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Revised M&A Accounting Rules Now in Effect: New Standards May Affect Structure, Timing, and Other Considerations

January 2009

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FASB's revised accounting standards for M&A deals, known as Statement of Financial Accounting Standards No. 141R, *Business Combinations* (FAS 141R), became effective on December 15. Companies reporting pursuant to GAAP must follow the revised standards for M&A deals closing after the start of their first annual reporting period after that date (for companies whose fiscal year is the calendar year, that means the revised standards will apply to deals closing on or after January 1, 2009).

The revised standards are intended to move U.S. M&A accounting towards the international standards concept of "fair value" reporting. In addition to their effect on closing period statements, the standards are likely to result in greater post-closing volatility in reported earnings for some deal structures. FASB recently decided, however, to reconsider one of the more controversial aspects of the revised standards that otherwise could require more detailed reporting of contingent liabilities (such as lawsuits) of a target company. The rule change will likely have the greatest impact on publicly traded companies, given the requirements of their SEC reports. However, it also will affect private companies that have loan covenants or other obligations tied to GAAP, or that may become targets of companies subject to FAS 141R.

This client alert provides a brief description of some of the key changes under FAS 141R. The full FASB release is available at www.fasb.org, along with proposed FAS 141R-a, which describes the potential changes with respect to contingent liabilities.

Key Changes

Most notably, FAS 141R requires acquirors to:

- use fair value when recording a target's assets and liabilities;
- determine the fair value of the consideration paid (such as the acquiror's stock) as of the acquisition date, rather than as of the signing date;
- record earnouts and other forms of contingent consideration at their fair value as of the acquisition date, and true up the recorded amounts to actual payments and changes in potential payments through post-closing adjustments to earnings;
- expense acquisition-related costs as they are incurred;
- expense most restructuring and exit activity costs at the time of the acquisition;
- recognize acquired in-process R&D as an indefinite-lived intangible asset; and
- accrue lawsuits and other pre-acquisition contingencies at their fair value if, at the time of the acquisition, they are "more likely than not" to occur (although the FASB is considering cutting back on this change).

Discussion

Fair Value Measurement

FAS 141R requires the acquiror to record the assets acquired and liabilities assumed at their fair values, with limited exceptions. This rule replaces the cost-allocation process, which required an allocation of the acquisition purchase price to the target's assets and liabilities. By departing from these standards, FAS 141R requires the use of new valuation techniques to determine fair value and eliminates the need for many of the assumptions relied upon during the cost-allocation process.

Measurement Date

FAS 141R requires the acquiror to determine the fair value of the assets acquired and liabilities assumed at the "acquisition date," which generally is the date that the acquiror achieves control. Because FAS 141R replaces the prior requirement to use the announcement date as the measurement date, it increases the importance of the closing date and adds uncertainty to the process of estimating the purchase price of an acquisition for accounting and reporting purposes. With these changes, acquirors may want to consider the use of accelerated closings and other arrangements that reduce the potential for fluctuations in the purchase price.

Earnouts and Other Contingent Consideration

FAS 141R requires acquirors to record earnouts and other forms of contingent consideration at their fair value on the acquisition date. If the contingencies are recorded as liabilities (for example, where the contingency is to be paid in cash or through a distribution of a variable number of shares), the acquiror also must remeasure the contingencies at each reporting date after the closing, and any changes to their fair value will be reflected in post-closing earnings. This effectively ensures some impact on post-closing earnings. The result also can be somewhat counterintuitive, since if the target does better than initially expected and a greater earnout payment may be triggered, the buyer's earnings will be decreased to reflect the additional expected earnout payment, and conversely if a target does not do as well as initially expected then any "savings" in the expected earnout payment will be reflected as increased earnings. The prior standards required companies to record earnouts and other forms of contingent consideration on the acquisition date only if their amounts were then determinable. Because earnouts are not typically structured to allow this sort of precise calculation at the closing, these contingencies were normally recorded post acquisition.

FAS 141R thus increases the costs recorded on the acquisition date and adds some complexity to accounting for both closing and post-closing periods. Acquirors should assess these impacts when considering whether to use earnouts and other forms of contingent consideration. Acquirors also may want to consider structuring earnouts that minimize the effects of some of these changes, such as using fixed share distributions to settle earnouts in order to avoid some of the earnings volatility that may result from the use of cash payments and other structures.

Acquisition-Related Costs

FAS 141R requires the acquiror to expense most transaction fees as incurred and include them on its income statement for each reporting period. Prior guidance allowed acquirors to capitalize these costs on the balance sheet and amortize them over time. This change increases the importance of the timing and scope of due diligence and other preliminary activities, including the potential of having to make accounting disclosure with respect to a transaction that the acquiror has not yet finalized or announced.

Restructuring and Exit Activity Costs

FAS 141R requires an acquiror to expense restructuring and exit activity costs as they are incurred. Prior guidance allowed the acquiror to capitalize these costs on the balance sheet. This change will result in the acquiror recording fewer liabilities on the acquisition date and incurring additional expenses during later reporting periods. Because these costs now have an impact on post-acquisition earnings, acquirors should consider the timing of these restructuring and exit activities and may want to structure deals in a way that requires the target company to incur these costs before the acquisition date.

Acquired In-Process Research and Development Costs

FAS 141R requires the acquiror to measure in-process research and development at their fair value at the time of the acquisition and capitalize them with an indefinite life. Consistent with other assets having indefinite lives, the acquiror must periodically test these costs for impairment and, upon completion or abandonment of the relevant project, either amortize these costs or write them off. This standard departs from prior accounting practices, which permitted acquirors to expense these acquired research and development costs immediately after the acquisition date. Acquirors should understand that these changes may increase post-acquisition costs by requiring a periodic valuation of the acquired in-process research and development projects.

Lawsuits and Other Pre-Acquisition Contingencies

As currently effective, FAS 141R requires acquirors to accrue lawsuits and other pre-acquisition contingencies at their fair values if, at the acquisition date, they are “more likely than not” to occur. This requirement departs from prior guidance, which generally required a company to accrue these items when their occurrence was “probable” and “reasonably estimable.” In response to concerns about potential disclosures with respect to litigation and other effects of this change, FASB recently proposed (in FAS 141R-a, issued by FASB on December 15) to require instead the accrual of these contingencies at their fair values at the acquisition date if, at that time, the fair values are reasonably determinable. FASB also recognized that the liability arising from a legal dispute may not be so determinable, particularly in the early stages of the dispute. Although FASB will not finalize this proposed rule until after expiration of the comment period on January 15, 2009, this change (if adopted) will have the same effective date as FAS 141R.

Conclusion

While decisions to pursue transactions should continue to be driven by underlying economics, rather than by accounting standards, companies should understand the impact of the new accounting standards when structuring and effecting M&A transactions. Companies should structure their transactions where possible to achieve the most effective accounting treatment.

Please contact your Morrison & Foerster LLP attorneys if you have any questions as to the matters discussed in this client alert.