously reported at historical basis in prior purchase accounting guidance. Noncontrolling interests now need to be reported under the guidance of FAS 160, *Noncontrolling Interests in Consolidated Financial Statements* (issued simultaneously with FAS 141R).

As you can see, there is a lot of new accounting guidance to be considered for 2009 acquisitions. Moreover, few accounting professionals have experience in this area due to the absence of significant acquisition activity during the year.

Summary of Key Changes
Required expensing of transaction costs. Under FAS 141R, transaction costs (i.e., legal, due diligence, accounting) relating to the acquisition must be expensed as incurred – no longer included in the purchase price of the target and capitalized, generally as a component of goodwill, in the opening balance sheet. However, costs incurred by the buyer relating to debt or equity securities issued in connection with the business combination should continue to be charged against the proceeds of such issuances in accordance with the GAAP for such transactions.

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Impaired Marketable Securities in Today's Environment

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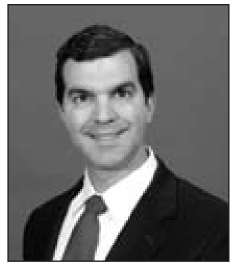
The recent economic downturn and declining investment markets have left a number of marketable securities impaired. As a result, financial reporting executives must further analyze their portfolios in order to decide how to report these losses and to defend their assertion that temporary losses will be recovered.

Reporting Investments in Securities
Companies investing in the securities of other entities are required to report their holdings based on a variety of factors. First, an entity must determine the nature of its investment by classifying it as either a debt security or an equity security.

Debt securities are characterized by a debtor/creditor relationship and generally include investments such as U.S. Treasury securities, U.S. government agency securities, municipal securities and corporate bonds. Equity securities, such as common, preferred, or other capital stock, represent an ownership interest in an enterprise, and may also represent the right to acquire or dispose of an ownership interest (e.g., warrants, rights, and call or put options).



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Once the nature of a security has been defined, an entity must further analyze its equity securities to determine if the fair value is "readily determinable." Generally, the fair value of an equity security is readily determinable if sales prices or quotations are currently available on a securities exchange such as the New York Stock Exchange, or in the case of mutual funds, the per share price is widely published. The term "marketable securities" is frequently used to refer to investments that encompass both debt securities and equity securities with readily determinable fair values.

Recording and Classification
The initial purchase of a marketable security is recorded at cost. At acquisition, companies classify their marketable securities into three groupings, based on their type (debt vs. equity) and on management's intent to hold the security. The three groupings are defined as follows:

- *Held to maturity* – securities purchased with the positive intent and ability to hold to maturity. This category only applies to debt securities since equity securities, by definition, do not have maturity dates.
- *Trading* – securities bought and held principally to be sold in the near-term. Trading securities are held usually by financial institutions and similar entities, and typically have a holding period measured in hours and days rather than months or years.
- *Available for sale* – securities that do not meet the criterion to be classified as held to maturity or trading.

As a practical matter, the investing activities of most small and midsized businesses are incidental to their operations. As such, the majority of operating companies classify their marketable

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Accounting for contingent considerations. FAS 141R includes the fair value of earn-outs and other forms of contingent consideration transferred for the target at the acquisition date. Determination of the fair value of such amounts will be based largely on assumptions of future performance and will require significant management judgment at the time of the acquisition. Imputed interest will be recorded in the income statement until payment is actually made. Any changes in the obligation based on actual experience will also be adjusted through the income statement (and not as an adjustment to goodwill) as they become known.

Accounting for expected restructuring costs. FAS 141R eliminates the ability to recognize a liability in purchase accounting for restructuring costs which are expected to be incurred in the future (i.e., obligations that do not represent a recordable liability as defined under GAAP). Under FAS 141R, restructuring activities that take place after closing will require expensing in the respective period's income statement.

Accounting for in-process research and development. FAS 141R requires the fair value of in-process research and development (R&D) to be capitalized as an indefinite-lived intangible asset until completion or abandonment of the project. Additionally, upon completion of the project, the R&D is amortized over the useful life or expensed if the project has been abandoned. Previously, in-process R&D would have been included in the purchase price allocation and immediately expensed at the acquisition date.

Accounting for bargain purchases. If applying FAS 141R results in negative goodwill, the buyer is required to perform a "careful review" of the factors that resulted in the negative goodwill. If, after this review, negative goodwill still exists (i.e., the purchase price is less than the fair value of the net acquired assets), the buyer recognizes a gain. Previously, an acquirer would have first used negative goodwill to reduce the carrying amount of certain acquired non-current assets before recording a gain.

Accounting for income tax expense. At times, a buyer will find that it no longer requires a valuation allowance on its deferred tax assets as a result of expected contributions from the acquired entity. If a buyer concludes that some or all of its existing valuation allowance is no longer required, the benefit associated with reducing or eliminating the valuation allowance will be recognized in income tax expense.

Conclusion
Although FAS 141R has been in effect since the beginning of the year, its effect has not been widely seen because of the recent decline of mergers and acquisitions. Nevertheless, we anticipate an increase in business combinations in the upcoming months and have seen situations where lending arrangements did not consider the impact of this change in accounting (which could cause significant covenant default problems in the future). Accounting professionals need to be aware of its implications as they consider financial terms of potential transactions and begin to record purchase accounting events in their financial statements. ■