



## IS A MERGER OR ACQUISITION IN YOUR FUTURE?

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### Consider the Impact of New Accounting Standards for Business Combinations Before You Act.

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Businesses contemplating a merger or acquisition should consider the accounting implications of the transaction prior to entering into any agreements. That's because the Financial Accounting Standards Board (FASB) recently issued Statement No. 141R, *Business Combinations*, establishing new standards for accounting for business combinations. Effective for transactions with closing dates that occur on or after December 15 (2009 for companies with a calendar year-end), Statement 141R will impact how businesses evaluate, negotiate and structure potential deals.

It is important to note that this statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. However, it does not apply to combinations between nonprofit organizations or the acquisition of a for-profit business by a nonprofit organization.

The good news – for companies that are considering converting to international standards – is that the new FASB regulations were created in a joint effort with the International Accounting Standards Board to bring about the establishment of a uniform set of accounting principles internationally. The FASB's stated objective

was to create greater consistency in the accounting for business combinations and to provide more complete, comparable and relevant information for the readers of financial statements. This is part of the FASB's continuing objective to provide more principles-based accounting guidance, rather than establishing a set of rules that can be picked apart in order to find loopholes.

The new FASB statement contains a number of changes to existing accounting standards. One key change is the use of full fair value accounting as the standard rather than the current cost allocation model when measuring assets acquired and liabilities assumed. As a result, 100 percent of the target company's assets and liabilities, including goodwill, will need to be recognized by the acquiring company at their full fair value (with very few exceptions specified in the standard), even when that fair value exceeds the acquisition price.

The treatment of acquisition costs will also change. For example, transaction costs and restructuring charges no longer can be included as components of the purchase price since they cannot be considered part of the acquired entity's fair value. Rather, they will now be generally expensed as incurred or treated as debt issue costs or equity issuance costs, as applicable.

### Key Provisions

The new standards expand the definitions of businesses and business combinations, requiring more entities to be classified as businesses and more transactions to qualify as business combinations regardless of whether control or interest has been transferred.

Another change is that acquiring companies will need to record all assets and liabilities at their respective fair values on the acquisition's closing date (the date on which the acquirer legally transfers consideration and assumes the assets and liabilities of the acquiree). The closing date is significant in that it is used to measure the fair value of the consideration paid.

Probably the most controversial portion of the standard is that when the acquired loans are reported at fair value, the existing allowance for the loan and lease losses (ALLL) disappears. Fair value becomes the new basis for those loans (the loans are not fair valued in subsequent periods), with no ALLL. Additional ALLL for those loans is not permitted unless losses are incurred subsequent to the acquisition date.

The systems that are needed to track those loans and the related interest income, which will be based on effective yield rather than contractual interest, may result in systems challenges for the acquirer. It may also result in systems challenges for the acquired entity if the acquired entity's systems are used for any length of time subsequent to the acquisition.

The valuation of certain assets and liabilities are departures from current practice. Issues such as pending litigation, long-lived assets, in-process research and development, and tax benefits will all be handled differently under the new rules. As a result, the determination of fair value may, in practice, require an independent valuation. The presumption that purchase price equals fair value is no longer valid.

The purchase price is the consideration paid, which may include cash and other assets, equity interest and contingent consideration, all of which must be measured at fair value as of the acquisition date. The accounting requirements for contingent consideration are a departure from current GAAP. Under FAS 141R, contingent consideration must now be classified as equity or a liability. Earn-out arrangements and other contractual contingencies are included under this requirement, which means subsequent changes in fair

value for certain liability-classified contingencies must be recognized in earnings thereafter until settled.

FASB 141R also requires additional disclosures to provide details regarding how the business combination affects the acquirer's financial statements and impact on future cash flows.

### **Implications**

The full ramifications of these changes will most likely present a significant challenge to the acquiring company given the difficulty in predicting any additional related expenses that may arise. The companies that enter into business combinations may need to place further reliance on third parties to determine fair values (as well as satisfy their auditors that the amounts recorded are fairly stated) and for assistance with system changes, which could lead to increased acquisition costs.

Overall, Statement 141R enacts a number of profound changes to the accounting standards that govern business combinations. It is important to evaluate any potential impact the new requirements may have on deals under consideration that may not be finalized before the end of the year. Management should prepare by working with their company's external auditors and accounting advisors to gauge the impact of these new standards.

### **About the Author**

James Weber is a Principal at S.R. Snodgrass, A.C., where his areas of expertise include external auditing and assurance services for financial institutions and other industries. Snodgrass is best known for our expertise in the financial services industry, where we currently serve over 175 financial institutions on a national scale. Accordingly, we have extensive industry business experience and sound working relationships with all of the regulatory agencies. Examples of that experience are displayed on our Web site's *Knowledge Bank* at [www.srsnodgrass.com](http://www.srsnodgrass.com), where you can view several articles and video presentations on banking-related topics, including webcasts on SOX 404 and Fair Value Measurements Under Statement of FAS 157

## Significant Changes of FAS 141R

Issue	Current GAAP	FAS 141R
Costs associated with acquisitions	Costs are deferred by adding them to purchase price.	Costs are charged to expense.
Purchase price is less than value of assets	Excess value considered negative goodwill. Carrying value reduced until total equals purchase price.	Acquired assets reported at fair value. Excess over purchase price recorded as a gain net of taxes.
Contingencies based on future events that may require buyer to pay additional or seller to refund some amount	Most contingent provisions ignored in purchase price. When payments are made, amounts are added to goodwill. Payments tied to stock price changes are credited as paid-in capital. Refunds result in reduced goodwill or paid-in capital.	Acquirer must record estimated fair value of contingent agreements as assets or liabilities.
Potential cash flows associated with in-process research and development	Buyers assign values to in-process R&D assets for recording the acquisition, but then immediately write them off.	In-process R&D is classified as intangible assets with indefinite lives until R&D phase is complete or abandoned. Recorded assets not written off or amortized--subject to impairment tests.
Other contingencies	Consolidated entity's statements recognize only loss contingencies deemed probable and reasonably estimable at acquisition date. Gain contingencies are not considered.	Acquirers must record all contractual contingent assets and liabilities at estimated fair value. Other contingencies are to be recorded at fair value if it is more likely than not that an asset or liability exists.
An acquirer gains control through smaller, non-controlling purchases	Total consideration paid is built up in layers. Once control is achieved, each layer's book value determines total consideration, even if sum isn't close to the aggregate fair value at the acquisition date.	Acquirer marks each incremental investment to fair value as of the acquisition date (the date the acquirer gains control). Gains and losses from the revaluation of those holdings included in current earnings.
Excess paid over the net asset value	Amount of consideration paid in excess of the aggregate fair value of the acquired assets and liabilities recorded as goodwill. No goodwill is attributed to non-controlling interests.	Acquirers must value assets and liabilities previously not considered, including research and development and contingencies, thus improving value of goodwill.
Changes to fair value of assets and liabilities acquired sub-sequent to acquisition date	Values assigned may be adjusted for up to a year following acquisition. Does not address whether adjustments should be reported in the current period or as restatement of equity.	Comparative financial statements are to be restated for any adjustments to fair value as of the acquisition date.

Source: Journal of Accountancy June 2008, "A New Day for Business Combinations. Paul B.W. Miller, Paul R. Bahnson, and Brian P. McAllister