FAS 141R And 160 Teleconference

March 12, 2008

Mike Maffei
BDO Seidman
mmaffei@bdo.com

Tom Selling
CPA
tomselling@grovesite.com

John Formica
PricewaterhouseCoopers
john.r.formica@us.pwc.com

Program

Review Of FAS 141R: Slides 3 through 17

FAS 141R Illustrations: Slides 18 through 23

Review Of FAS 160: Slides 24 through 41

FAS 160 Illustrations: Slides 42 and 43

FAS 141R Background: How We Got Here

Phase 1

- Resulted in issuance of FAS 141, *Business Combinations,* and FAS 142, *Goodwill and Other Intangible Assets* in 2001
  - Eliminated pooling-of-interests method and goodwill amortization
  - Did NOT reconsider most of APB 16 purchase method guidance

Phase 2

- Joint project with the IASB to achieve convergence
- Goal to improve purchase accounting guidance
  - Transparency of financial statements
  - Consistency with conceptual framework
- Overall movement toward fair value accounting

FAS 141R Status: Where We Are

FASB standards issued December 2007

- FASB Statement No. 141(R), *Business Combinations* (FAS 141R)
- FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51* (FAS 160)

- Effective for annual periods beginning after Dec. 15, 2008 (Jan. 1, 2009 for calendar year-end companies); early adoption prohibited

IASB Standards issued January 2008

- IFRS 3R, *Business Combinations*
- IAS 27R, *Consolidated and Separate Financial Statements* (IAS 27R)

- Effective for annual periods beginning after July 1, 2009 (Jan. 1, 2010 for calendar year-end companies); early adoption allowed

FAS 141R: Acquisition Method

- Replaces term *"purchase accounting method"*
- Focus on fair value of acquiree, not on the cost of the portion purchased
  - Fair value of parent's portion
  - Fair value of non-controlling interest
- Full fair values of assets/liabilities/non-controlling interests reported for acquisitions of less than 100%
  - Limited exceptions to fair value guidance
    - Deferred tax assets and liabilities (FAS 109, FIN 48)
    - Employee benefits (FAS 87, FAS 106)
    - Share-based payments (FAS 123R)
    - Operating leases (FAS 13)
    - Assets held for sale (FAS 144)
    - Indemnification assets → NEW
    - Reacquired Rights → NEW

FAS 141R: Key Provisions and Implications

Key Provision	Before 141R	After 141R	Implication
Change in definition of a business	A self-sustaining integrated set of activities and assets to provide a return to investors. Business must have inputs, processes and outputs (EITF 98-3)	*Business* must be *capable* of being conducted and managed to provide a return to investors (e.g., dividends, lower cost, increased share price or other economic benefits)	More transactions or events will qualify as business combinations and will be accounted for at fair value
Change in definition of a business combination	A business combination is a transaction in which the acquirer obtains control of a business through the purchase of equity interests or net assets	A business combination is a transaction or *other event* in which the acquirer obtains control of one or more businesses	More transactions or events will qualify as business combinations and will be accounted for at fair value

FAS 141R: Key Provisions and Implications

Key Provision	Before 141R	After 141R	Implication
Record acquisitions of a business at fair value	Cost accumulation model	Record all assets acquired and liabilities assumed at fair value, with limited exceptions	Underlying assets and liabilities to be recorded at fair value at the date control is obtained (acquisition date). Significant impact on accounting for step and partial business combinations
Definition of fair value	Various definitions (SFAS Nos. 141, 142, 144, etc); both entry and exit prices	Fair value is an exit price between knowledgeable, unrelated parties. Fair value determined in accordance with the assets highest and best use by other market participants, regardless of whether acquirer intends to use the acquired asset	Fair value of assets and liabilities is based on market participant assumptions as opposed to company specific assumptions (SFAS No. 157, *Fair Value Measurement*), which may present new valuation challenges

FAS 141R: Key Provisions and Implications

Key Provision	Before 141R	After 141R	Implication
Measurement date changed to acquisition date	Announcement date generally used to value equity securities	Fair value of the purchase price, including the issuance of equity securities, will generally be on the acquisition date	Simplifies accounting because equity securities will no longer be measured at the announcement date. However, may introduce volatility/uncertainty in estimating the final purchase price due to market price changes between the announcement date and the acquisition date
Acquisition costs expensed	Capitalize external acquisitions costs – historical cost concept	Recognize separately from a business combination and generally expensed as incurred	Will lead to lower income in pre-combination period and may require disclosure prior to transaction announcement date. Expensing of acquisition costs will result in less goodwill.

FAS 141R: Key Provisions and Implications

Key Provision	Before 141R	After 141R	Implication
Research and development activities in process at the acquisition date	The fair value of research and development activities in process at the acquisition date is immediately expensed if no alternative future use	IPR&D intangible assets initially recognized and measured at fair value and subsequently treated as indefinite-lived assets subject to amortization upon completion or impairment if the asset is subsequently impaired or abandoned	IPR&D charges will affect future earnings when the IPR&D asset is amortized or impaired in subsequent periods rather than expensed at the acquisition date. Assessing IPR&D intangible assets for impairment will prove challenging as projects evolve over time
Restructuring costs expensed	Record restructuring costs of the acquired business as part of the purchase price	Restructuring costs generally will be expensed in periods subsequent to the acquisition date	The expensing of restructuring costs will result in increased charges to earnings, likely over several reporting periods, as the new business is integrated, and less goodwill

FAS 141R: Key Provisions and Implications

Key Provision	Before 141R	After 141R	Implication
Transactions involving earn-outs or other forms of contingent consideration	Generally record when issued/settled	Record at fair value on acquisition date; subsequently adjust to fair value through earnings unless equity contingent consideration	Measuring contingent consideration at fair value may require complex valuation techniques. Contingent consideration arrangements that qualify as liabilities will result in fair value adjustments in subsequent periods, which will directly affect earnings, rather than additional purchase price
Measurement period adjustments	Allocation period not to exceed one year, with changes in acquisition accounting prospectively	Measurement period not to exceed one year, with changes in acquisition accounting resulting in the revision of prior period financial statements presented in prospective filings	Greater need to focus on acquisition accounting (e.g., valuation of intangibles) during due diligence

FAS 141R: Key Provisions and Implications

Key Provision	Before 141R	After 141R	Implication
Income taxes	Recognition of tax benefits would reduce: (i) goodwill (ii) non-current intangible assets and lastly (iii) income tax expense	Measurement period changes related to tax benefits would first reduce goodwill and then income tax expense. Change in deferred-tax asset valuation allowances and acquired income tax uncertainties after the measurement period will affect income tax expense	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. Applies to business combinations consummated prior to the effective date.
Full Goodwill/Fair Value of minority interest recorded in partial business combinations	Record acquired interest at cost; record minority interest based on carryover basis; recognize goodwill only for acquired interests	Record both controlling interest and noncontrolling interest (NCI) at fair value and recognize the entire goodwill of the acquired business; record holding gains/losses on previously held equity interest when control is achieved (i.e. step acquisitions)	Full fair value recognized rather than layers of different values; fair value of non-controlling interests could affect operating metrics (e.g. increase in amortization and depreciation charges and debt covenant measurements)

FAS 141R Issues: Contingent Assets and Liabilities

- Contingencies arising from contractual rights/obligations should be recognized at fair value (both assets and liabilities)
- Non-contractual contingencies should be recognized if it is *more likely than not* that the item meets the definition of an asset or liability
  - Recognize at fair value
  - If *more likely than not* threshold not met at acquisition date, subsequent accounting will follow other GAAP, including FAS 5

FAS 141R Issues: Contingent Assets and Liabilities

- Subsequent measurement
  - Until new information becomes available, carry at acquisition date fair value
  - When new information becomes available
    - Liabilities: Measure at higher of acquisition date fair value or FAS 5 amount
    - Assets: Measure at lesser of acquisition date fair value or best estimate of future settlement amount
- Fair value measurements might require complex valuation techniques

FAS 141R Issues: Contingent Consideration

- All consideration is measured and recognized at fair value at the acquisition date, including contingent consideration
  - Part of consideration exchanged
  - Subsequent changes in fair value do NOT affect business combination accounting
  - Subsequent re-measurement of contingent consideration
    - Not re-measured if classified as equity
    - Re-measured to fair value, with changes in income, if classified as liability
      - Change in OCI if contingent consideration is a hedging instrument per FAS 133

FAS 141R Issues: Contingent Consideration

- Measurement period guidance clarified
- Entity must distinguish between two situations
  - New/better information about facts and circumstances that *existed at* the acquisition
  - *Changes in circumstances* that occurred *after* the acquisition date
  - Former affects purchase price, business combination accounting (generally goodwill); latter is recognized in earnings during the period of the change

FAS 141R Issues: Bargain Purchases

- In bargain purchases, non-current assets are recorded at fair value
  - No pro-rata reduction of allocated purchase price (negative goodwill)
  - Goodwill would not be recorded
  - Will result in larger extraordinary gain

FAS 141R Recap: Key Considerations

- Expanded scope
- Timing will be critical
- Expanded use of fair value may increase costs of compliance (time and $$)
- Effect of new rules on earnings
- Subsequent re-measurement and monitoring requirements

FAS 141R Numerical Illustration: Facts

- Acquisition price of subsidiary: $1,000
- Portion acquired: 70%
- Fair value of subsidiary: $1,405
  - Note that $1,350 < $1,000/70% = $1,429
  - Difference of $79 is ‘control premium’
- Fair value of identifiable assets acquired: $900
  - Valuation difference due to assets with remaining life of 10 years
- Fair value of liabilities assumed: $300

FAS 141R Numerical Illustration: Acquisition Date

	Parent	Sub	Consolidated Purchase Method	Consolidated Acquisition Method
Investment in Sub	$1,000			
Other assets	2,000	800	2,870	2,900
Goodwill			580	805
Total assets	$3,000	$ 800	$ 3,450	$ 3,705
Liabilities	$ 500	$ 300	$ 800	$ 800
Minority interest in SubCo			150	
Shareholders' Equity				
Non-controlling interest in SubCo				405
Retained earnings and paid-in cap.	2,500	500	2,500	2,500
Total liab. & shareholders' eq.	$3,000	$ 800	$ 3,450	$ 3,705

Goodwill Calculations		
Acquisition price	$ 1,000	$ 1,000
Non-controlling interest		405
Portion of SubCo's book value attributed to ParentCo	(350)	
Increment to book value of SubCo's net assets	(70)	
Fair value of assets acquired		(900)
Fair value of liabilities assumed		300
	$ 580	$ 805

FAS 141R Points-Of-Acquisition Date Illustration 1

- Identifiable assets acquired and liabilities assumed
  - Full fair value, instead of old hybrid approach
    - Old: 2,870 = 2,000 + 800 + .7(900 – 800)
    - New: 2,900 = 2,000 + 900
- Goodwill is still a residual
  - Generally greater, because it includes goodwill attributable to NCI
  - NCI portion not displayed separately, but need to know it when testing goodwill for impairment
- Minority interest vs. NCI
  - Differences in classification and measurement
  - Measurement is 30% of FV of subsidiary *without* control premium

FAS 141R Points-Of-Acquisition Date Illustration 2

- Measurement of control premium and NCI:
  - Let X = Control premium
  - X = $1,000 - .7($1,405 – X)
  - X = $55
  - NCI = .3($1,405 - $55) = $405

FAS 141R Numerical Illustration: End Of 1st Period

			Consolidated	
	Parent	Sub	Purchase Method	Acquisition Method
Investment in Sub	$1,000			
Other assets	2,410	1,005	3,478	3,562
Goodwill			580	805
Total assets	$3,410	$1,005	$ 4,058	$ 4,367
Liabilities	$ 510	$ 305	$ 815	$ 815
Minority interest in SubCo			210	
Shareholders' Equity				
Non-controlling interest in SubCo				462
Retained earnings and paid-in cap.	2,900	700	3,033	3,090
Total liab. & shareholders' eq.	$3,410	$1,005	$ 4,058	$ 4,367
Revenues	$1,000	$ 500	$ 1,500	$ 1,500
Additional depreciation			(7)	(10)
Other expenses	(600)	(300)	(900)	(900)
Minority interest in earnings of sub			(60)	
Net income	$ 400	$ 200	$ 533	$ 590
Earnings attributable to NCI				(57)
Earnings attributable to Parent				$ 533

FAS 141R: Points Of End-Of-Year Illustration

- Additional step on income statement
  - New bottom line?
- Depreciation is higher, because of full fair value
- Net income attributed to NCI and owners' equity

FAS 160: Partial And Step Acquisitions

- Full fair value recognition including full goodwill of the acquiree
  - Recognize all (100%) net assets at fair value
  - Record both controlling and non-controlling interests at fair value and recognize full goodwill (exception for IFRS)
  - Eliminates previous accounting practice of recording
    - Acquired interest at fair value
    - Minority interest at carryover basis
    - Goodwill only for controlling interest
  - Re-measure any previously held equity interest in the acquiree to fair value
    - Recognize any unrealized gains or losses on previously held equity interests in earnings (i.e. the difference between fair value and book value)

FAS 160: Partial And Step Acquisitions

Impacts

- Companies will recognize more goodwill
- Increases the magnitude of impairment charges in future periods (e.g. impairment of goodwill, long-lived assets, etc.)
- Creates significant valuation and measurement issues (e.g. control premium, goodwill impairment, etc.)

FAS 160: Non-Controlling Interests

- Non-controlling interest (NCI) generally classified as equity
  - Economic entity model adopted for partial business combinations
    - Financial statements present equity ownership based on the economic/consolidated entity vs. parent company
    - Non-controlling interest is no longer considered “mezzanine”
  - Non-controlling interest is recorded at fair value on the acquisition date and classified as equity
    - Gains/losses on previously held equity interest in the acquiree are recorded in the income statement after <u>control is achieved</u> in step acquisitions

FAS 160: Non-Controlling Interests

- Non-controlling interest as equity (cont.)
  - Subsequent transactions with non-controlling interest are reflected as equity transactions if there is <u>no change in control</u>
  - Gains/losses on the retained equity ownership and realized gains/losses on equity ownership sold are recorded when <u>control is lost</u> in a partial disposition

FAS 160: Non-Controlling Interests

Impacts

- Significant departure from the historical cost model
- Gains/losses from transactions with non-controlling interest are eliminated, unless control is lost
- Excess of the consideration transferred for an additional interest in a consolidated subsidiary over the book value will be treated as a distribution/dividend (a deduction from paid-in-capital)
- Consolidated equity will generally be increased by classification of non-controlling interest as equity, and balance sheet ratios will also be affected
- Financial statements will no longer reflect transactions based on the historical capital investment

FAS 160: Control is Achieved

Transactions	Previous	New
Acquire 30%	Equity method investment at cost	Equity method investment at cost
Acquire additional 50% (now 80%)	Fair value additional 50% and consolidate minority interest of 20%, recorded at carryover basis	Fair value 100% of all assets and liabilities (including NCI) and consolidate; record gain/loss on original 30%

- Step acquisition to obtain control will now result in the recognition of a gain or loss on previously held investment

FAS 160: No Change in Control – Acquisition

Transactions	Previous	New
Acquire 80%	Fair Value 80%; Carryover basis 20%	Fair value 100% of all assets and liabilities (including NCI)
Acquire additional 10% (now 90%)	FV additional 10%, step acquisition	Equity transaction

- Acquisition of an additional interest in a partially owned subsidiary will be treated as an equity transaction
- Impact: Could result in a large change in APIC, based on the difference between fair value and book value of NCI

FAS 160: No Change in Control – Disposal

Transactions	Previous	New
Acquire 80%	Fair Value 80%; Carryover basis 20%	Fair value 100% of all assets and liabilities (including NCI)
Dispose of 20%	Record gain or loss on disposition	Equity transaction

- Partial disposal of interest in partially owned subsidiary will be treated as an equity transaction
- No gain or loss will be recorded on disposition

FAS 160: Control is Lost

Transactions	Previous	New
Acquire 80%	Fair value 80%; Carryover basis 20%	Fair value 100% of all assets and liabilities (including NCI)
Dispose of 60% (now 20%)	Record gain/loss on shares sold	Record gain/loss on shares sold and gain/loss to revalue the remaining interest (i.e., the 20%) to fair value

- Partial disposal where control is lost will now result in:
  - Realized gains/losses on the interest sold
  - Adjustment of interest retained to fair value and recognition of a gain or loss

FAS 160: Non-Controlling Interests – Supplemental Schedule

Parent Co.

Notes to Consolidated Financial Statements

Net Income Attributable to Common Shareholders of Parent Co. and Transfers (to) from Noncontrolling Interests in Subsidiary A

Year Ended December 31, 20X3

The purpose of this schedule is to disclose the effects of transactions with noncontrolling shareholders on the equity available to the common shareholders of Parent Co.

	20X3	20X2	20X1
Net income attributable to Parent Co.	$ 30,000	$ 25,000	$ 30,000
Transfers (to) from the noncontrolling interests in Subsidiary A			
Premium received from sale of Subsidiary A stock	-	10,000	-
Premium paid to purchase Subsidiary A stock	(8,000)	-	-
Net transfers (to) from noncontrolling interest in Subsidiary A	(8,000)	10,000	-
Change from net income attributable to Parent Co. and transfers to noncontrolling interests in Subsidiary A	$ 22,000	$ 35,000	$ 30,000

This schedule is required to be presented in the notes to the consolidated financial statements.

FAS 160: Non-Controlling Interests

Accumulated other comprehensive income (AOCI) adjustments in a change in

ownership

- The carrying value of AOCI is adjusted to reflect change in ownership interest through an adjustment to APIC attributable to controlling interest
- Example:
  - Parent owns 80% equity interest in subsidiary
  - Subsidiary equity balance is $250,000, including $30,000 in AOCI
  - Parent purchases additional 10% of subsidiary equity for $35,000 cash
  - NCI decrease is $25,000 (10% of carrying value of NCI of $250,000)

FAS 160: Non-Controlling Interests

The following entries would be made:

Dr. NCI	$22,000	
Dr. APIC		$13,000
Cr. Cash		$35,000

To reflect the parent's acquisition of 10% of subsidiary's equity

Dr. NCI	$3,000
Cr. AOCI	$3,000

To reflect the allocation of AOCI based on the 10% acquisition of the subsidiary by the parent

FAS 160: Non-Controlling Interests

Losses beyond the non-controlling interest's equity in a subsidiary

– If a partially owned subsidiary generates losses that exceed the non-controlling interest's portion of the subsidiary's equity:
  - Losses will continue to be attributed to the non-controlling interests (even if the non-controlling interests are not legally required to fund losses)
  - May create a deficit balance

Impact: Will increase earnings of the controlling interest in situations where losses exceed the non-controlling interest's portion of the subsidiaries' equity

FAS 160: Change In Presentation On Income Statement

Old Presentation

Consolidated Income Statement
Sales
Costs, Expenses, Other
+/- Minority Interest
Net Income
Earnings for EPS

=

New Presentation

Consolidated Income Statement
Sales
Costs, Expenses, Other
Net Income
+/- Noncontrolling Interest
Net Income attributable to controlling interest
Earnings for EPS

FAS 160: Non-Controlling Interests

- **Disclosures for non-controlling interest include the following:**

  - Disclose separately on face of the financial statements: Net income and comprehensive income attributable to the parent and non-controlling interest
  - Disclose in the notes or on face of the financial statements:
    - Income from continuing operations
    - Discontinued operations
    - Extraordinary amounts attributable to the parent
    - Reconciliation of parent, non-controlling interests and total equity

FAS 160: Non-Controlling Interests

- Disclosures for non-controlling interest include the following:

  - Disclose the effects of transactions with non-controlling interest on controlling interest equity attributable to the parent (separate schedule)
  - Disclose gain or loss on deconsolidation of a subsidiary
  - Requires presentation of non-controlling interest in previous periods to be revised (e.g. reclassify from “mezzanine” to equity)

FAS 160: Non-Controlling Interests

New Disclosure

Consolidated Statement of Changes in Equity

			Parent Company Shareholders				
	Total	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Paid-in Capital	Noncontrolling Interest in Subsidiary A
Beginning Balance	**CU415,000**		**CU155,000**	**CU20,000**	**CU200,000**	**CU40,000**	**-**
Sale of subsidiary A stock to noncontrolling interests	**50,000**			**(4,000)**		**10,000**	**44,000**
Comprehensive Income							
Net Income	29,000	CU 29,000	25,000				4,000
Other Comprehensive Income, net of tax:							
Unrealised gains on securities	15,000	15,000		12,000			3,000
Foreign Currency Translation Adjustment	(5,000)	(5,000)		(4,000)			(1,000)
Other Comprehensive Income, net of tax:	10,000	10,000					
Comprehensive Income	**39,000**	**CU 39,000**					
Dividends declared on common stock	(10,000)		(10,000)				
Ending Balance	**CU494,000**		**CU170,000**	**CU24,000**	**CU200,000**	**CU50,000**	**CU50,000**

FAS 160: Transition Provision Considerations

- After the adoption of FAS 141R, subsequent changes to goodwill recorded under FAS 141 will continue to follow historical GAAP
  - Contingent consideration
  - Adjustments to EITF 95-3 restructuring reserves
  - Tax benefits on non-qualified share-based awards
  - Measurement period adjustments
- One exception: Adjustments to deferred tax valuation allowances and tax uncertainties are an adjustment to the income tax provision, unless they represent a measurement period adjustment
- Other transition issues to consider on the adoption of FAS 141R and FAS 160 include:
  - Acquisition-related costs related to pending acquisitions
  - Partial acquisitions and dispositions of non-controlling interests created in FAS 141 transactions

FAS 160: Review Question

– Under FAS 160, if Company A sells a 60% investment of its 100%-owned Subsidiary X and thus "loses control" of the subsidiary, how should Company A account for this transaction?

a) Gain or loss is recorded for the portion sold; retained portion of Sub X recorded at carrying value

b) Gain/loss is recorded for the portion sold; retained portion is re-measured at FV and additional G/L is recorded for the portion retained

FAS 160: Review Question Answer

- Correct answer is b
  - Under FAS 160, when control is lost (i.e., from > 50% ➢ < 50%), a gain or loss is recorded for the portion soldm *and* the retained portion is re-measured at FV and an additional G/L is recorded for the portion retained