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Pitfalls Emerge in New Merger Accounting

By Tammy Whitehouse — November 17, 2009

Corporate America has now had nearly a full year to adjust to new rules that radically changed how mergers and acquisitions are accounted for. It's been a bumpy ride, and at least some companies have found themselves stuck in valuation sinkholes.

The rules went into effect at the start of 2009 as Financial Accounting Standard No. 141(R), *Business Combinations* (subsequently housed in the new Accounting Standards Codification as Topic 805, *Business Combinations*), and require companies to use fair-value accounting to a much greater extent when valuing deals and the net assets required. That alone set some people to worrying that merger plans might be skewed to fit favorable accounting treatments.

Then came the Great Recession of 2009. M&A activity was knocked flat; total deals done in the United States is down 23 percent this year compared to 2008, according to DealLogic, and total value is down 35 percent. Companies had few deals they could use as real-life examples to help them determine the fair value of their own transactions.

Twelve months later, "The good news is people are still buying and looking at opportunities to acquire businesses based on the economics, and not letting the accounting drive their interest in the company," says Steve Hobbs, managing director at consulting firm Protiviti.

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Mark Maxson, a principal with Deloitte Financial Advisory Services, says big companies that routinely pursue merger or acquisition opportunities have digested FAS 141(R) and its implications. Smaller companies or those that aren't continually on the prowl for a good acquisition target, however, are still getting up to speed.

It's not unusual for the accounting to become a last-minute thought as a deal is about to be announced, Maxson says. "That's where there can be some pretty frenzied surprises."

Hauser

In the past, such surprises were rare; old accounting rules generally let companies book the purchase price as the value of the deal, says Jan Hauser, a partner at PricewaterhouseCoopers. Now, companies must value each acquired asset individually, from the perspective of a hypothetical third party.

With M&A activity so scarce, however, both companies and auditors alike are relying much more on third-party valuation specialists to help them define fair values, says Wayne Pinnell, managing partner of regional auditing firm Haskell & White. But even with outside help, he adds, estimates vary. “We just dealt with a client recently that got three different appraisals on the same thing, and they were all pretty different,” he says.


Fox

Those circumstances have created a sense of delayed implementation, says Bert Fox, a partner at Grant Thornton. “Even though it’s late in the year, in some ways we’re still in the first wave of implementation of the standard,” he said.

Defining Your Terms

For starters, uncertainty has increased about what constitutes a business combination, says Jay Hanson, national director of accounting for McGladrey & Pullen. When FAS 141(R) was adopted, it established a new definition for the term “business”—and the result is a much murkier understanding of whether an acquisition is a full working business or only a smattering of assets.


Hanson

The distinction is important because the accounting for an asset differs considerably from the accounting for a business purchase. The question looms in real estate transactions, says Hanson, where folks can’t always agree on whether the purchase of a building should be considered an asset or a business.

If the building is empty, it’s clearly an asset, Hanson says. But if it’s loaded with tenants who have contracts producing cash flow and employees who manage the property, it’s more likely a business.

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Principal,
Deloitte Financial Advisory Services

The problem crops up often with oil and gas properties or biotech facilities, Hanson adds. “As you start subtracting things away from what meets the definition of a business, or adding things to what *doesn’t* meet the definition, you get lots of ‘Hmm, I’m not sure,’” he says.

Fox says there are “considerably more things that can qualify as a business under the revised standard,” and that catches many companies by surprise. If companies aren’t involving auditors with those transactions as they are occurring, he warns, that could lead to some year-end surprises—but he believes most public companies are savvy enough to bring auditors onboard early.

In-process research and development (IPRD) has also taken some convoluted turns as a result of the new standard, Hanson says. During a merger, companies must establish a fair value for IPRD, and then capitalize and amortize it over time rather than expense it all at once. That requires companies to track projects carefully and test their values for impairment at least annually.

The oddity is that the accounting differs when companies purchase IPRD outside the context of a merger. The Emerging Issues Task Force of the Financial Accounting Standards Board is considering whether some changes might be necessary to make the accounting more consistent.

That requirement to do an annual impairment test on acquired IPRD means companies must first put processes and procedures in

FSP ON FAS 141(R)

Below is an excerpt from the FASB staff position on business combinations, “Accounting for Assets

Formica

place to track the progress on those projects, and then determine their value on an ongoing basis, says John Formica, a partner with PricewaterhouseCoopers.

For technology-intensive companies with a number of projects under way, that can become a significant undertaking. “A lot of companies are working through the mechanics in the system and the administration they’ll need in order to comply with this standard,” he says.

Earnout Risk

Contingent consideration, or earnouts, are another challenge for companies. Contingent consideration is the term often associated with a merger that compels the buyer to make future payments to the seller based upon some future performance criteria. FAS 141(R) now requires companies to establish a fair value for that agreement and revisit it periodically over the life of the obligation, with changes in value flowing to earnings.

Contingent consideration is an ongoing valuation issue if it’s initially recorded as a liability, and it will have direct earnings consequences after the acquisition, Hauser says. “It’s a bit of a brave new world on how one values these arrangements.”

The paradox, Fox says, is that companies typically strike earnout agreements only when the buyer and seller can’t agree on the value of the business changing hands. “Regardless of that fact, they still have to sit down and say, ‘Here’s the value of these earnouts,’” he says.

Given the remeasurement requirement, companies also need systems and processes for tracking contingent consideration after a deal closes. “Some companies are getting up to speed pretty fast, and some of them struggle,” Fox says.

Dan Gary, a partner in the transactions and restructuring group at KPMG, says companies are also considering materiality as

Acquired and Liabilities Assumed in a Business Combination That Arise From Contingencies.”

Initial Recognition and Measurement

7. An acquirer shall recognize at fair value, at the acquisition date, an asset acquired or a liability assumed in a business combination that arises from a contingency if the acquisition-date fair value of that asset or liability can be determined during the measurement period. For example, the acquisition-date fair value of a warranty obligation often can be determined.

8. If the acquisition-date fair value of an asset acquired or a liability assumed in a business combination that arises from a contingency cannot be determined during the measurement period, an asset or a liability shall be recognized at the acquisition date if both of the following criteria are met:

- (a) Information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date. It is implicit in this condition that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur.
- (b) The amount of the asset or liability can be reasonably estimated. Criteria (a) and (b) shall be applied using the guidance in Statement 5 and in FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, for application of similar criteria in paragraph 8 of Statement 5.

9. If neither the criterion in paragraph 7 nor the criteria in paragraph 8 are met at the acquisition date using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer shall not recognize an asset or liability as of the acquisition date. In periods after the acquisition date, the acquirer shall account for an asset or a liability arising from a contingency that does not meet the recognition criteria at the acquisition date in accordance with other applicable GAAP, including Statement 5, as appropriate.

10. Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be recognized initially at fair value in accordance with the guidance for contingent consideration arrangements in Statement 141(R).

Subsequent Measurement and Accounting

11. An acquirer shall develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature.

12. Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in paragraph 65 of Statement 141(R).

Disclosures 13. An acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effects of a business combination that occurs either during the current reporting period or after the reporting period but before the financial statements are issued.

14. For each business combination that occurs during the reporting period, an acquirer shall disclose the following in the footnote that describes the business combination:

- (a) For assets and liabilities arising from contingencies recognized at the acquisition date:
  1. The amounts recognized at the acquisition date and the measurement basis applied (that is, at fair value or at an amount recognized in accordance with Statement 5 and Interpretation 14)
  2. The nature of the contingencies.

Gary

it pertains to accounts receivable acquired in a business combination. The new rules say companies can no longer establish a general loss allowance pertaining to all accounts receivable, but instead must put a fair value on each balance.

An acquirer may aggregate disclosures for assets or liabilities arising from contingencies that are similar in nature.

- (b) For contingencies that are not recognized at the acquisition date, the disclosures required by Statement 5 if the criteria for disclosures in that Statement are met.

Source

FSP FAS 141R-1 Staff Position on Contingencies (April 1, 2009).

"That's an incredibly burdensome task," he says. "There's a possibility that the effort around that is not justified." Companies that conclude that no material difference exists might decide to follow prior accounting practices using a more aggregated approach, he says.

Terri Garland, a litigation partner with Morrison & Foerster, says companies are in "the calm before the storm" of legal challenges around 2009 transactions. Lawsuits are practically a matter of routine for all transactions these days, but plaintiff lawyers are waiting for the first round of financial statements under new accounting rules before acting.

"It's often not until you have that first audit after the year in which the new standards go into practice that you then find problems," she says.

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