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FAS141R:

Acquiring minds want to know

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In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141 (revised), Business Combinations, or FAS 141R.

So what impact will this highly anticipated pronouncement have on the acquiring company's financial statements? The following executive summary, written by RoseRyan senior consultant Maureen Earley, provides answers.

FAS141R executive summary

FAS 141R reaffirms many of the provisions of the old FAS 141, including that the only allowable method of accounting for a business combination is the acquisition method, formerly known as the purchase method. However, changes in four major areas are contained in FAS 141R. Because of these changes, FAS 141R is likely to have an impact on the acquiring company's income statement, both in the period of the acquisition and in future periods, as discussed below:

Transaction costs: expense as incurred

Virtually every business combination incurs transaction costs to some degree. Transaction costs include such things as investment bankers fees, regulatory agency fees, SEC registration fees, legal and accounting fees and similar costs directly related to completing the acquisition. Under the old rules, transaction costs were considered part of the purchase price and, in most cases, increased the amount of goodwill attributed to the acquired company. No more! FAS 141R requires that transaction costs must be expensed as incurred. In a large transaction, this may have a significant impact on the acquiring company's bottom line as these costs can easily run into the millions or tens of millions of dollars. In addition, because some transaction costs are necessarily incurred prior to the closing of the acquisition, some of these expenses will likely be reflected in the income statement before any potential benefit from the acquisition is realized.

Restructuring: costs included in income statements after acquisitions

In conjunction with the consummation of a business combination, the acquired company may be subject to restructuring. This may include workforce reductions for redundant personnel and vacating duplicate facilities. Prior to FAS 141R, the estimated cost of the restructuring was included as a liability in the purchase price allocation and therefore, served to increase goodwill.

Under FAS 141R, this treatment is no longer allowed. Instead, all restructuring activities will be subject to the requirements of Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities (FAS 146) FAS 146 does not allow restructuring amounts to be recorded until the liability has been incurred, which, in the case of an acquisition-related restructuring, is not until after the acquisition is completed, and individual employees have been notified or the facility has actually been vacated. This will result in business combination restructuring charges being recorded subsequent to the acquisition and reflected in the income statement.

In-process research and development: heads-up for biotech and high tech

IPR&D arises when the acquired company has projects under development that have not yet reached technological feasibility. The acquisition of a high-tech company frequently results in the allocation of a significant portion of the purchase price to IPR&D. FAS 141R completely changes the accounting treatment of IPR&D. Previously, amounts allocated to IPR&D were expensed upon the close of the acquisition and immediately recognized in the income statement.

Under FAS 141R, amounts allocated to IPR&D will be capitalized as an indefinite-lived intangible asset on the balance sheet and must be evaluated periodically for impairment. When the project is completed, an expected life will be determined and the IPR&D will be amortized to expense over the expected life. IPR&D amounts that used to be expensed immediately and were largely ignored by the investment community will now impact future periods.

Contingencies: fair value factor adds complexity

Contingencies in business combinations come in two flavors—contingent consideration that the acquiring company may be required to pay and contingent liabilities that the acquired company may be subject to. Under the old rules, contingent consideration generally was not recorded until it was determined to be payable, at which point the purchase price was adjusted and goodwill was increased. Contingent liabilities, such as those related to pending litigation, tax audits or similar issues, were recorded only if they were probable and estimable. Adjustments to contingent liabilities related to taxes could be made indefinitely and were reflected in goodwill; adjustments to non-tax items were reflected in goodwill during the purchase allocation period (up to one year) and in the income statement subsequent to the purchase allocation period.

Many business combinations are consummated with no contingencies, so this area will not impact every business combination. However, accounting for contingencies under FAS 141R will be complex. FAS 141R requires that many contingencies, including contingent consideration and any contingencies related to contracts, be recorded at their fair value as of the acquisition date. How companies will determine the fair value of a contingency will be a complex and time-consuming process, and one that will likely add to the transaction costs discussed above.

If the contingency is ultimately settled for an amount that is different than what was recorded as part of the purchase price allocation, the difference will be reflected in the income statement.

Although FAS 141R will rarely affect a business decision to undertake a business combination, careful construction of a business combination may provide better accounting results and less impact to the acquiring company's bottom line.

About the author: A senior consultant with RoseRyan with more than 25 years' experience in finance and accounting, Maureen Earley provides technical accounting and SEC expertise and acts as a technical resource for the RoseRyan team. She has provided a hands-on leadership role in IPOs or follow-on offerings for many clients, including Agilent Technologies, Healtheon, VeriSign and Remedy. Earley also has significant experience in mergers and acquisitions, most recently assisting Symantec with their acquisition of Veritas. She has filled SEC reporting roles for Symantec, Hewlett-Packard, VeriSign, Adobe and Solectron and regularly advises clients on the interpretation and implementation of new accounting pronouncements as well as existing GAAP.